SEIBELS BRUCE GROUP INC
Form 10-Q
November 14, 2002

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

ý	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For Quarter Ended September 30, 2002

or

o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission file number 0-8804

THE SEIBELS BRUCE GROUP, INC.

(Exact name of registrant as specified in its charter)

South Carolina	**57-0672136**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1501 Lady Street (PO Box 1), Columbia, SC	**29201(2)**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code **(803) 748-2000**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o

Indicate by check mark whether the registrant is an accelerated filer as defined in Rule 12b-2 of the Exchange Act. Yes o No ý

Indicate the number of shares outstanding of each of the registrant s classes of common stock as of the latest practicable date: 7,831,690 shares of Common Stock, $1 par value, at November 14, 2002.

PART I-FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
THE SEIBELS BRUCE GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Amounts shown in thousands, except share data)

	September 30, 2002	December 31, 2001
	(Unaudited)	
ASSETS		
Cash and investments:		
Debt securities, available-for-sale, at market (cost of $33,742 in 2002 and $32,507 in 2001)	$ 35,539	$ 33,538
Equity securities	5,766	5,961
Cash and short-term investments	5,561	6,375
Total cash and investments	46,866	45,874
Accrued investment income	535	702
Premiums and agents balances receivable, net of allowance for doubtful accounts of $3,151 in 2002 and $3,013 in 2001	3,483	2,604
Premium notes receivable, net of allowance for doubtful accounts of $5 in 2002 and $750 in 2001	28	3,668
Reinsurance recoverable on paid losses and loss adjustment expenses	10,121	10,246
Reinsurance recoverable on unpaid losses and loss adjustment expenses	33,991	40,832
Property and equipment, net	1,146	807
Prepaid reinsurance premiums-ceded business	35,000	36,548
Deferred policy acquisition costs	1,525	1,200
Goodwill	4,513	4,513
Other assets	11,925	3,644
Total assets	$ 149,133	$ 150,638
LIABILITIES		
Losses and loss adjustment expenses:		
Reported and estimated losses and claims - retained business	$ 25,857	$ 21,334
- ceded business	32,753	38,785
Adjustment expenses - retained business	5,175	4,709
- ceded business	1,238	2,047
Unearned premiums:		
Property and casualty - retained business	7,232	6,116
- ceded business	35,000	36,548
Balances due other insurance companies	5,632	3,372
Debt	0	7,721
Other liabilities and deferred items	5,501	10,442
Total liabilities	118,388	131,074

COMMITMENTS AND CONTINGENCIES		
SPECIAL STOCK, no par value, authorized 5,000,000 shares		
Issued and outstanding 0 and 209,000 shares in 2002 and 2001, respectively, of cumulative $0.62, convertible, redeemable, nonvoting, special preferred stock	0	2,090
Issued and outstanding 0 and 50,000 shares in 2002 and 2001, respectively, of cumulative $0.625 convertible, redeemable, nonvoting, special preferred stock	0	500
Total special stock	0	2,590
SHAREHOLDERS EQUITY		
Adjustable Rate Cumulative Nonvoting Preferred Special Stock, issued and outstanding 800,000 shares	8,000	0
Common stock, $1 par value, authorized 17,500,000 shares, issued and outstanding 7,831,690 shares	7,832	7,832
Additional paid-in-capital	61,989	61,989
Accumulated other comprehensive income	1,910	1,134
Accumulated deficit	(48,986)	(53,981)
Total shareholders equity	30,745	16,974
Total liabilities and shareholders equity	$ 149,133	$ 150,638

THE SEIBELS BRUCE GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Amounts shown in thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	**2001**	**2002**	**2001**
Revenues:				
Commission and service income	$ 9,568	$ 9,461	$ 26,490	$ 28,069
Premiums earned	13,682	3,288	20,726	11,016
Net investment income	562	600	1,647	1,899
Other interest income, net	7	309	53	919
Net realized gain (loss)	13	51	2,480	(167)
Policy fees and other income	308	579	1,367	2,308
Total revenues	24,140	14,288	52,763	44,044
Expenses:				
Losses and loss adjustment expenses	10,978	1,260	15,164	6,286
Policy acquisition costs	7,189	5,816	18,600	17,448
Interest expense	4	168	164	597
Other operating costs and expenses	4,230	5,984	13,547	16,584
Special items	0	(156)	0	(156)
Total expenses	22,401	13,072	47,475	40,759
Income from operations, before (benefit) provision for income taxes	1,739	1,216	5,288	3,285
(Benefit) provision for income taxes	(30)	30	(30)	30
Net income	1,769	1,186	5,318	3,255
Other comprehensive income:				
Change in value of marketable securities, less reclassification adjustments of $13 and $51 for gains included in net income for the three months ended September 30, 2002 and 2001, respectively, and $68 and $51 for gains included in net income for the nine months ended September 30, 2002 and 2001, respectively	744	750	776	1,208
Comprehensive net income	$ 2,513	$ 1,936	$ 6,094	$ 4,463
Basic earnings per share	$ 0.21	$ 0.15	$ 0.64	$ 0.40
Weighted average shares outstanding	7,832	7,832	7,832	7,832
Diluted earnings per share	$ 0.21	$ 0.14	$ 0.62	$ 0.40
Weighted average shares outstanding	8,028	8,233	8,164	8,204

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THE SEIBELS BRUCE GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30,
(Amounts shown in thousands)
(Unaudited)

	2002	2001
Cash flows from operating activities:		
Net income	$ 5,318	$ 3,255
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in loss of unconsolidated subsidiaries	206	519
Provision for (recovery of) losses on premiums and agents balances receivable, net	138	(811)
Recovery of losses on premium notes receivable	(745)	(301)
Amortization of deferred policy acquisition costs	18,600	17,448
Depreciation and amortization	391	378
Realized gain on settlement of life insurance policy	(294)	0
Realized gain on sale of previously nonmarketable equity security	(2,117)	0
Realized gain on sale of investments, net	(68)	(51)
Realized loss on sale of property and equipment, net	0	218
Change in assets and liabilities:		
Accrued investment income	167	185
Premiums and agents balances receivable	(1,017)	886
Premium notes receivable	4,385	(1,898)
Reinsurance recoverable on losses and loss adjustment expenses	6,966	7,749
Prepaid reinsurance premiums-ceded business	1,548	2,387
Deferred policy acquisition costs	(18,925)	(17,448)
Unpaid losses and loss adjustment expenses	(1,852)	(12,958)
Unearned premiums	(432)	(1,004)
Balances due other insurance companies	2,260	(651)
Accrued restructuring charges	0	(276)
Other, net	(9,708)	3,271
Net cash provided by operating activities	4,821	898
Cash flows from investing activities:		
Proceeds from investments sold or matured	10,503	7,056
Cost of investments acquired	(12,849)	(10,385)
Proceeds from property and equipment sold, net	0	2
Purchases of property and equipment	(655)	(78)
Net cash used in investing activities	(3,001)	(3,405)
Cash flows from financing activities:		
Issuance of Adjustable Rate Cumulative Nonvoting Preferred Special Stock	8,000	0

Redemption of Special Stock	(2,590)	0
Repayment of debt	(7,721)	(1,829)
Dividends paid	(323)	(121)
Net cash used in financing activities	(2,634)	(1,950)
Net decrease in cash and short-term investments	(814)	(4,457)
Cash and short-term investments, January 1	6,375	10,410
Cash and short-term investments, September 30	$ 5,561	$ 5,953
Supplemental cash flow information:		
Interest paid	$ 164	$ 597
Income taxes (recovered) paid	$ (30)	$ 30

THE SEIBELS BRUCE GROUP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars shown in thousands except per share amounts)
(Unaudited)

NOTE 1. GENERAL

Basis of Presentation and Principles of Consolidation

The accompanying consolidated financial statements include the accounts of The Seibels Bruce Group, Inc. (the Company) and its wholly-owned subsidiaries and have been prepared, without audit, in conformity with accounting principles generally accepted in the United States (GAAP) pursuant to the rules and regulations of the Securities and Exchange Commission. All significant intercompany balances and transactions have been eliminated in consolidation and, in the opinion of management, all normal and recurring adjustments necessary for the fair presentation of the Company s unaudited interim financial position, results of operations and cash flows have been recorded. These financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company s annual report on Form 10-K for the year ended December 31, 2001 filed with the Securities and Exchange Commission. The results of operations for the interim periods are not necessarily indicative of the results for a full year.

Description of the Business

The Company provides automobile, commercial, flood and other property and casualty insurance services and products to customers located primarily in the southeastern United States. In this capacity, the Company s primary sources of revenue include premiums earned from its risk-bearing property and casualty insurance operations as well as commission and service income from its fee-based products and services, both of which are summarized as follows:

<u>Risk-Bearing Property and Casualty Insurance Operations:</u>

<u>Nonstandard Automobile</u>

The Company s North Carolina domiciled insurance subsidiary, Universal Insurance Company (UIC), provides nonstandard automobile insurance coverage to insureds located primarily in the state of North Carolina. In this capacity, UIC retains the risk of loss for the physical damage coverage components of the policy and cedes substantially all of the liability coverage components of the policy to the North Carolina Reinsurance Facility (NC Facility). Approximately 16.9% and 30.9% of the Company s premiums earned for the nine months ended September 30, 2002 and 2001, respectively, and approximately 11.6% and 29.8% of the Company s premiums earned for the three months ended September 30, 2002 and 2001, respectively, was earned by UIC.

Through its nonowners automobile program, Catawba Insurance Company (Catawba) provides supplemental automobile insurance coverage policies in South Carolina to employee drivers of company owned, operated and insured vehicles. Approximately 2.9% and 7.4% of the Company s premiums earned for the nine months ended September 30, 2002 and 2001, respectively, and approximately 1.3% and 7.9% of the Company s premiums earned for the three months ended September 30, 2002 and 2001, respectively, was earned through the nonowners automobile program.

Commercial Lines

South Carolina Insurance Company (SCIC) and Catawba offer various commercial lines insurance products to its insureds, including commercial automobile, commercial package, business owners policies and garage liability policies. This business is written in the states of South Carolina, North Carolina, Tenneessee, Georgia and Kentucky. Approximately 33.6% and 47.5% of the Company s premiums earned for the nine months ended September 30, 2002 and 2001, respectively, and approximately 17.1% and 60.2% of the Company s premiums earned for the three months ended September 30, 2002 and 2001, respectively, was earned through its commercial lines operations.

Workers Compensation

Effective January 1, 2002, SCIC and Consolidated American Insurance Company (CAIC) issued workers compensation insurance master policies to a professional employment organization headquartered in Mesa, Arizona to provide workers compensation insurance for that organization s client companies located in California (SCIC) and Arizona (CAIC). The program was intended to be a fronting program administered by the professional employment organization, with minimal underwriting risk to SCIC and CAIC due to the anticipated placement of multiple layers of reinsurance coverage. As described more fully in HDC *Workers Compensation Program*, the program was the subject of litigation and mediation during 2002. Premiums written and earned through this program amounted to 46.1% and 69.9% of total premiums earned for the nine and three months ended September 30, 2002, respectively, none of which was recorded until September 2002 because sufficient information, including premium information and information necessary to estimate incurred losses, was not available until that time.

On August 21, 2002, the South Carolina Department of Insurance (SCDOI) issued an Order Imposing Administrative Supervision and Appointing Supervisor (the Order). The Order placed three of the Company s insurance subsidiaries, SCIC, Catawba and CAIC, under administrative supervision for at least six months. Provisions of the Order provided for SCIC, CAIC and Catawba to immediately cease

writing risk-bearing business (except the National Flood Insurance Program (NFIP)) and for SCIC and CAIC to immediately cease renewal of existing risk-bearing business.

On August 23, 2002, Catawba submitted to the SCDOI a request to permit Catawba (1) to continue to write its existing risk-bearing business and (2) to renew, in all states in which Catawba is also licensed, the risk-bearing commercial lines business previously written through SCIC. On September 4, 2002, the SCDOI notified Catawba that this request had been approved (the Approval). The Approval permits Catawba to continue to write its existing risk-bearing business and allows Catawba to renew the risk-bearing commercial lines business previously written through SCIC in the states of South Carolina, Georgia and Tennessee. Management of SCIC and its affiliate, UIC, have petitioned the North Carolina Department of Insurance (NCDOI) to allow UIC to renew SCIC s risk-bearing commercial lines business in the state of North Carolina. The only other state in which SCIC wrote risk-bearing commercial lines business is Kentucky. Catawba has submitted an application to write this business in Kentucky. Until these applications are approved the business in North Carolina and Kentucky is being runoff.

Fee-Based Property and Casualty Insurance Operations:

NC Facility

The NC Facility is a state-sponsored plan for insuring North Carolina drivers outside of the voluntary market. Two of the Company s insurance subsidiaries, SCIC and UIC, derive commission and service income from business they cede to the NC Facility but neither retains any underwriting risk. Approximately 18.8% and 20.1% of the Company s commission and service income for the nine months ended September 30, 2002 and 2001, respectively, and approximately 15.9% and 18.6% of the Company s commission and service income for the three months ended September 30, 2002 and 2001, respectively, was earned from the NC Facility.

South Carolina Reinsurance Facility (SC Facility)

Catawba is one of three servicing carriers for the SC Facility, a state-sponsored plan for insuring South Carolina drivers outside of the voluntary market. In its capacity as a servicing carrier, Catawba receives commission and service income from the SC Facility but retains no underwriting risk. The SC Facility began its planned runoff effective March 1, 1999, at which time no new business was accepted into the SC Facility. Effective October 1, 1999, voluntary renewals were no longer accepted by the SC Facility. However, servicing carriers were able to cede renewal business to the SC Facility until March 1, 2002, at which time final runoff of the SC Facility commenced. Approximately 5.0% and 13.3% of the Company s commission and service income for the nine months ended September 30, 2002 and 2001, respectively, and approximately 2.9% and 10.8% of the Company s commission and service income for the three months ended September 30, 2002 and 2001, respectively, was earned from the SC Facility. The South Carolina Associated Auto Insurers Plan (SCAAIP) became effective in March 1999 and will survive the SC Facility. The SCAAIP offers the Company access to additional fee-based revenue with no underwriting risk. However, thus far into the runoff of the SC Facility, the Company has not experienced significant activity in the SCAAIP.

National Flood Insurance Program (NFIP)

Through its subsidiaries, SCIC and Catawba, the Company participates in the NFIP, a flood insurance program administered by the federal government. In this capacity, the Company receives commissions and fees from the NFIP, but retains no underwriting risk. Approximately 47.0% and 40.5% of the Company s commission and service income for the nine months ended September 30, 2002 and 2001, respectively, and approximately 47.5% and 43.7% of the Company s commission and service income for the three months ended September 30, 2002 and 2001, respectively, was earned from the NFIP.

On September 12, 2002, the Company announced that it had received notice from the Federal Emergency Management Agency (FEMA) that FEMA did not intend to offer the Company a Financial Assistance/Subsidy Arrangement with the Federal Insurance and Mitigation Administration for the fiscal year beginning October 1, 2002, effectively terminating the Company s participation in the NFIP. Though the Company s numerous efforts to change FEMA s decision were unsuccessful, it was able to obtain an extension of the existing arrangement for renewal business only through December 31, 2002, at which time the inforce policies must be transitioned to the NFIP, or to another carrier in the NFIP, and the Company s servicing carrier status will be terminated.

Claims Adjusting and Management Services

The Company receives fee-based income from its catastrophe, property and casualty and automobile claims adjusting services and liability runoff management services. The Company s premium concentration in the catastrophe-heavy Southeast led to the creation of a catastrophe adjusting business, Insurance Network Services, Inc. (INS), to manage the Company s internal claims volume. Currently, INS is a full service claims organization offering an array of capabilities to the insurance industry, including all-lines claim handling, automobile appraisals, catastrophe claim adjusting and glass claim services. Approximately 12.6% and 10.4% of the Company s commission and service income for the nine months ended September 30, 2002 and 2001, respectively, and approximately 11.8% and

10.4% of the Company s commission and service income for the three months ended September 30, 2002 and 2001, respectively, was earned from INS largest customer, QualSure Insurance Corporation (see Note 2).

Flood Zone Determinations and Compliance Tracking Services

Through its subsidiary, America s Flood Services, Inc. (AFS), located in Rancho Cordova, California, the Company offers fee-based flood zone determinations and compliance tracking services to a variety of customers and institutions located throughout the United States. The operations of AFS are not dependent upon any single customer or class of customers.

Managing General Agency Services

Effective July 1, 2002, one of the Company s subsidiaries, Seibels, Bruce & Company (SBC), entered into an agreement with a Florida domiciled insurance company to serve as managing general agent for that company s low-value dwelling homeowners insurance program in the state of Florida until such time as that program is runoff or rolled to the insurance operations of another carrier. Under either scenario, the Company does not expect to recognize significant revenue related to the agreement after 2002. In its capacity as managing general agent, SBC is responsible for policy issuance and administration, customer service and claims administration. SBC s claims administration responsibilities are fulfilled through a Claims Administration Services Agreement with INS for a fee based upon subject written premium. SBC earned commission and service income amounting to 2.7% and 7.6% of total commission and service income for the nine and three months ended September 30, 2002, respectively, from this managing general agency agreement.

HDC Workers Compensation Program

Effective January 1, 2002, SCIC and CAIC issued two workers compensation insurance master policies to Human Dynamics Corporation (HDC) and included as named insureds, Infinet Holdings, Inc. (Infinet) and HDC Financial Services Corporation (HDC Financial and together with HDC and Infinet, collectively, the HDC Group). The HDC Group is a professional employment organization. SCIC and CAIC did not obtain the approval of the SCDOI prior to issuing the master policies and were subsequently ordered by the SCDOI to cancel them. Litigation was initiated in the Superior Court of the State of Arizona on March 25, 2002 by the HDC Group against SCIC and CAIC alleging that they issued two workers compensation insurance master policies to the HDC Group and subsequently cancelled them in violation of Arizona law. On July 9, 2002, an Arizona Superior Court Judge ruled that the policies are in effect from January 1, 2002 through December 31, 2002.

In September 2002, SCIC, CAIC and the HDC Group mediated several outstanding issues which resulted in an Interim Agreement between the parties that was approved by the Arizona Superior Court in October 2002. In accordance with the court-approved Interim Agreement, the HDC Group is responsible for funding all losses of the HDC 2002 workers compensation program (HDC Program). Reinsurance coverage for the HDC Program was obtained on October 21, 2002 effective for losses incurred between January 1, 2002 and December 31, 2002 and amounting to $15,000 in excess of $5,000 per occurrence. SCIC and CAIC, upon receiving approval from the SCDOI, elected to retain the risk for losses amounting to $4,000 in excess of $1,000 per occurrence for premiums prescribed in the court-approved Interim Agreement. In addition, SCIC and CAIC are to receive fronting fees equal to 4% of collected premium under the HDC Program as well as reimbursement for actual boards, bureaus, assessments and premium taxes incurred for the insurance policies. All premiums not remitted to the reinsurers or to SCIC and CAIC are retained by the HDC Group and are the primary source of funding for the losses of the HDC Program. To facilitate claims administration and payment, the court-approved Interim Agreement requires the HDC Group to fund two escrow accounts in amounts determined pursuant to the terms of the court-approved Interim Agreement. SCIC, CAIC and the HDC Group are all considered secured creditors with respect to funds held in the escrow accounts. SCIC and CAIC have secured creditor status in both escrow accounts with respect to the amount of funds necessary to pay claims and loss adjustment expenses for the HDC Program. The HDC Group has secured creditor status for funds in both escrow accounts that are in excess of the amount necessary to pay claims and loss adjustment expenses relating to the HDC Program.

Premiums and losses of the HDC Program are recorded on the books of SCIC and CAIC as direct insurance activity and ceded as applicable to reinsurers. SCIC and CAIC, in consultation with their consulting actuary, have established reserves for estimated unpaid losses and loss adjustment expenses, including estimates of incurred but not reported claims and related reinsurance recoverables. A summary of the results of operations of the HDC Program, excluding administrative expenses, for the nine months ended

September 30, 2002 is as follows:

Direct earned premium	$	10,046
Ceded earned premium		483
Net earned premium		9,563
Direct incurred losses and loss adjusting expenses		8,885
Ceded incurred losses and loss adjusting expenses		483
Net incurred losses and loss adjusting expenses		8,402
Excess of earned premium over losses and loss adjusting expenses		1,161
Estimated boards, bureaus, assessments and premium taxes		759
Net results, representing fronting fees	$	402

HDC Program premiums not remitted to the reinsurers or to SCIC and CAIC, but rather retained by the HDC Group pursuant to the court-approved Interim Agreement amounted to $7,742 for the nine months ended September 30, 2002. SCIC and CAIC have included in Other Assets in the accompanying balance sheets at September 30, 2002, $7,742 (Asset for Prefunded Losses) which SCIC and CAIC, in consultation with their consulting actuary, have determined to be an appropriate estimate of the ultimate incurred losses to be funded by HDC for the layer of loss representing the first $1,000 per occurrence. In making this estimate, assumptions used are consistent with those used in establishing reserves for estimated unpaid losses and loss adjustment expenses. At September 30, 2002, this asset is uncollateralized, given that neither of the associated escrow accounts had yet been funded. SCIC and CAIC will monitor the asset for impairment and if any amounts are estimated to be unrealizable, such as due to the HDC Group s inability to fund losses as required by the court-approved Interim Agreement, an appropriate provision will be made. At September 30, 2002, management does not believe that any provision for impairment is required.

Except for the layer of losses retained by SCIC and CAIC ($4,000 in excess of $1,000 per occurrence), changes in the estimated liability for losses and loss adjustment expenses for the HDC Program are not expected to have a net impact on SCIC and CAIC results of operations. The estimated Asset for Prefunded Losses related to the first $1,000 per occurrence, and reinsurance recoverable related to $15,000 in excess of $5,000 per occurrence, are expected to vary by the same amount as any change in the estimated reserves for losses and loss adjustment expenses in those layers, offsetting any impact on operations. Due to limited historical loss experience for the population of insureds participating in the HDC program, estimates of the liability for losses and loss adjustment expenses and the related Asset for Prefunded Losses and reinsurance recoverable may vary significantly from amounts recorded at September 30, 2002.

Fair Value of Financial Instruments

Investments in debt securities are classified as either held-to-maturity, available-for-sale or trading. The Company currently holds all securities as available-for-sale, and reports them at fair value, with subsequent changes in value reflected as unrealized investment gains and losses credited or charged directly to accumulated other comprehensive income included in shareholders equity. The fair values of debt securities were determined from nationally quoted market rates. The fair value of certain municipal bonds is assumed to be equal to amortized cost where no market quotations exist.

The fair values of the Company s cash and short-term investments approximate carrying values due to the short-term nature of those instruments.

Premiums and agents balances receivable and premium notes receivable are carried at historical cost, net of an estimated allowance for doubtful accounts, which approximates fair value as a result of timely collections and evaluations of recoverability with a provision for uncollectable amounts. Premium notes receivable are generally short-term in nature, with a duration of approximately six months.

Cash and Short-term Investments

Cash and short-term investments consists of cash on hand, time deposits and commercial paper. Short-term investments have an original maturity of three months or less and are considered to be cash equivalents.

Premium Notes Receivable

One of the Company s subsidiaries, Premium Budget Plan, Inc. (PBP), has historically offered premium financing arrangements to the insureds of UIC. Under these arrangements, UIC received full payment of its premiums receivable from PBP who, in turn, collected a down payment from the insureds and financed the remaining premium balance over a six month term. PBP received interest income from insureds on premiums it financed, as well as a variety of set-up and maintenance fees associated with the related premium finance contracts. Beginning in December 2001, UIC initiated an installment billing program for its insureds as an alternative to PBP s premium financing arrangements and PBP began runoff.

Allowance for Uncollectable Accounts

The Company routinely evaluates the collectability of receivables and has established an allowance for uncollectable accounts for agents balances and direct billed balances receivable and premium notes receivable in the amount of approximately $3,156 and $3,763 at September 30, 2002 and December 31, 2001, respectively. At the time PBP was placed into runoff, management established substantial additional reserves for uncollectable premium notes receivable based upon its historical experience with PBP s operations, its business environment and the fact that the business was moving into runoff. However, as a result of significant receivables monitoring and collections efforts by both the Company s internal collections department and the unaffiliated management company, PBP s actual and final bad debt exposure was substantially less than historically experienced or expected. Therefore, for the three and nine months ended September 30, 2002, PBP s allowance for uncollectable premium notes receivable was reduced by approximately $107 and $440 through a credit to earnings.

Property and Equipment

Property and equipment is stated at cost and, for financial reporting purposes, depreciated on a straight-line basis over the estimated useful lives of the assets. For income tax purposes, accelerated depreciation methods are used. Maintenance and repairs costs are charged to expense as incurred.

Key Man Life Insurance Policies

The Company is the beneficiary of several key man life insurance policies maintained on certain former directors or officers of the Company. During the three months ended June 30, 2002, the Company recorded a gain on the settlement of one of these policies of $294. As of September 30, 2002 and December 31, 2001, the net cash value of the paid up in force policies was $311 and $851, respectively, and is included in other assets.

Property and Casualty Unpaid Losses and Loss Adjustment Expenses

The liability for property and casualty unpaid losses and loss adjustment expenses (LAE) includes:

- An accumulation of case estimates for losses reported prior to the close of the accounting period.

Estimates of incurred-but-not-reported losses, including a supplemental provision for reported claims, based upon past experience and current circumstances.

Estimates of allocated, as well as unallocated, LAE liabilities determined by applying percentage factors to the unpaid loss reserves, with such factors determined on a by-line basis based on past results of paid loss expenses to paid losses.

The deduction of estimated amounts recoverable from salvage, subrogation and second injury funds.

Estimated losses for reinsurance assumed.

Management performs a complete review of the above components of the Company s reserves to evaluate the adequacy of such reserves. Management believes the reserves are adequate but not excessive; however, establishing reserves is an estimation process and significant changes in such estimates may occur and would be recorded in the period so determined.

Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. This method also requires the recognition of future tax benefits such as net operating loss carryforwards to the extent that realization of such benefits is more likely than not. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

As of December 31, 2001, the Company had unused tax operating loss carryforwards and capital loss carryforwards of $103,921 for income tax purposes. However, due to change in ownership events that occurred in June 1998, January 1997, and January 1995, the Company s use of the net operating loss carryforwards is subject to maximum limitations in future years of approximately $2,200 per year. Net operating loss carryforwards available for use in 2002 are approximately $12,177 due to losses incurred in 1998, 1999 and 2000 after the change in ownership events occurred and carryover of previous years unused limitations.

The Company has determined, based on its earnings history, that a valuation allowance should be maintained against the entire net deferred

tax asset at September 30, 2002 and December 31, 2001.

Commission and Service Income and Policy Fees

Commission and service income is predominately derived from servicing carrier, managing general agent and claims processing activities. The commission income related to producing and underwriting the business is recognized in the period in which the business is written. Service income and fees related to claims processing are recognized on an accrual basis as earned.

Property and Casualty Premiums

Property and casualty premiums are reflected in income when earned as computed on a monthly pro-rata basis. Written premiums and earned premiums have been reduced by reinsurance placed with other companies, including amounts related to business produced through the NFIP, the NC Facility and the SC Facility.

Other Interest Income

Other interest income includes interest received on reinsurance balances withheld, agents balances receivable, balances due from the SC Facility and the SCAAIP, and financing of premium notes receivable. Other interest income is recognized on an accrual basis as earned.

Policy Acquisition Costs

Policy acquisition costs attributable to property and casualty operations represent that portion of the cost of writing business that varies with, and is primarily related to, the production of business. Such costs are deferred and charged against income as the premiums are earned. The deferral of policy acquisition costs is subject to the application of recoverability tests to each primary line or source of business based on past and anticipated underwriting results. The deferred policy acquisition costs that are not recoverable from future policy revenues, if any, are expensed. The Company considers anticipated investment income in determining whether premium deficiencies exist.

Management Compensation Program

During 2001, the Compensation Committee of the Company s Board of Directors recommended, and the Board of Directors approved, the adoption of an incentive compensation program covering certain members of management. Awards under the plan were payable each March and were based upon the Company s performance during the prior year ended December 31. The provisions of the plan required recipients to achieve a designated market value based ownership level in the Company to be eligible to participate in the plan. The Company had accrued $526 and

$852 for its obligations under the plan at June 30, 2002 and December 31, 2001, respectively. As a result of the events and activities occurring during the third quarter of 2002, management estimated that no amounts would be paid under the plan related to the operations of 2002. Accordingly, the Company reversed the entire accrued liability of $526 in September 2002 through a credit to earnings. On October 3, 2002, the Plan was terminated by the Company s Board of Directors.

Comprehensive Income

Comprehensive income is a measure of all non-owner changes in equity of an entity and includes net income plus changes in certain assets and liabilities that are reported directly through equity.

Earnings Per Share

In accordance with SFAS No. 128, Earnings Per Share, the Company measures earnings per share at two levels: basic earnings per share and diluted earnings per share. Basic per share data is calculated by dividing income allocable to common stockholders by the weighted average number of shares outstanding during the year. Diluted per share data is calculated by dividing income allocable to common stockholders by the weighted average number of shares outstanding during the year, as adjusted for the potentially dilutive effects of stock options, warrants and/or convertible preferred stock, unless the common equivalent shares are antidilutive.

Use of Estimates in Preparation of Financial Statements

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates, although, in the opinion of the management, such differences would not be significant.

Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated or completed after June 30, 2001. SFAS No. 141 also specifies criteria for intangible assets acquired in a business combination to be recognized and reported apart from goodwill. SFAS No. 142 establishes accounting and reporting standards for acquired

goodwill and other intangible assets and supersedes APB Opinion No. 17, Intangible Assets. It requires an entity to separate its goodwill, intangible assets with definite useful lives and intangible assets with indefinite useful lives. Goodwill and intangible assets with indefinite useful lives are no longer subject to periodic amortization. Rather they are subject to impairment tests that are required to be performed on at least an annual basis. At September 30, 2002 and December 31, 2001, the Company had unamortized goodwill totaling $4,513 associated with its November 1997 and March 1998 purchases of The Innovative Company (former 100% owner of UIC and PBP) and AFS, respectively. Annual amortization of goodwill, which ceased to be recorded effective January 1, 2002 upon the adoption of SFAS No. 142, was $125. The Company did not incur impairment to either component of the goodwill as a result of adopting SFAS No. 142 and the Company has no other material intangible assets falling under the scope of the statement.

In June 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS No. 143 requires the recognition, as a component of asset cost, of the fair value of a liability for an asset retirement obligation in the period in which it is incurred if a reasonable estimate of fair value can be made. Under this statement, the liability is discounted and accretion expense is recognized using the credit-adjusted risk-free interest rate in affect when the liability was initially recognized. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002. The Company is in the process of evaluating the impact that the adoption of SFAS No. 143 will have on its consolidated financial position and results of operations.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This statement supersedes FASB statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of and the accounting and reporting provisions of APB Opinion No. 30, Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001. SFAS No. 144 changes the criteria for classifying an asset as held-for-sale. The standard also broadens the scope of businesses to be disposed of that qualify for reporting as discontinued operations, and changes the timing of recognizing losses on such operations. Adoption of SFAS No. 144 had no material impact on the Company s consolidated financial position or results of operations.

In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44, and 62, Amendment of FASB Statement No. 13, and Technical Corrections. This statement will require gains and losses on extinguishments of debt for fiscal years beginning after May 15, 2002 to be classified as income or loss from continuing operations rather than as extraordinary items as previously required. The Company is in the process of evaluating the impact that the adoption of SFAS No. 145 will have on its consolidated financial position and results of operations.

In July 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. This statement addresses financial accounting and reporting for costs associated with exit or disposal activities. SFAS No. 146 is effective for exit or disposal activities that are initiated after December 31, 2002. The Company is in the process of evaluating the impact that the adoption of SFAS No. 146 will have on its consolidated financial position and results of operations.

NOTE 2. INVESTMENTS

The Company s investments in debt securities are considered available-for-sale securities and carried at fair value at September 30, 2002 and December 31, 2001. Unrealized gains and losses on debt securities are credited or charged directly to accumulated other comprehensive income and included in shareholders equity.

The Company s equity securities consist of its investments in Sunshine State Holding Corporation (Sunshine) and QualSure Holding Corporation (QualSure). During the fourth quarter of 1997, the Company invested $854 in Sunshine for an ownership interest of 21.49%. Sunshine owns 100% of the issued and outstanding stock of Sunshine State Insurance Company, a Florida-based writer of homeowners insurance. Effective January 21, 2000, three of the Company s insurance subsidiaries collectively acquired a 30.625% equity ownership interest in QualSure for $4,900. QualSure is the holding company parent of QualSure Insurance Corporation, a homeowners take-out insurance company domiciled in the State of Florida. In connection with this investment, the Company s claims adjusting and management services subsidiary, INS, entered into a Claims Administration Services Agreement with QualSure Insurance Corporation to adjudicate all of its claims for a fee based upon subject earned premium. As each of these investments exceeds 20% of the equity of each respective company, the Company s equity in the undistributed earnings of the unconsolidated affiliates, using the equity method, are included in current earnings.

Effective October 3, 2002, the Company s ownership interest in QualSure with a carrying value of $4,144 was redeemed by QualSure for $4,775. Under the terms of the redemption, INS will continue to provide claim administration services to QualSure Insurance Corporation under an exclusive contract at a reduced rate. Additionally, the litigation that was initiated in the United States District Court for the Middle District of Florida, Tampa Division in November 2001 by QualSure against SCIC, Catawba and CAIC as well as the resulting litigation by SCIC, Catawba and CAIC against QualSure was dismissed with prejudice on October 17, 2002.

At December 31, 2001, the Company owned 32,676 shares of common stock of Insurance Services Offices, Inc. (ISO) which it had received in 1997 as a result of ISO converting from a mutual organization to a stock company. Since the equity security received in connection with the conversion was not marketable, the Company had historically valued the investment at cost ($0). In February 2002, ISO offered, and the Company accepted, to repurchase the Company s shares for a price of $64.80 per share, resulting in a realized investment gain of $2,117.

Short-term investments are carried at cost, which approximates fair value.

NOTE 3. REINSURANCE ARRANGEMENTS

From December 31, 1999 until July 1, 2002, UIC operated under a 75% quota share reinsurance agreement for its risk-bearing nonstandard automobile operations. Effective July 1, 2002, the 75% quota share reinsurance agreement expired and was replaced with a 60% quota share reinsurance agreement.

Effective June 30, 1999 and continuing through June 30, 2000, SCIC operated under a 90% quota share reinsurance agreement for its risk-bearing commercial lines operations. This agreement was amended to become a 70% quota share reinsurance agreement effective April 1, 2000, and the amended agreement was terminated at the Company s request effective April 1, 2001. The Company s commercial lines business is now reinsured through facultative, excess of loss, catastrophe and umbrella reinsurance.

Reinsurance coverage for the HDC Program was obtained on October 21, 2002 effective for losses incurred between January 1, 2002 and December 31, 2002 and amounting to $15,000 in excess of $5,000 per occurrence.

Reinsurance contracts do not relieve the Company of its obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to the Company. The Company evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvency.

The Company issues a substantial number of automobile and flood insurance policies for, and fully reinsures those risks with, the SC Facility, the NC Facility and the NFIP. While the amount of reinsurance recoverable under these arrangements is significant, the Company believes the balances due from the SC Facility, the NC Facility and the NFIP are fully collectable due to each governmental agency s ability to assess policyholders and member companies for funding deficiencies.

NOTE 4. DEFERRED POLICY ACQUISITION COSTS

Policy acquisition costs incurred and amortized to income on property and casualty business for the nine months ended September 30, 2002 and 2001 were as follows:

	2002	2001
Deferred at the beginning of the period	$ 1,200	$ 400
Costs incurred and deferred during year:		
Commissions and brokerage	12,829	13,086
Taxes, licenses and fees	3,503	2,617
Other	2,593	1,745
Total	18,925	17,448
Amortization charged to income during the period	(18,600)	(17,448)
Deferred at the end of the period	$ 1,525	$ 400

NOTE 5. PROPERTY AND CASUALTY UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSE

Activity in the liability for unpaid losses and LAE for the nine months ended September 30, 2002 and 2001 is summarized as follows:

	2002	2001
Liability at the beginning of the period:		
Gross liability per balance sheet	$ 66,875	$ 85,833
Ceded reinsurance recoverable, classified as an asset	(40,832)	(50,012)
Net liability	26,043	35,821
Provision for claims occurring in the current year	14,871	6,477
Increase (decrease) in estimated losses and LAE for claims occurring in prior years	293	(191)
	15,164	6,286
Losses and LAE payments for claims occurring during:		
Current year		