

CONSOLIDATED FINANCIAL STATEMENTS

Midwest Medical Insurance Holding Company and Subsidiaries
Years Ended December 31, 2003 and 2002

Midwest Medical Insurance Holding Company and Subsidiaries

Consolidated Financial Statements

Years Ended December 31, 2003 and 2002

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Report of Independent Auditors

The Board of Directors
Midwest Medical Insurance Holding Company
and Subsidiaries

We have audited the accompanying consolidated balance sheets of Midwest Medical Insurance Holding Company and Subsidiaries (the Company) as of December 31, 2003 and 2002, and the related consolidated statements of income, changes in shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Midwest Medical Insurance Holding Company and Subsidiaries at December 31, 2003 and 2002 and the consolidated results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.



February 2, 2004

Midwest Medical Insurance Holding Company and Subsidiaries

Consolidated Balance Sheets

(In Thousands, Except for Share Amounts)

	December 31	
	2003	2002
Assets		
Investments:		
Fixed maturities at fair value (amortized cost: 2003 – \$142,250; 2002 – \$143,633)	\$146,054	\$144,323
Equity securities at fair value (cost: 2003 – \$33,082; 2002 – \$27,932)	40,986	32,153
Short-term	59,402	41,025
Other at fair value (cost: 2003 – \$42,012; 2002 – \$40,297)	47,978	38,201
	294,420	255,702
Cash	2,519	1,105
Accrued investment income	1,533	1,774
Premiums receivable	11,456	9,648
Reinsurance recoverables on paid and unpaid losses	13,155	17,020
Amounts due from reinsurers	4,018	3,991
Deferred income taxes	2,547	6,873
Other assets	9,302	8,205
Total assets	\$338,950	\$304,318
Liabilities and shareholders' equity		
Liabilities:		
Unpaid losses and loss adjustment expenses	\$166,411	\$148,763
Unearned premiums	23,947	19,724
Amounts due to reinsurers	1,902	6,843
Other liabilities	21,950	17,973
Total liabilities	214,210	193,303
Shareholders' equity:		
Class B Common Stock – authorized, issued and outstanding, 1 share	1	1
Class C Common Stock – authorized, 300,000 shares; issued and outstanding, 11,027 shares in 2003 and 10,847 shares in 2002; no par value	–	–
Paid-in capital	12,789	12,789
Retained earnings	100,657	96,367
Accumulated other comprehensive income, net of tax:		
Net unrealized appreciation of investments	11,665	1,858
Minimum pension liability	(372)	–
Total shareholders' equity	124,740	111,015
Total liabilities and shareholders' equity	\$338,950	\$304,318

See accompanying notes.

Midwest Medical Insurance Holding Company and Subsidiaries

Consolidated Statements of Income

(In Thousands)

	Year Ended December 31	
	2003	2002
Revenues:		
Net premiums earned	\$ 77,854	\$70,472
Net investment income	9,657	11,404
Realized capital gains	6,275	1,358
Other	7,325	3,782
	101,111	87,016
Losses and expenses:		
Losses and loss adjustment expenses	75,176	74,819
Underwriting, acquisitions and insurance expenses	10,086	10,203
Other operating expenses	9,834	8,114
	95,096	93,136
Income (loss) before income taxes	6,015	(6,120)
Income tax expense (benefit)	1,725	(2,564)
Net income (loss)	\$ 4,290	\$ (3,556)

See accompanying notes.

Midwest Medical Insurance Holding Company and Subsidiaries

Consolidated Statements of Changes in Shareholders' Equity

(In Thousands)

	Total	Class B Common Stock	Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income
Balance at December 31, 2001	\$126,887	\$1	\$12,789	\$ 99,923	\$14,174
Comprehensive loss:					
Net loss	(3,556)	-	-	(3,556)	-
Other comprehensive loss:					
Unrealized losses on securities, net of \$5,883 in tax benefits	(11,420)	-	-	-	(11,420)
Reclassification adjustment for gains included in net income, net of \$462 in taxes	(896)	-	-	-	(896)
Total comprehensive loss	<u>(15,872)</u>				
Balance at December 31, 2002	111,015	1	12,789	96,367	1,858
Comprehensive income:					
Net income	4,290	-	-	4,290	-
Other comprehensive income:					
Unrealized gains on securities, net of \$7,186 in taxes	13,948	-	-	-	13,948
Reclassification adjustment for gains included in net income, net of \$2,134 in taxes	(4,141)	-	-	-	(4,141)
Minimum pension liability, net of \$191 in tax benefits	(372)	-	-	-	(372)
Total comprehensive income	<u>13,725</u>				
Balance at December 31, 2003	<u>\$124,740</u>	<u>\$1</u>	<u>\$12,789</u>	<u>\$100,657</u>	<u>\$11,293</u>

See accompanying notes.

Midwest Medical Insurance Holding Company and Subsidiaries

Consolidated Statements of Cash Flows

(In Thousands)

	Year Ended December 31	
	2003	2002
Operating activities		
Net income (loss)	\$ 4,290	\$ (3,556)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Decrease in accrued investment income	241	445
(Increase) decrease in premiums receivable	(1,808)	196
Decrease (increase) in reinsurance recoverables	3,865	(2,492)
Increase in amounts due from reinsurers	(27)	(2,334)
(Increase) decrease in other assets	(413)	2,641
Deferred tax provision	(535)	(2,192)
Increase in unpaid losses and loss adjustment expenses	17,648	30,189
Increase in unearned premiums	4,223	4,235
Decrease in policyholder dividends	-	(4,050)
(Decrease) increase in amounts due to reinsurers	(4,941)	68
Increase in other liabilities	4,045	2,692
Premium amortization, net of accretion of bond discount	1,875	193
Realized capital gains	(6,275)	(1,358)
Net cash provided by operating activities	22,188	24,677
Investing activities		
Purchases of fixed maturity investments and equity securities	(234,148)	(194,513)
Purchases of other investments	(2,428)	(20,297)
Sales of fixed maturity investments and equity securities	235,494	206,689
Calls and maturities of fixed maturity investments	-	1,700
Net purchases of short-term investments	(18,377)	(19,484)
Net cash used in investing activities	(19,459)	(25,905)
Financing activities		
Debt repayment	(1,930)	-
Debt proceeds	615	1,315
Net cash (used in) provided by financing activities	(1,315)	1,315
Increase in cash	1,414	87
Cash at beginning of year	1,105	1,018
Cash at end of year	\$ 2,519	\$ 1,105

See accompanying notes.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements

December 31, 2003

1. Accounting Policies

Organization and Operations

The consolidated financial statements include the accounts of Midwest Medical Insurance Holding Company (Midwest Holding) and its wholly owned subsidiaries, Midwest Medical Insurance Company (Midwest Medical), MMIC Benefits, Inc. (Benefits), Midwest Medical Solutions, Inc. (Medical Solutions) and MMIC Business Office Solutions, Inc. (Office Solutions). All transactions between Midwest Holding and its subsidiaries have been eliminated in consolidation.

Hereafter, Midwest Holding, Midwest Medical, Benefits, Medical Solutions and Office Solutions shall be collectively referred to as the Company unless the reference pertains to a specific entity.

The Company, through its subsidiary Midwest Medical and its predecessors, has been providing professional liability insurance to physicians in the Upper Midwest since October 1980. The current structure of the Company is the result of a reorganization in 1988 followed by two business combinations with other insurers. In 1993, the Company merged with Iowa Physicians Mutual Insurance Trust. In 1996, the Company merged with Medical Liability Mutual Insurance Company of Nebraska. Each combination was accounted for as a pooling-of-interests.

During 1997, the Company formed Medical Solutions to develop businesses that would strengthen and promote the independence and interdependencies of physicians, clinics and hospitals that the Company serves. Medical Solutions currently provides practice enhancement software, security consulting and technology services and support.

Benefits was incorporated in 1995 and began active operations in January 1999 with the acquisition of a book of business from Johnson-McCann Benefits, Inc. Benefits subsequently sold its group insurance book of business back to Johnson-McCann Benefits, Inc. and one other producer effective December 31, 2003 (see Note 2). Prior to the sale, Benefits was an insurance agency that specialized in providing clients with group insurance products such as health, dental, life, disability and workers' compensation. Benefits will continue to serve an intermediary role in providing clients with workers' compensation and business owners' protection insurance products.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

1. Accounting Policies (continued)

Office Solutions began operations in February 2002 to provide physicians with business office outsourcing services. The main outsourcing service is the billing and collection of patient accounts. To improve overall company administration, Office Solutions was sold to Medical Solutions effective December 31, 2003, and its operations will be merged with Medical Solutions in 2004.

Midwest Holding provides management and administrative services to Midwest Medical and Medical Solutions for a fee generally equal to the cost of services provided. Benefits and Office Solutions operate independently and do not have management agreements with Midwest Holding.

Midwest Medical provides professional liability insurance to physicians, clinics, hospitals and health care systems in Minnesota, Iowa, Nebraska, North Dakota, South Dakota, Wisconsin and Illinois. Insurance policies issued by Midwest Medical are on a “claims made” basis and provide coverage for the policyholder for claims first made against the policyholder and reported to Midwest Medical during the policy period for claims which occurred on or after the retroactive date stated in the policy.

Midwest Medical provides, upon payment of an additional premium, a reporting endorsement which extends the period in which claims otherwise covered by the “claims made” policy may be reported to Midwest Medical. In the event of death or permanent disability of a policyholder, the reporting endorsement is issued without additional premium. Upon retirement, as defined in the policy, a policyholder with at least five years of consecutive coverage with Midwest Medical is eligible for a credit toward the additional premium for the reporting endorsement.

Prior acts coverage may be purchased by policyholders who were previously insured under a “claims made” policy with another professional liability insurer for an additional premium at the option of the insured in lieu of purchasing reporting endorsement coverage from the previous insurer.

Basis of Presentation

The consolidated financial statements have been presented in conformity with accounting principles generally accepted in the United States, which differ in certain respects from statutory accounting practices followed by Midwest Medical in reporting to the Minnesota Department of Commerce (see Note 13).

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

1. Accounting Policies (continued)

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, as well as disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

Investments

The principal investment objectives of the Company's portfolio, which support the long-term underwriting operations and enhance the financial strength and stability of the Company, are, in order of emphasis, provide optimal levels of after-tax income, conserve principal, maintain the necessary level of liquidity to meet business needs, and maximize potential long-term rates of return.

Although management believes the Company has the ability to hold its fixed maturity investment portfolio to maturity, all investments, including fixed maturities, are classified as "available for sale," as management may take advantage of opportunities to increase total return through sales of selected securities in response to changing market conditions. As a result, the Company's investments are carried at fair value, with unrealized holding gains and losses reflected as a separate component of accumulated other comprehensive income, net of applicable deferred taxes.

Fair values are based on quoted market prices, where available. For fixed maturity investments not actively traded, fair values are estimated using values obtained from independent pricing services.

Short-term investments are principally money market funds, repurchase agreements and commercial paper with maturities of less than one year. Short-term investments are recorded at cost, which approximates fair value.

Other investments consist of less than 20% equity interests in nontraded real estate investment trusts and an international equity limited partnership. The real estate investment trusts are recorded at appraised value or the initial public offering price prior to an appraised value being established. The international equity limited partnership is recorded at its net asset value.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

1. Accounting Policies (continued)

Realized gains and losses on sales of investments are reported on a pretax basis as a component of income and are determined on the specific identification basis.

When evidence indicates a decline which is other than temporary in the underlying value or earning power of individual investments, such investments are written down to fair value by a charge to income.

Factors that management may consider in determining whether an other-than-temporary condition exists include:

- Whether a market decline is attributable to specific adverse conditions for a particular investment.
- Whether a market decline is attributable to general market conditions that reflect prospects of the economy as a whole or prospects of a particular industry.
- The length of time and the extent to which fair value has been less than amortized cost.
- The financial condition of the issuer.
- The intent and ability of management to retain the investment for a period of time sufficient to allow for prudent anticipation of a recovery in market value.
- Whether dividends have been reduced or eliminated or scheduled interest payments on debt securities have not been made.

Securities Lending

The Company engages in securities lending through its investment custodian, U.S. Bank, whereby certain securities are loaned to other institutions for short periods of time. Such securities are in investments on the consolidated balance sheets. The market value of the loaned securities is monitored on a daily basis, with additional collateral obtained or refunded as the market value of the loaned securities fluctuates. Initial collateral, primarily cash, is required at a rate of 102% of the market value of a loaned security. The collateral is deposited by the borrower with U.S. Bank and retained and invested by U.S. Bank according to the terms of the securities lending agreement to generate additional income. The agreement also provides that U.S. Bank will indemnify the

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

1. Accounting Policies (continued)

Company if the borrower defaults, becomes insolvent or fails to return the loaned securities. As of December 31, 2003 and 2002, the Company had securities on loan with a fair market value of \$62,076,000 and \$78,042,000, which were collateralized by \$63,948,000 and \$80,654,000 of cash, respectively. The fair market value of the collateral was 103% of the fair market value of the securities on loan in 2003 and 2002, respectively. The Company has not repledged the collateral.

Losses and Loss Adjustment Expenses

The liability for unpaid losses and loss adjustment expenses represents management's best estimate of the ultimate cost of all such amounts which are unpaid at the balance sheet dates. The liability is based on both case-by-case estimates and statistical analysis and projections using the historical loss experience of Midwest Medical and gives effect to estimates of trends in claim severity and frequency. These estimates are continually reviewed, and as adjustments become necessary, such adjustments are included in current operations. Midwest Medical believes that the estimate of the liability for losses and loss adjustment expenses is reasonable.

Premiums

Premiums received are recorded as earned ratably over the lives of the policies to which they apply. A portion of premiums received is deferred to recognize Midwest Medical's obligation to provide reporting endorsement coverage without additional premium upon the death, disability or retirement of policyholders. This amount is recorded as an unearned premium reserve and represents the actuarially determined present value of future benefits to be provided less the present value of future revenues to be received.

Policyholder Dividends

Midwest Medical implemented a policyholder dividend program in 1999. Policyholder dividends are accrued when approved by the Board of Directors and are recorded as a separate component of losses and expenses in the consolidated statements of income.

Dividends are generated from unanticipated profits on prior coverage years. Declared dividends are allocated to policyholders proportionately based on current year written premium. To receive a dividend, a policyholder is required to have been insured in the applicable coverage year and remain insured throughout the year the dividend is paid. Declared dividends are generally paid in quarterly installments in the year following declaration.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

1. Accounting Policies (continued)

Participating policies represented approximately 96% of total premiums in force and premium income at December 31, 2003 and 2002. No dividends were declared for the years ended December 31, 2003 and 2002.

Reinsurance

Midwest Medical purchases reinsurance in order to reduce its liability on individual risks and to enable it to write business at limits it otherwise would be unable to accept. Reinsurance contracts are principally excess-of-loss contracts, which indemnify Midwest Medical for losses in excess of a stated retention limit up to the policy limits. Midwest Medical remains obligated for amounts ceded in the event that the reinsurers do not meet their obligations.

Acquisition Costs

The Company's deferred acquisition costs (DACs) represent the costs of acquiring new insurance, principally agent or broker commissions and state premium taxes. DACs are amortized ratably over the lives of the policies to which they apply. The unamortized portion of DACs is reflected on the consolidated balance sheets as a component of other assets.

Other Revenues

Other revenues consist primarily of Benefits' commission income from insurance carriers and Medical Solutions' technology consulting and software sales and support to health care providers. Generally, such revenues are earned as the related services and products are performed or provided.

Noncash Transaction

The recording of a minimum pension liability for the Supplemental Executive Retirement Plan (SERP) in 2003 is a noncash transaction that impacted other assets by \$684,000, deferred income taxes by \$191,000 and other liabilities by \$1,247,000. The net effect was a reduction in other comprehensive income of \$372,000.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

1. Accounting Policies (continued)

Income Taxes

The Company files a consolidated tax return with its subsidiaries. Income tax expense is allocated to the subsidiaries based upon separate company taxable income under a tax-sharing agreement. The Company uses the asset and liability method of accounting for income taxes. Deferred income tax assets or liabilities are recognized for the temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and amounts used for income tax purposes.

2. Asset Sale

As mentioned in Note 1, Benefits sold its group insurance book of business to Johnson-McCann Benefits, Inc. and one other producer effective December 31, 2003. Proceeds from the sale will be substantially based on the commissions received by the buyers from 2004 through 2007 on the book of business sold at December 31, 2003. Total sale proceeds are estimated at \$3,322,000, resulting in the recording of a \$1,583,000 gain on sale before income taxes. These amounts will be adjusted as actual payments are received. The gain on sale was recorded in other income on the consolidated statements of income.

3. Capital Structure

Midwest Holding has issued two classes of common stock. Each physician insured receives one share of Class C stock at no cost upon commencing coverage with Midwest Medical. The share of stock must be returned to the Company upon termination of insurance coverage. There is no payment to the shareholder upon return of Class C shares. Each share entitles the owner to one vote on matters that are subject to shareholder vote or approval. In the event of liquidation, sale, or similar transaction involving Midwest Holding or Midwest Medical, Class C shareholders would participate in the proceeds according to a distribution formula developed by the Board of Directors. This formula takes into account the underwriting risk classification and years of coverage of each shareholder.

Midwest Holding has also issued one share of Class B voting stock that carries with it the right to elect the Board of Directors of Midwest Holding. The Minnesota Medical Association and the Iowa Medical Society currently exercise these voting rights. A majority of the Class C shareholders may at any time, by a two-thirds vote, elect to redeem the Class B share at cost.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

4. Investments

Components of net investment income are summarized as follows:

	2003	2002
	<i>(In Thousands)</i>	
Fixed maturities	\$ 7,236	\$ 9,363
Equity securities	353	597
Short-term investments	735	478
Other investments	2,491	2,008
	10,815	12,446
Investment expenses	(1,158)	(1,042)
	\$ 9,657	\$11,404

The cost (amortized cost for fixed maturities) and fair value of available-for-sale investments are as follows:

	December 31, 2003			
	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
	<i>(In Thousands)</i>			
Fixed maturities:				
United States government	\$ 54,518	\$1,066	\$(117)	\$ 55,467
Public utilities	1,451	122	-	1,573
Industrial and other	86,281	3,042	(309)	89,014
Total	\$142,250	\$4,230	\$(426)	\$146,054
Equity securities:				
Common stock:				
Banks, trusts and insurance companies	\$ 3,818	\$1,703	\$ -	\$ 5,521
Industrial, miscellaneous and other	29,264	6,316	(115)	35,465
Total	\$ 33,082	\$8,019	\$(115)	\$ 40,986
Other long-term investments:				
Real estate investment trusts	\$ 22,193	\$1,876	\$ -	\$ 24,069
International equity limited partnership	19,819	4,090	-	23,909
Total	\$ 42,012	\$5,966	\$ -	\$ 47,978

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

4. Investments (continued)

	December 31, 2002			Market Value
	Cost	Gross Unrealized Gains	Gross Unrealized Losses	
	<i>(In Thousands)</i>			
Fixed maturities:				
United States government	\$ 68,926	\$1,864	\$ (134)	\$ 70,656
Public utilities	1,451	-	(48)	1,403
Industrial and other	73,256	2,245	(3,237)	72,264
Total	<u>\$143,633</u>	<u>\$4,109</u>	<u>\$(3,419)</u>	<u>\$144,323</u>
Equity securities:				
Common stock:				
Banks, trusts and insurance companies	\$ 3,126	\$1,331	\$ -	\$ 4,457
Industrial, miscellaneous and other	24,806	4,126	(1,236)	27,696
Total	<u>\$ 27,932</u>	<u>\$5,457</u>	<u>\$(1,236)</u>	<u>\$ 32,153</u>
Other long-term investments:				
Real estate investment trust	\$ 20,424	\$ 998	\$ -	\$ 21,422
International equity limited partnership	19,873	-	(3,094)	16,779
Total	<u>\$ 40,297</u>	<u>\$ 998</u>	<u>\$(3,094)</u>	<u>\$ 38,201</u>

The components of the unrealized appreciation on available-for-sale securities as of December 31 are as follows:

	2003	2002
	<i>(In Thousands)</i>	
Fixed maturities:		
Gross unrealized gains	\$ 4,230	\$4,109
Gross unrealized losses	(426)	(3,419)
Equity securities:		
Gross unrealized gains	8,019	5,457
Gross unrealized losses	(115)	(1,236)
Other long-term investments:		
Gross unrealized gains	5,966	998
Gross unrealized losses	-	(3,094)
	<u>17,674</u>	<u>2,815</u>
Deferred income taxes	(6,009)	(957)
	<u>\$11,665</u>	<u>\$1,858</u>

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

4. Investments (continued)

The amortized cost and market value of fixed maturities at December 31, 2003, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Market Value
<i>(In Thousands)</i>		
Due in one year or less	\$ 2,962	\$ 3,147
Due after one year through five years	2,907	3,270
Due after five years through ten years	36,903	38,049
Due after ten years	99,478	101,588
	\$142,250	\$146,054

Proceeds from sales of available-for-sale investments and the related gross realized gains and losses are as follows:

	Proceeds From Sales	Gross Realized Gains	Gross Realized Losses
<i>(In Thousands)</i>			
Year ended December 31, 2003:			
Fixed maturities	\$207,882	\$4,588	\$ (992)
Equity securities	27,612	4,913	(2,234)
Year ended December 31, 2002:			
Fixed maturities	\$160,162	\$5,138	\$(1,470)
Equity securities	46,527	6,103	(6,800)

At December 31, 2003 and 2002, a fixed maturity investment carried at \$2,240,000 and \$2,319,000, respectively, was on deposit with the Minnesota Department of Commerce as required by law.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

4. Investments (continued)

Investments with unrealized losses at December 31, 2003 are summarized as follows:

	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
	<i>(In Thousands)</i>					
Fixed maturities:						
United States						
government	\$14,825	\$114	\$ 385	\$ 3	\$15,210	\$117
Public utilities	—	—	—	—	—	—
Industrial and other	19,126	180	8,125	129	27,251	309
	33,951	294	8,510	132	42,461	426
Equity securities:						
Common stock:						
Banks, trust and insurance companies	—	—	—	—	—	—
Industrial, miscellaneous and other	1,914	110	1,598	5	3,512	115
	1,914	110	1,598	5	3,512	115
Total securities with unrealized loss	\$35,865	\$404	\$10,108	\$137	\$45,973	\$541

During 2003, the Company did not experience any declines in investment values that were deemed other than temporary requiring the recognition of realized investment losses. During 2002, the Company recorded realized investment losses for declines in value that were deemed other than temporary on fixed maturity securities totaling \$1,613,000.

At December 31, 2003, the Company has 30 securities with unrealized losses, of which 24 are fixed maturity investments and 6 are equity security investments. Industrial and other fixed maturity investments are the Company's largest investment category and contain 16 positions with unrealized losses. Only two of those positions have had unrealized losses for longer than 12 months, and one of them is the largest single unrealized loss issue at \$96,000, which is less than 3% of the holding's cost. This temporary impairment relates primarily to credit concerns raised by several rating agencies toward the end of 2002 over the issuer's restructuring plans. Most of these concerns did not come to fruition during 2003, resulting in a substantial recovery in the issue's fair value. The issuer is current on its semiannual interest payments, and the Company expects to receive full value at maturity. The remaining unrealized loss positions in the industrial and other fixed maturity investment category are primarily interest rate-driven, and the Company has the ability to hold these securities until they mature or recover in value.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

4. Investments (continued)

Net unrealized appreciation of fixed maturities increased (decreased) by \$3,114,000 and \$(1,902,000), and net unrealized appreciation of equity securities increased (decreased) by \$3,683,000 and \$(13,047,000) for the years ended December 31, 2003 and 2002, respectively. Net unrealized appreciation of other long-term investments increased (decreased) by \$8,062,000 and \$(3,712,000) for the years ended December 31, 2003 and 2002, respectively.

5. Unpaid Losses and Loss Adjustment Expenses

The reconciliation of the liability for unpaid losses and loss adjustment expenses is as follows:

	2003	2002
	<i>(In Thousands)</i>	
Balance as of January 1, net of reinsurance recoverables	\$132,231	\$104,870
Incurred related to:		
Current year	72,781	71,919
Prior years	2,395	2,900
Total incurred	75,176	74,819
Paid related to:		
Current year	5,339	3,889
Prior years	47,001	43,569
Total paid	52,340	47,458
Balance as of December 31, net of reinsurance recoverables	155,067	132,231
Reinsurance recoverables at December 31	11,344	16,532
Balance as of December 31, gross	\$166,411	\$148,763

Midwest Medical continually evaluates emerging trends in the development of loss liabilities. Based on this analysis, management periodically adjusts its estimates of ultimate losses.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

6. Segment Information

The Company is organized along four main product and service groups. Management and administrative services provided by Midwest Holding are the Management business segment. Professional liability insurance provided by Midwest Medical is the Insurance business segment. Technology-based products and services provided by Medical Solutions and Office Solutions are the Technology business segment. Agency services provided by Benefits to assist clients in obtaining appropriate employee-related insurance products are the Agency business segment. The business and accounting policies of the reportable segments are described in Note 1 to the consolidated financial statements. Management evaluates the performance of each business segment based primarily on profit or loss from operations. With the exception of the international equity limited partnership and foreign stocks and bonds held as investments by Midwest Medical, all business transactions are conducted in the United States. The following financial information summarizes the results of operations and total assets reported by the business segments for the years ended 2003 and 2002.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

6. Segment Information (continued)

	2003					
	Management	Insurance	Technology	Agency	Eliminations ⁽¹⁾	Consolidated
	<i>(In Thousands)</i>					
Revenues:						
External customers	\$ –	\$ 77,854	\$ 2,848	\$2,508	\$ –	\$ 83,210
Intersegment	18,386	–	529	–	(18,915)	–
Net investment income	435	9,838	6	4	(626)	9,657
Other ⁽²⁾	1	6,234	–	1,583	426	8,244
	18,822	93,926	3,383	4,095	(19,115)	101,111
Total expenses	19,713	85,261	6,550	2,687	(19,115)	95,096
(Loss) income before tax	(891)	8,665	(3,167)	1,408	–	6,015
Income tax (benefit) expense	(581)	2,895	(1,076)	487	–	1,725
Net (loss) income	\$ (310)	\$ 5,770	\$(2,091)	\$ 921	\$ –	\$ 4,290
Total assets	\$132,215	\$335,864	\$ 3,390	\$3,464	\$(135,983)	\$338,950

⁽¹⁾ Intersegment eliminations for revenues and expenses are primarily for management and administrative services provided by Midwest Holding. Eliminations for assets consist primarily of investments in wholly owned subsidiaries, intersegment receivables for management fees and reclassifications between assets and liabilities primarily for taxes.

⁽²⁾ Other revenues consist primarily of net realized capital gains and a gain on an asset sale by Benefits.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

6. Segment Information (continued)

	2002					
	Management	Insurance	Technology	Agency	Eliminations ⁽¹⁾	Consolidated
	<i>(In Thousands)</i>					
Revenues:						
External customers	\$ –	\$ 70,472	\$ 1,754	\$2,373	\$ –	\$ 74,599
Intersegment	16,106	–	264	–	(16,370)	–
Net investment (loss) income	(416)	11,391	3	2	424	11,404
Other ⁽²⁾	26	1,411	–	–	(424)	1,013
	<u>15,716</u>	<u>83,274</u>	<u>2,021</u>	<u>2,375</u>	<u>(16,370)</u>	<u>87,016</u>
Total expenses	<u>17,289</u>	<u>85,023</u>	<u>4,546</u>	<u>2,648</u>	<u>(16,370)</u>	<u>93,136</u>
Loss before tax	(1,573)	(1,749)	(2,525)	(273)	–	(6,120)
Income tax benefit	(522)	(1,096)	(859)	(87)	–	(2,564)
Net loss	<u>\$ (1,051)</u>	<u>\$ (653)</u>	<u>\$(1,666)</u>	<u>\$ (186)</u>	<u>\$ –</u>	<u>\$ (3,556)</u>
Total assets	<u>\$117,398</u>	<u>\$294,277</u>	<u>\$ 2,051</u>	<u>\$3,139</u>	<u>\$(112,547)</u>	<u>\$304,318</u>

⁽¹⁾ Intersegment eliminations for revenues and expenses are primarily for management and administrative services provided by Midwest Holding. Eliminations for assets consist primarily of investments in wholly owned subsidiaries, intersegment receivables for management fees and reclassifications between assets and liabilities primarily for taxes.

⁽²⁾ Other revenues consist primarily of net realized capital gains.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

7. Income Taxes

Components of income tax expense (benefit) are as follows:

	2003	2002
	<i>(In Thousands)</i>	
Current provision	\$2,260	\$ (372)
Deferred tax provision	(535)	(2,192)
	\$1,725	\$(2,564)

The Company's income taxes differ from the federal statutory rate applied to income before tax as follows:

	2003	2002
	<i>(In Thousands)</i>	
Income before tax at the federal statutory rate of 34%	\$2,045	\$(2,081)
Dividends received deductions (net of proration adjustment)	(65)	(58)
Non-deductible expenses	46	43
State income taxes, net of federal tax benefit	3	(12)
Benefit for prior year income taxes	(322)	(443)
Other	18	(13)
	\$1,725	\$(2,564)

The Company made income tax payments of \$332,000 and \$7,000 in 2003 and 2002, respectively.

The components of the net deferred income tax asset (liability) as of December 31 are as follows:

	2003	2002
	<i>(In Thousands)</i>	
Deferred tax assets:		
Unpaid losses and loss adjustment expenses	\$ 4,722	\$4,463
Liabilities not currently deductible	2,111	1,775
Unearned and advanced premiums	1,991	1,442
Minimum pension liability	191	-
Other	2,073	2,045
	11,088	9,725
Deferred tax liabilities:		
Unrealized gains	(6,009)	(957)
Other	(2,532)	(1,895)
	(8,541)	(2,852)
	\$ 2,547	\$6,873

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

7. Income Taxes (continued)

The Company is required to establish a valuation allowance for any portion of the deferred income tax assets that management believes will not be realized. In the opinion of management, it is more likely than not that the Company will realize the benefit of the deferred income tax assets, and therefore, no valuation allowance has been established.

8. Reinsurance

To reduce overall risk, including exposure to large losses, Midwest Medical participates in various reinsurance programs. Midwest Medical would only become liable for losses in excess of its retention limits in the event that any reinsuring company were unable to meet its obligations under the existing agreement. Management is not aware of any such default at December 31, 2003. Midwest Medical evaluates the financial condition of its reinsurers and monitors concentration of credit risk arising from similar geographic regions, activities or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. Reinsurance recoverables on paid and unpaid losses of \$4,200,000 and \$4,602,000 are associated with a single reinsurer, General Reinsurance Corporation, at December 31, 2003 and 2002, respectively. In 2003 and 2002, Midwest Medical also holds collateral under related reinsurance agreements in the form of letters of credit totaling \$3,857,000 and \$5,290,000, respectively, that can be drawn upon in the event the applicable reinsuring company is unable to pay its obligation to Midwest Medical.

Midwest Medical is authorized to issue policies with limits not to exceed \$12,000,000 for each claim and \$14,000,000 in the aggregate under each policy in any one policy year. Limits in excess of \$12,000,000 for each claim and \$14,000,000 annual aggregate are available to physicians and clinics through reinsurance placed on a facultative basis by Midwest Medical. Midwest Medical's reinsurance program is structured in two components: "basic" and "excess." Under the basic component, Midwest Medical generally retains the first \$1,000,000 of each claim and reinsures the next \$1,000,000 through a treaty under which premiums are based on a flat rate and could be subject to adjustment through a profit sharing provision. Under the excess component, Midwest Medical acts as an intermediary and cedes the full amount of the risk for policies with limits of \$2,000,000 for each claim and \$4,000,000 in the aggregate up to \$12,000,000 for each claim and \$14,000,000 in the aggregate. The reinsurance premium for the excess component is a percentage of the preceding layer of coverage gross of any ceding commission paid by reinsurers to Midwest Medical.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

8. Reinsurance (continued)

The effect of reinsurance on premiums written and earned for 2003 and 2002 is as follows:

	2003		2002	
	Written	Earned	Written	Earned
	<i>(In Thousands)</i>		<i>(In Thousands)</i>	
Current year:				
Direct	\$103,774	\$99,452	\$90,291	\$86,111
Assumed	40	139	215	160
Ceded – basic	(9,422)	(9,226)	(8,264)	(7,892)
Ceded – excess	(12,329)	(12,498)	(9,553)	(7,591)
	82,063	77,867	72,689	70,788
Prior years:				
Ceded	(13)	(13)	(316)	(316)
Net	\$ 82,050	\$77,854	\$72,373	\$70,472

Loss and loss adjustment expenses incurred are net of applicable reinsurance of \$(639,000) and \$8,343,000 for the years ended December 31, 2003 and 2002, respectively.

9. Benefit Plans

The Company sponsors a number of postretirement and deferred compensation benefit plans. The principal plans are discussed below; other such plans are not significant individually or in the aggregate.

Substantially all employees of Midwest Holding are covered by a noncontributory defined contribution pension plan. Contributions to the plan are based upon each covered employee's salary. Substantially all employees at Midwest Holding are also covered by a 401(k) plan that provides a 50% match on employee contributions subject to certain limitations. Total contributions charged to expense for the years ended December 31, 2003 and 2002, were \$911,000 and \$830,000, respectively.

Midwest Holding provides an unfunded SERP which is a non-qualified, defined benefit retirement plan covering certain Midwest Holding officers. Benefits are based upon years of service and compensation. Although the plan is technically unfunded, Midwest Holding invests in specified assets which are designed to coordinate with the projected obligation under the SERP. The net periodic pension cost for this plan was \$871,000 and

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

9. Benefit Plans (continued)

\$651,000 for the years ended December 31, 2003 and 2002, respectively. The liability recognized in the consolidated balance sheets at December 31, 2003 and 2002, related to this plan was \$4,729,000 and \$4,035,000, respectively. The additional minimum pension liability for 2003 was \$1,247,000.

In 2003, Midwest Holding began providing an unfunded Deferred Compensation Plan (DCP), which is a non-qualified, voluntary plan that provides eligible key management employees of Midwest Holding the opportunity to defer pretax dollars. Benefits provided by the DCP are supplemental to Midwest Holding's other benefit plans. The liability recognized in the consolidated balance sheet at December 31, 2003 related to this plan was \$457,000.

10. Leases

The Company leases office space and equipment under lease agreements that expire at various intervals over the next five years and are subject to renewal options at market rates prevailing at the time of renewal. Rental expense for all leases was \$1,318,000 and \$1,315,000 for 2003 and 2002, respectively. At December 31, 2003, future minimum payments under noncancelable leases are as follows (in thousands):

2004	\$ 702
2005	804
2006	759
2007	518
2008	508
Thereafter	821
	<u>\$4,112</u>

11. Debt

In 2002, Medical Solutions negotiated an installment loan in the amount of \$1,930,000 to finance the purchase of an unlimited license agreement to resell electronic practice management and electronic medical records software. The loan called for 36 monthly payments of \$58,634 with an effective interest rate of approximately 5.9%. Two loan installments totaling \$1,315,000 were received in December 2002, while the remainder of the loan was received early in 2003. Interest expense of \$86,000 was incurred prior to the loan being paid off in 2003.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

12. Commitment and Contingencies

The Company is named as a defendant in various legal actions in the course of conducting its business. Management believes the resolution of those actions will not have a material effect on the Company's financial position or results of operations.

13. Reconciliation With Statutory Accounting Principles

The National Association of Insurance Commissioners (NAIC) revised the *Accounting Practices and Procedures Manual* in a process referred to as Codification. The revised manual became effective January 1, 2001. Midwest Medical's domiciliary state of Minnesota adopted the provisions of the revised manual. The revised manual has changed, to some extent, prescribed statutory accounting practices and resulted in changes to the accounting practices that Midwest Medical used to prepare its statutory-basis financial statements. Although the implementation of Codification had a negative impact on Midwest Medical's statutory-basis capital and surplus, management believes Midwest Medical remains in compliance with all regulatory and contractual obligations.

Accounting principles generally accepted in the United States differ in certain respects from the accounting practices prescribed or permitted by insurance regulatory authorities (statutory basis).

The following is a reconciliation of net income (loss) and shareholders' equity under U.S. GAAP with that reported for Midwest Medical on a statutory basis:

	Net Income (Loss)	
	Year Ended December 31	
	2003	2002
	<i>(In Thousands)</i>	
On the basis of U.S. GAAP, Midwest Medical only	\$5,770	\$ (653)
Additions (deductions):		
Deferred acquisition costs	(800)	—
Deferred income taxes	(431)	(1,589)
Prescribed short-term investment value differences	(282)	(4)
Other	16	(1)
On the basis of statutory accounting principles	<u>\$4,273</u>	<u>\$(2,247)</u>

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

13. Reconciliation With Statutory Accounting Principles (continued)

	Shareholders' Equity	
	December 31	
	2003	2002
	<i>(In Thousands)</i>	
On the basis of U.S. GAAP, Midwest Medical only	\$121,600	\$107,056
Additions (deductions):		
Deferred acquisition costs	(800)	-
Deferred income taxes	1,565	233
Unrealized gain on fixed maturities	(3,804)	(685)
Nonadmitted assets	(133)	(3,919)
Prescribed short-term investment value differences	(270)	(4)
On the basis of statutory accounting principles	\$118,158	\$102,681

Under Minnesota insurance statutes, Midwest Medical is required to maintain statutory surplus in excess of ten times its per risk reinsurance retention limit. Since Midwest Medical limited its retention to \$1,000,000 on any single risk, the minimum statutory surplus level was \$10,000,000 for 2003.

Dividends that exceed the greater of 10% of Midwest Medical's prior year-end policyholder surplus or Midwest Medical's prior year net income excluding realized capital gains are considered extraordinary under Minnesota insurance statutes. Payment of extraordinary dividends is subject to the approval of the Commissioner of the Minnesota Department of Commerce. At December 31, 2003, the maximum dividend that may be paid by Midwest Medical in 2004 without regulatory approval is approximately \$11,816,000. Cash dividends paid to Midwest Holding by Midwest Medical in 2003 and 2002 were \$1,000,000 and \$-0-, respectively.