

CONSOLIDATED FINANCIAL STATEMENTS

Midwest Medical Insurance Holding Company and Subsidiaries  
Years Ended December 31, 2004 and 2003

Midwest Medical Insurance Holding Company and Subsidiaries

Consolidated Financial Statements

Years Ended December 31, 2004 and 2003

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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, 2004 and 2003, 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and 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, 2004 and 2003, 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 4, 2005



# Midwest Medical Insurance Holding Company and Subsidiaries

## Consolidated Statements of Income

*(In Thousands)*

	<b>Year Ended December 31</b>	
	<b>2004</b>	<b>2003</b>
Revenues:		
Net premiums earned	\$ 96,026	\$ 77,854
Net investment income	11,883	9,657
Realized capital gains	4,532	6,275
Other	3,246	7,325
	<b>115,687</b>	101,111
Losses and expenses:		
Losses and loss adjustment expenses	90,173	75,176
Underwriting, acquisition and insurance expenses	13,548	10,086
Other operating expenses	5,978	9,834
	<b>109,699</b>	95,096
Income before income taxes	5,988	6,015
Income tax expense	1,752	1,725
Net income	<b>\$ 4,236</b>	<b>\$ 4,290</b>

*See accompanying notes.*

## Midwest Medical Insurance Holding Company and Subsidiaries

### Consolidated Statements of Changes in Shareholders' Equity

*(In Thousands)*

	<b>Total</b>	<b>Class B Common Stock</b>	<b>Paid-In Capital</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Income</b>
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	124,740	1	12,789	100,657	11,293
Comprehensive income:					
Net income	4,236	-	-	4,236	-
Other comprehensive income:					
Unrealized gains on securities, net of \$3,779 in taxes	7,336	-	-	-	7,336
Reclassification adjustment for gains included in net income, net of \$1,541 in taxes	(2,991)	-	-	-	(2,991)
Minimum pension liability, net of \$134 in tax benefits	(259)	-	-	-	(259)
Total comprehensive income	<u>8,322</u>				
Balance at December 31, 2004	<u><b>\$133,062</b></u>	<b>\$1</b>	<b>\$12,789</b>	<b>\$104,893</b>	<b>\$15,379</b>

*See accompanying notes.*

# Midwest Medical Insurance Holding Company and Subsidiaries

## Consolidated Statements of Cash Flows

(In Thousands)

	<b>Year Ended December 31</b>	
	<b>2004</b>	<b>2003</b>
<b>Operating activities</b>		
Net income	\$ 4,236	\$ 4,290
Adjustments to reconcile net income to net cash provided by operating activities:		
(Increase) decrease in accrued investment income	(429)	241
Decrease (increase) in premiums receivable	60	(1,808)
(Increase) decrease in reinsurance recoverables	(1,880)	3,865
Decrease (increase) in amounts due from reinsurers	61	(27)
Increase in other assets	(2,713)	(413)
Deferred tax provision	(390)	(535)
Increase in unpaid losses and loss adjustment expenses	22,535	17,648
Increase in unearned premiums	2,626	4,223
Decrease in amounts due to reinsurers	(185)	(4,941)
Increase in other liabilities	3,864	4,045
Premium amortization, net of accretion of bond discount	1,216	1,875
Realized capital gains	(4,532)	(6,275)
Net cash provided by operating activities	<u>24,469</u>	<u>22,188</u>
<b>Investing activities</b>		
Purchases of fixed maturity investments and equity securities	(200,952)	(234,148)
Sales of fixed maturity investments and equity securities	131,335	235,494
Calls and maturities of fixed maturity investments	16,317	-
Purchases of other investments	(722)	(2,428)
Sales of other investments	6,000	-
Purchases of trading securities	(13,357)	-
Sales of trading securities	1,618	-
Net sales (purchases) of short-term investments	35,623	(18,377)
Net cash used in investing activities	<u>(24,138)</u>	<u>(19,459)</u>
<b>Financing activities</b>		
Debt repayment	-	(1,930)
Debt proceeds	-	615
Net cash used in financing activities	<u>-</u>	<u>(1,315)</u>
Increase in cash	331	1,414
Cash at beginning of year	2,519	1,105
Cash at end of year	<u>\$ 2,850</u>	<u>\$ 2,519</u>

See accompanying notes.

# Midwest Medical Insurance Holding Company and Subsidiaries

## Notes to Consolidated Financial Statements

December 31, 2004

### 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 Agency, Inc. (Agency) and MMIC Technology Solutions, Inc. (Solutions). All transactions between Midwest Holding and its subsidiaries have been eliminated in consolidation.

Hereafter, Midwest Holding, Midwest Medical, Agency and 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.

Agency was incorporated in 1995 and began active operations in January 1999 with the acquisition of a book of business from Johnson-McCann Benefits, Inc. Agency 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, Agency specialized in providing clients with group insurance products such as health, dental, life, disability and workers' compensation. Agency continues as an intermediary that provides clients with workers' compensation, business owners' protection and non-standard professional liability insurance products.

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

# Midwest Medical Insurance Holding Company and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

### **1. Accounting Policies (continued)**

Midwest Holding provides management and administrative services to Midwest Medical and Solutions for a fee generally equal to the cost of services provided. Agency operates independently and does not have a management agreement 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).

### **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.

# Midwest Medical Insurance Holding Company and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

### 1. Accounting Policies (continued)

#### 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, most investments, including fixed maturities, equity securities and other, 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 carries these investments at fair value, with unrealized holding gains and losses reflected as a separate component of accumulated other comprehensive income, net of applicable deferred taxes.

Trading securities consist of fixed maturities and preferred stocks that are convertible into common stock at the option of the Company. Trading securities are carried at fair value with unrealized holding gains and losses reflected as realized gains/losses in the consolidated statements of income.

Fair values for fixed maturity and equity securities 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.

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.

Short-term investments are principally money market funds, repurchase agreements and fixed maturities purchased with maturities of less than one year. Short-term investments are recorded at cost, which approximates fair 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, 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 the custodian and retained and invested by the custodian according to the terms of the securities lending agreement to generate additional income. The agreement also provides that the custodian will indemnify the Company if the

# Midwest Medical Insurance Holding Company and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

### **1. Accounting Policies (continued)**

borrower defaults, becomes insolvent or fails to return the loaned securities. As of December 31, 2004 and 2003, the Company had securities on loan with a fair market value of \$11,249,000 and \$62,076,000, which were collateralized by \$11,507,000 and \$63,948,000 of cash, respectively. The fair market value of the collateral was 102% and 103% of the fair market value of the securities on loan in 2004 and 2003, 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.

# Midwest Medical Insurance Holding Company and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

### **1. Accounting Policies (continued)**

#### **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.

Participating policies represented approximately 98% and 96%, respectively, of total premiums in force and premium income at December 31, 2004 and 2003. No dividends were declared for the years ended December 31, 2004 and 2003.

#### **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.

# Midwest Medical Insurance Holding Company and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

### **1. Accounting Policies (continued)**

#### **Other Revenues**

Other revenues consist primarily of Agency commission income from insurance carriers and 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 2004 and 2003 is a noncash transaction that impacted other assets by \$593,000 and \$684,000, deferred income taxes by \$325,000 and \$191,000 and other liabilities by \$1,549,000 and \$1,247,000. The net effect was a reduction in accumulated other comprehensive income of \$631,000 and \$372,000 at December 31, 2004 and 2003, respectively.

#### **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, Agency 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 were estimated at \$3,322,000, resulting in the recording of a \$1,583,000 gain on sale before income taxes for 2003. During 2004, actual payments exceeded prior estimates resulting in the recording of an additional \$235,000 of sale proceeds and gain on sale before income taxes. These amounts will continue to be adjusted as actual payments are received. The gain on sale was recorded in other income on the consolidated statements of income.

# Midwest Medical Insurance Holding Company and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

### 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.

### 4. Investments

Components of net investment income are summarized as follows:

	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
Fixed maturities	<b>\$ 9,677</b>	\$ 7,236
Equity securities	<b>709</b>	353
Other investments	<b>2,594</b>	2,491
Trading securities	<b>(24)</b>	–
Short-term investments	<b>351</b>	735
	<b>13,307</b>	10,815
Investment expenses	<b>(1,424)</b>	(1,158)
	<b>\$11,883</b>	\$ 9,657



## Midwest Medical Insurance Holding Company and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 4. Investments (continued)

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

	2004	2003
	<i>(In Thousands)</i>	
Fixed maturities:		
Gross unrealized gains	\$ 5,096	\$ 4,230
Gross unrealized losses	(523)	(426)
Equity securities:		
Gross unrealized gains	8,329	8,019
Gross unrealized losses	(57)	(115)
Other long-term investments:		
Gross unrealized gains	11,412	5,966
Gross unrealized losses	-	-
	24,257	17,674
Deferred income taxes	(8,247)	(6,009)
	\$16,010	\$11,665

The amortized cost and market value of fixed maturities at December 31, 2004, 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	\$ -	\$ -
Due after one year through five years	5,985	6,182
Due after five years through ten years	47,377	48,388
Due after ten years	147,133	150,498
	\$200,495	\$205,068

## Midwest Medical Insurance Holding Company and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 4. Investments (continued)

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

	<b>Proceeds From Sales</b>	<b>Gross Realized Gains</b>	<b>Gross Realized Losses</b>
	<i>(In Thousands)</i>		
Year ended December 31, 2004:			
Fixed maturities	\$ 70,942	\$1,493	\$ (467)
Equity securities	60,393	4,600	(2,238)
Other	6,000	445	(138)
Year ended December 31, 2003:			
Fixed maturities	\$207,882	\$4,588	\$ (992)
Equity securities	27,612	4,913	(2,234)

The gross realized losses on sales of equity securities during 2004 were primarily the result of a change in the investment manager. The Company moved from an investment manager that used an actively managed, large-cap, growth investment style to an investment manager that uses a passively managed, Russell 3000 indexed, tax advantaged investment style.

At December 31, 2004 and 2003, a fixed maturity investment carried at \$2,120,000 and \$2,240,000, 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, 2004 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 States, municipalities and political subdivisions	\$ 9,837	\$117	\$2,837	\$ 20	\$12,674	\$137
Public utilities	13,719	113	-	-	13,719	113
Industrial and other	-	-	-	-	-	-
	16,246	226	5,031	47	21,277	273
	39,802	456	7,868	67	47,670	523
Equity securities:						
Common stock:						
Public utilities	-	-	-	-	-	-
Banks, trust and insurance companies	111	1	-	-	111	1
Industrial, miscellaneous and other	549	14	261	42	810	56
	660	15	261	42	921	57
Total securities with unrealized loss	\$40,462	\$471	\$8,129	\$109	\$48,591	\$580

During 2004 and 2003, the Company did not experience any declines in investment values that were deemed other than temporary requiring the recognition of realized investment losses.

At December 31, 2004, the Company has 137 securities with unrealized losses, of which 104 are fixed maturity investments and 33 are equity security investments. Only 12 of those positions have had unrealized losses for longer than 12 months. The largest single unrealized loss for fixed maturities that is longer than 12 months is \$(13,000), which is less than 2% of the holding's cost. The Company believes this is primarily an interest rate-driven temporary impairment. The issuer is current on monthly interest payments and the Company expects to receive full value at maturity. Most of the unrealized loss positions in fixed maturity investments are interest rate-driven, and the Company has the ability to hold these securities until they mature or recover in value. The largest single and only unrealized loss for equity securities that is longer than 12 months is \$(42,000), which is less than 14% of the holding's cost. The Company believes this is primarily a pharmaceutical industry and product specific-driven temporary impairment. The issuer has made 264 consecutive quarterly dividend payments, and a recovery in value can be reasonably expected within the next year.

## Midwest Medical Insurance Holding Company and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 4. Investments (continued)

Net unrealized appreciation of fixed maturities increased by \$769,000 and \$3,114,000 and net unrealized appreciation of equity securities increased by \$368,000 and \$3,683,000 for the years ended December 31, 2004 and 2003, respectively. Net unrealized appreciation of other long-term investments increased by \$5,446,000 and \$8,062,000 for the years ended December 31, 2004 and 2003, respectively.

Gross trading realized gains were \$150,000 and gross trading realized losses were \$(5,000) for trading securities for the year ended December 31, 2004.

Gross mark-to-market realized gains were \$736,000 and gross mark-to-market realized losses were \$(47,000) for trading securities for the year ended December 31, 2004.

#### 5. Unpaid Losses and Loss Adjustment Expenses

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

	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
Balance as of January 1, net of reinsurance recoverables	<b>\$155,067</b>	\$132,231
Incurred related to:		
Current year	<b>83,377</b>	72,781
Prior years	<b>6,796</b>	2,395
Total incurred	<b>90,173</b>	75,176
Paid related to:		
Current year	<b>3,511</b>	5,339
Prior years	<b>67,833</b>	47,001
Total paid	<b>71,344</b>	52,340
Balance as of December 31, net of reinsurance recoverables	<b>173,896</b>	155,067
Reinsurance recoverables at December 31	<b>15,050</b>	11,344
Balance as of December 31, gross	<b>\$188,946</b>	\$166,411

# Midwest Medical Insurance Holding Company and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

### **5. Unpaid Losses and Loss Adjustment Expenses (continued)**

Midwest Medical continually evaluates emerging trends in the development of loss liabilities. Based on this analysis, management periodically adjusts its estimates of ultimate losses. The increase in unfavorable development on prior years is primarily due to late development on 2002 report year claims in Minnesota. This later development resulted from a change in the Minnesota statute of limitations from two to four years that was enacted during 1999 and was ultimately applied retroactively. This has caused a longer period of time to elapse between a preliminary report of a potential compensable event and an actual claim or suit being filed.

### **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 Solutions are the Technology business segment. Property and casualty insurance intermediary services provided by Agency 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 2004 and 2003.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

**6. Segment Information (continued)**

	2004					
	Management	Insurance	Technology	Agency	Eliminations <sup>(1)</sup>	Consolidated
	<i>(In Thousands)</i>					
Revenues:						
External customers	\$ –	\$ 96,026	\$ 2,547	\$ 350	\$ –	\$ 98,923
Intersegment	18,805	–	139	–	(18,944)	–
Net investment income	165	12,184	5	2	(473)	11,883
Other <sup>(2)</sup>	39	4,453	–	235	154	4,881
	<b>19,009</b>	<b>112,663</b>	<b>2,691</b>	<b>587</b>	<b>(19,263)</b>	<b>115,687</b>
Total expenses	<b>20,113</b>	<b>103,721</b>	<b>4,886</b>	<b>242</b>	<b>(19,263)</b>	<b>109,699</b>
(Loss) income before tax	<b>(1,104)</b>	<b>8,942</b>	<b>(2,195)</b>	<b>345</b>	<b>–</b>	<b>5,988</b>
Income tax (benefit) expense	<b>(262)</b>	<b>2,634</b>	<b>(740)</b>	<b>120</b>	<b>–</b>	<b>1,752</b>
Net (loss) income	<b>\$ (842)</b>	<b>\$ 6,308</b>	<b>\$(1,455)</b>	<b>\$ 225</b>	<b>\$ –</b>	<b>\$ 4,236</b>
Total assets	<b>\$142,070</b>	<b>\$372,873</b>	<b>\$ 2,397</b>	<b>\$2,339</b>	<b>\$(143,266)</b>	<b>\$376,413</b>

<sup>(1)</sup> 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.

<sup>(2)</sup> Other revenues consist primarily of net realized capital gains and a gain on an asset sale by Agency.

Midwest Medical Insurance Holding Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

**6. Segment Information (continued)**

	<b>2003</b>					
	<b>Management</b>	<b>Insurance</b>	<b>Technology</b>	<b>Agency</b>	<b>Eliminations<sup>(1)</sup></b>	<b>Consolidated</b>
	<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 <sup>(2)</sup>	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

<sup>(1)</sup> 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.

<sup>(2)</sup> Other revenues consist primarily of net realized capital gains and a gain on an asset sale by Agency.

## 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:

	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
Current provision	<b>\$2,142</b>	\$2,260
Deferred tax provision	<b>(390)</b>	(535)
	<b>\$1,752</b>	\$1,725

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

	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
Income before tax at the federal statutory rate of 34%	<b>\$2,036</b>	\$2,045
Tax-exempt income (net of proration adjustment)	<b>(213)</b>	-
Dividends received deductions (net of proration adjustment)	<b>(137)</b>	(65)
Nondeductible expenses	<b>50</b>	46
State income taxes, net of federal tax benefit	<b>5</b>	3
Benefit for prior year income taxes	<b>(10)</b>	(322)
Other	<b>21</b>	18
	<b>\$1,752</b>	\$1,725

The Company made income tax payments of \$2,010,000 and \$332,000 in 2004 and 2003, respectively.

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

	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
Deferred tax assets:		
Unpaid losses and loss adjustment expenses	<b>\$ 5,003</b>	\$ 4,722
Liabilities not currently deductible	<b>2,808</b>	2,111
Unearned and advanced premiums	<b>2,262</b>	1,991
Minimum pension liability	<b>325</b>	191
Other	<b>1,716</b>	2,073
	<b>12,114</b>	11,088
Deferred tax liabilities:		
Unrealized gains	<b>(8,247)</b>	(6,009)
Other	<b>(3,035)</b>	(2,532)
	<b>(11,282)</b>	(8,541)
	<b>\$ 832</b>	\$ 2,547

# 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, 2004. 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. At December 31, 2004, reinsurance recoverables on paid and unpaid losses of \$4,157,000 are associated with a single reinsurer, Hannover Ruckversicherungs Ag. At December 31, 2003, reinsurance recoverables on paid and unpaid losses of \$4,200,000 are associated with a single reinsurer, General Reinsurance Corporation. In 2004 and 2003, Midwest Medical also holds collateral under related reinsurance agreements in the form of letters of credit totaling \$8,709,000 and \$3,857,000, respectively, that can be drawn upon in the event the applicable reinsuring company is unable to pay its obligation to Midwest Medical.

In March 2004, Midwest Medical commuted all reinsurance agreements with Gerling Global Reinsurance Company of America (Gerling). This resulted in a payment by Gerling of \$2,400,000 to Midwest Medical in return for the release from its exposure to future losses. This resulted in ceded paid losses and ceded loss adjustment expenses of \$2,200,000 and \$200,000, respectively, being recorded by Midwest Medical. These ceded paid losses and ceded loss adjustment expenses were directly offset by an increase in direct loss and loss adjustment expense reserves resulting in no net loss or gain under the commutation.

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

## Midwest Medical Insurance Holding Company and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 8. Reinsurance (continued)

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.

The effect of reinsurance on premiums written and earned for 2004 and 2003 is as follows:

	2004		2003	
	Written	Earned	Written	Earned
	<i>(In Thousands)</i>		<i>(In Thousands)</i>	
Current year:				
Direct	\$120,380	\$117,754	\$103,774	\$99,452
Assumed	-	-	40	139
Ceded – basic	(11,549)	(11,312)	(9,422)	(9,226)
Ceded – excess	(10,489)	(10,786)	(12,329)	(12,498)
	98,342	95,656	82,063	77,867
Prior years:				
Ceded	370	370	(13)	(13)
Net	\$ 98,712	\$ 96,026	\$ 82,050	\$77,854

Loss expenses incurred are net of applicable reinsurance of \$15,018,000 and \$(639,000) for the years ended December 31, 2004 and 2003, 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, 2004 and 2003, were \$939,000 and \$911,000, respectively.

# Midwest Medical Insurance Holding Company and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

### 9. Benefit Plans (continued)

Midwest Holding provides an unfunded SERP which is a non-qualified, defined benefit retirement plan covering certain Midwest Holding officers. All SERP amounts are determined by an outside actuary and reviewed with management on an annual basis. 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 \$897,000 and \$871,000 for the years ended December 31, 2004 and 2003, respectively. The liability recognized in the consolidated balance sheets at December 31, 2004 and 2003, related to this plan was \$5,451,000 and \$4,729,000, respectively. The additional minimum pension liability for 2004 and 2003 was \$1,549,000 and \$1,247,000, respectively.

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 sheets at December 31, 2004 and 2003, related to this plan was \$1,152,000 and \$457,000, respectively.

### 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 \$1,088,000 and \$1,318,000 for 2004 and 2003, respectively. At December 31, 2004, future minimum payments under noncancelable leases are as follows (in thousands):

2005	\$ 804
2006	785
2007	532
2008	497
2009	418
Thereafter	383
	<u>\$3,419</u>

## Midwest Medical Insurance Holding Company and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **11. Debt**

In 2002, 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.

#### **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. Management believes Midwest Medical complies with all regulatory and contractual obligations of the revised manual.

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).

## Midwest Medical Insurance Holding Company and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 13. Reconciliation With Statutory Accounting Principles (continued)

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

	<b>Net Income</b>	
	<b>Year Ended December 31</b>	
	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
On the basis of U.S. GAAP, Midwest Medical only	<b>\$6,308</b>	\$5,770
(Deductions) additions:		
Deferred acquisition costs	<b>(251)</b>	(800)
Deferred income taxes	<b>289</b>	(431)
Mark-to-market realized gain on trading securities, net of tax	<b>(455)</b>	-
Prescribed short-term investment value differences	<b>270</b>	(266)
On the basis of statutory accounting principles	<b>\$6,161</b>	\$4,273
	<hr/> <hr/>	
	<b>Shareholders' Equity</b>	
	<b>December 31</b>	
	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
On the basis of U.S. GAAP, Midwest Medical only	<b>\$132,273</b>	\$121,600
(Deductions) additions:		
Deferred acquisition costs	<b>(1,051)</b>	(800)
Deferred income taxes	<b>1,912</b>	1,565
Mark-to-market realized gain on trading securities, net of tax	<b>(455)</b>	-
Unrealized gain on fixed maturities	<b>(4,573)</b>	(3,804)
Nonadmitted assets	<b>(40)</b>	(133)
Prescribed short-term investment value differences	<b>-</b>	(270)
On the basis of statutory accounting principles	<b>\$128,066</b>	\$118,158
	<hr/> <hr/>	

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 2004.

## Midwest Medical Insurance Holding Company and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **13. Reconciliation With Statutory Accounting Principles (continued)**

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, 2004, the maximum dividend that may be paid by Midwest Medical in 2005 without regulatory approval is approximately \$12,807,000. Cash dividends paid to Midwest Holding by Midwest Medical in 2004 and 2003 were \$-0- and \$1,000,000, respectively.