PROFESSIONALS DIRECT INC
Form 10QSB
May 13, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-QSB

(MARK ONE)
[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2005

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from __________ to __________

Commission File Number: **000-49786**

PROFESSIONALS DIRECT, INC.
(Exact Name of Small Business Issuer as Specified in its Charter)

Michigan (State or Other Jurisdiction of Incorporation or Organization)	**38-3324634** (I.R.S. Employer Identification No.)
161 Ottawa Ave., N.W., Suite 607 **Grand Rapids, Michigan 49503** (Address of Principal Executive Offices)	**(616) 456-8899** (Issuer's Telephone Number, Including Area Code)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 __X__ No____

There were 333,500 shares of Common Stock outstanding as of April 30, 2005.

Transitional Small Business Disclosure Format (check one): Yes ____ No__X__.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

PROFESSIONALS DIRECT, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEET
(Unaudited)

March 31,		**2005**
		(000)
Assets		
Fixed maturities held to maturity, at amortized cost	$	**803**
Fixed maturities available for sale, at fair value		**32,354**
Other invested asset, at cost which approximates fair value		**268**
Total investments		**33,425**
Cash and cash equivalents		**6,089**
Receivables:		
Amounts due from reinsurers		**13,134**
Other		**1,696**
Prepaid reinsurance premiums		**4,066**
Deferred acquisition costs		**1,443**
Net deferred federal income taxes		**1,612**
Other assets		**1,785**
		29,825
Total Assets	$	**63,250**
Liabilities and Shareholders' Equity		
Liabilities		
Loss and loss adjustment expense reserves	$	**30,571**
Unearned premiums		**11,209**
Amounts due to reinsurers		**1,951**
Lines of credit		**2,200**
Other liabilities		**1,736**
Accrued interest		**1,553**
Surplus certificates		**2,531**
Trust preferred securities		**2,000**
Total Liabilities		**53,751**

Shareholders' Equity		
Preferred stock, no par (500,000 shares authorized, no shares issued)		-
Common stock, no par (5,000,000 shares authorized, 333,500 shares issued and outstanding)		**3,206**
Retained earnings		**6,721**
Accumulated other comprehensive loss		**(428)**
Total Shareholders' Equity		**9,499**
Total Liabilities and Shareholders' Equity	$	**63,250**

See accompanying notes to condensed consolidated financial statements.

PROFESSIONALS DIRECT, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (LOSS)
AND COMPREHENSIVE INCOME (LOSS)
(Unaudited)

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
	(000)	(000)
Revenues		
Net premiums earned	**$ 3,703**	$ 4,547
Fees and commissions earned	**39**	129
Net investment income	**239**	198
Finance and other income earned	**35**	42
Total revenues	**4,016**	4,916
Expenses		
Losses and loss adjustment expenses	**3,937**	2,287
Operating and administrative	**854**	1,547
Interest	**110**	118
Total expenses	**4,901**	3,952
Income (loss) before federal income taxes (benefit)	**(885)**	964
Federal Income Taxes (Benefit)	**(307)**	328
Net income (loss)	**(578)**	636
Other Comprehensive Income (Loss) (Net of tax (benefit) of $(109) and $118, respectively)	**(211)**	230
Comprehensive income (loss)	**$ (789)**	**$ 866**
Per share of common stock (not in thousands):		
Basic and diluted net income (loss) per share	**$ (1.73)**	$ 1.91
Basic and diluted comprehensive income (loss) per share	**(2.37)**	2.60

See accompanying notes to condensed consolidated financial statements.

PROFESSIONALS DIRECT, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended March 31, 2005	2004
	(000)	(000)
Operating Activities		
Net income (loss)	**$ (578)**	$ 636
Adjustments to reconcile net income to net cash from operating activities:		
Deferred federal income taxes	**(65)**	(166)
Depreciation and amortization	**232**	248
Changes in operating assets and liabilities:		
Amounts due from reinsurers	**(6,855)**	(112)
Other receivables	**157**	(281)
Prepaid reinsurance premiums	**97**	(1,215)
Deferred acquisition costs	**(28)**	79
Other assets	**(380)**	(33)
Loss and loss adjustment expense reserves	**9,523**	1,027
Amounts due to reinsurers	**(85)**	1,896
Unearned premiums	**471**	(55)
Other liabilities	**(37)**	600
Accrued interest	**33**	40
Net cash from operating activities	**2,485**	2,664
Investing Activities		
Cost of fixed maturities acquired	**(1,708)**	(3,909)
Proceeds from sales or maturities of fixed maturities	**1,257**	262
Cost of property and equipment acquired	**(32)**	(13)
Net cash for investing activities	**(483)**	(3,660)
Financing Activities		
Net repayments under lines of credit	**(307)**	(130)
Net cash for financing activities	**(307)**	(130)
Net Increase (Decrease) in Cash and Cash Equivalents	**1,695**	(1,126)
Cash and Cash Equivalents, beginning of period	**4,394**	7,006

Cash and Cash Equivalents, end of period	**$**	**6,089**	$	5,880
Supplemental Disclosures of Cash Flow Information				
Federal income tax payments - net	**$**	-	$	312
Interest payments		**77**		78

See accompanying notes to condensed consolidated financial statements.

PROFESSIONALS DIRECT, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1.   Basis of Presentation

  The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries (Professionals Direct Insurance Company (PDIC), a property and casualty insurance company providing professional liability insurance to attorneys; Professionals Direct Employer Organization, Inc., an inactive Michigan professional employer organization; Professionals Direct Finance, Inc. (Finance), a premium finance company; Professionals Direct Insurance Services, Inc. (Services), a company providing underwriting, claims, accounting, information technology services and selling professionals liability and other insurance), plus Lawyers Direct Risk Purchasing Group which the Company controls.

  The condensed consolidated financial statements and notes as of and for the three months ended March 31, 2005 and 2004 are unaudited. The condensed consolidated financial statements reflect all adjustments (consisting of normal recurring accruals) that are, in the opinion of management, necessary for the fair presentation of the financial position, results of operations and cash flows for the interim periods. The results of operations for the interim periods should not be considered indicative of results to be expected for the full year.

  Certain amounts reported for the prior year have been reclassified to conform to the current year's presentation.

2.   Income (Loss) per Share

  Basic income (loss) per share is computed by dividing net income or loss by the weighted average number of shares of common stock outstanding for the period (333,500 for the three months ended March 31, 2005 and 2004). Diluted income per share is equal to basic income per share as there are no stock options or other dilutive instruments outstanding.

Item 2. Management's Discussion and Analysis or Plan of Operation

The following discussion and analysis should be read in conjunction with the condensed consolidated financial statements and the notes thereto included elsewhere in this report. The following discussion of our financial condition and results of operations contains certain forward-looking statements. A discussion of the limitations of forward-looking statements appears at the end of this section.

Introduction

Net premiums earned and operating and administrative expenses incurred decreased because cessions to reinsurers and ceding commissions increased effective January 1, 2004. Loss and loss adjustment expenses increased because of changes in prior years' loss estimates. The following table and discussion compares the financial results for 2005 and 2004:

	Three Months Ended March 31,			
	2005	**2004**	**Change**	**Percent Change**
	(in thousands of dollars, except for per share data)			
Revenues:				
Net premiums earned	$ 3,703	$ 4,547	$ (844)	(18.6%)
Fees and commissions earned	39	129	(90)	(69.8%)
Net investment income	239	198	41	20.7%
Finance and other income earned	35	42	(7)	(16.7%)
Total Revenues	4,016	4,916	(900)	(18.3%)
Expenses:				
Losses and loss adjustment expenses	3,937	2,287	1,650	72.1%
Operating and administrative	854	1,547	(693)	(44.8%)
Interest	110	118	(8)	(6.8%)
Total Expenses	4,901	3,952	949	24.0%
Income (loss) before federal income taxes (benefit)	(885)	964	(1,849)	(191.8%)
Federal income taxes (benefit)	(307)	328	(635)	(193.6%)
Net income (loss)	$ (578)	$ 636	$ (1,214)	(190.9%)
Selected Balance Sheet Data: (at end of period)				
Total investments and cash	$ 39,514	$ 39,100	$ 414	1.1%
Total assets	63,250	50,604	12,646	25.0%
Total liabilities	53,751	39,876	13,875	34.8%
Total shareholders' equity	9,499	10,728	(1,229)	(11.5%)
Per Share Data:				
Net income (loss)	$ (1.73)	$ 1.91	$ (3.64)	(190.6%)
Shareholders' equity	$ 28.48	$ 32.17	$ (3.69)	(11.5%)

***Results of Operations (000 omitted)*:**

The following is a summary and analysis of the material revenue and expense components of our operational results for the first quarter of 2005.

  Net premiums earned. Net premiums earned are equal to direct premiums earned (premiums earned for policies written) less ceded premiums earned (amounts ceded to reinsurers). The decrease in net premiums earned resulted primarily from higher ceded premium earned.

The following is a summary of premiums written by PDIC:

	Three Months Ended March 31,			
	2005	**2004**	**Change**	**Percent Change**
	(in thousands of dollars)			
Direct premiums written	$ 6,450	$ 5,984	$ 466	7.8%
Net premiums written	4,270	3,277	993	30.3%

Direct premiums written increased 7.8% over the same period a year ago. PDIC's new business premium writings in the first quarter of 2005 increased $340 compared to the same period for 2004, accounting for 73% of the increase. The remainder of the increase is attributable to an overall increase in premium rates. Net premiums written are greater than a year ago as a result of a decrease in the amount of premium ceded under the 2005 reinsurance treaty and from the elimination of an additional ceded premium liability related to an older treaty.

  Fees and Commissions Earned. Fees and commissions originate from two primary sources. The first, membership fees, are earned by Lawyers Direct Risk Purchasing Group, an affiliate organized and managed by Services, as part of the Lawyers Direct® program for one to five person law firms. The second, commissions, are earned by Services from placing insurance with unrelated third parties. In the first quarter of 2005, fees and commissions earned were reduced by the reversal of contingent ceding commissions which resulted from the first quarter loss development. Absent this reversal, fee and commission income would have increased $23.

  Net Investment Income. Net investment income is comprised of interest on fixed maturity investments and realized investment gains and losses. The investment income increase of $41 or 20.7% in the first quarter of 2005 as compared to 2004 is largely attributable to an improvement in average yield.

  Finance and Other Income Earned. Finance income is generated from premium financing incidental to the sale of PDIC's insurance policies. Premium financing is offered to PDIC policyholders in Michigan and selected other states. A decrease in the outstanding balance of finance contracts caused premium finance income to decrease slightly in the first quarter of 2005 as compared to 2004.

  Losses and Loss Adjustment Expenses. The loss ratio is the sum of the losses and loss adjustment expenses incurred expressed as a percentage of net premiums earned. The loss ratio for the first quarter of 2005 was 106.3% compared to 50.3% for the same period in 2004. This increase resulted primarily from increases in the estimate of prior years' losses.

Overall profitability is materially influenced by the loss estimate of current year claims, plus the favorable or adverse development of prior years' reserves. During the first quarter of 2005, PDIC recorded losses and loss adjustment expenses of $3,937 of which $2,443 was for claims which were made and reported in the current year and $1,494 was for claims which were made and reported in years prior to 2005. During the first quarter of 2004, PDIC recorded losses and loss adjustment expenses of $2,287 of which $1,887 was for claims which were made and reported in 2004 and $400 was for claims which were made and reported in years prior to 2004. The increase in prior years' losses resulted from adjusting those years' loss ratios to reflect recent experience.

During the first quarter of 2005, loss severity significantly increased both direct and ceded loss reserves. These increases were the primary cause for the significant increases in total assets and total liabilities.

PDIC is required to maintain reserves for payment of losses and loss adjustment expenses for reported claims and for claims incurred but not reported, arising from policies that have been issued. PDIC provides for the ultimate cost of those claims without regard to how long it takes to settle them or the time value of money. The determination of reserves involves actuarial and statistical projections of what PDIC expects to be the cost of the ultimate settlement and administration of such claims based on facts and circumstances then known, estimates of future trends in claim severity, and other variable factors such as inflation and changing judicial theories of liability. As part of the process of establishing those estimates, the following should be noted:

(a)   Estimates of the loss reserve liability are reviewed by independent actuaries twice a year. Various methodologies are used to calculate the appropriate amount of the loss reserve liability that should be recorded each year.

(b)   In the years after a claim is reported, there is a significant amount of uncertainty over what the ultimate loss will be. Therefore, estimating the loss reserve liability for claims recently reported tends to be more difficult. As claims get older, the loss reserve liabilities may be estimated with less inaccuracy, but are still subject to material fluctuations until the claims are paid or otherwise closed. Eventually, all claims in a particular year are closed and no additional development, favorable or adverse, will be experienced because the amount of the claims is certain.

(c)   A factor that impacts incurred losses is reserve development from prior years. Favorable or adverse development occurs when subsequent estimates of the loss reserve liability change. A subsequent decrease in estimate results in favorable development; a subsequent increase in estimate results in adverse development. Favorable or adverse development is reflected as a decrease or increase in the current year's loss and loss adjustment expenses.

The estimation of ultimate liability for losses and loss adjustment expenses is an inherently uncertain process and does not represent an exact calculation of that liability. PDIC's current reserve policy recognizes this uncertainty by maintaining bulk reserves or case supplement reserves to provide for the possibility that actual results may be less favorable compared to the estimated costs relative to the normal case reserve estimation process. The bulk reserve is determined by estimating the ultimate liability for the claims which have been made and reported and then subtracting the case reserves. PDIC does not discount its reserves to recognize the time value of money.

When a claim is reported to PDIC, claims personnel establish a case reserve for the estimated amount of the ultimate payment. This estimate reflects an informed judgment based upon general insurance reserving practices and on the experience and knowledge of the estimator regarding the nature and value of the specific claim, the severity of injury or damage, and the policy provisions relating to the type of loss. The claims staff periodically adjusts case reserves as more information becomes available.

Each quarter, PDIC computes its estimated liability using appropriate principles and procedures. Because the establishment of loss reserves is an inherently uncertain process, however, there can be no assurance that losses will not exceed reserves. Adjustments in aggregate reserves, if any, are reflected in the operating results of the period during which such adjustments are made. As required by insurance regulatory authorities, PDIC annually receives a statement of opinion from its appointed actuary concerning the reasonableness of its reserves.

  Operating and Administrative Expenses. Operating and administrative expenses for the first quarter of 2005 compared to the same period for 2004 decreased $693 or 44.8%. This decrease primarily resulted from ceding commissions earned which were $462 and $144 in 2005 and 2004, respectively. In addition, acquisition costs declined as a result of greater efficiencies.

  Interest Expense. Interest expense for the first quarter of 2005 decreased $8 from the same period of 2004, resulting from decreased line of credit debt offset by higher rates.

  Income Taxes. The effective federal income tax rate was 34.7% for 2005 and 34.0% for 2004, both of which approximate the expected rate.

Financial Condition, Liquidity, and Capital Resources (000 omitted):

The primary sources of liquidity, on both a short-term and long-term basis, are: funds provided by insurance premiums collected, net investment income, recoveries from reinsurance, and proceeds from the maturity or sale of invested assets. The primary uses of cash, on both a short-term and long-term basis, are: losses, loss adjustment expenses, operating expenses, reinsurance premiums, taxes, debt repayment and acquisition of investments.

Trends or uncertainties that may have an impact on short-term or long-term liquidity include changes in the cost and availability of reinsurance, changes in interest rates and changes in investment income. As the costs of obtaining reinsurance may change in the future, we intend to adjust the rates we charge our customers. However, such rate changes may be limited by competition. We believe that we will be able to manage reinsurance costs so the impact on overall liquidity is minimized.

When interest rates decline, the cost of borrowing decreases and the market value of our investment portfolio, which primarily consists of debt securities, generally increases. At the same time, the overall yield on new investments tends to decrease. When interest rates increase, the opposite effects are realized. While interest rates continue to be at historically low levels, they are starting to increase. We believe that it is unlikely material gains will be realized on portfolio assets or be a source of liquidity during 2005.

Net cash flow from operations for the first quarter of 2005 was $2,485 compared to $2,664 for the first quarter of 2004, a decrease of $179. As written and ceded premiums have stabilized, so has cash flow from operations. Cash flow for both quarters was invested in fixed maturities and net repayments of lines of credit.

At March 31, 2005, cash and cash equivalents totaled $6,089. This represents liquid assets available to meet operating, loss and reinsurance payments. It is expected that cash and cash equivalents will be maintained at approximately this level for the balance of 2005.

To provide additional liquidity, we have three lines of credit available from a bank. The first line is a $1,800 revolving line used by Finance to finance insurance premiums and bears interest at .5% over the bank's prime rate. The second line is for $1,000, which can be used for potential acquisitions, and bears interest at 1% over the bank's prime rate. The third line is a $3,000 facility that requires quarterly principal payments of $150 which began April 1, 2004 and will conclude October 1, 2006. As a result of the declining balance feature, the maximum credit available under this facility at March 31, 2005 was $2,400, of which $2,200 was outstanding as of March 31, 2005. These lines of credit require, among other things, that we maintain a minimum tangible net worth of $7,500, that PDIC maintain a minimum surplus of not less than 240% of the Authorized Control Level Risk Based Capital (as defined by the National Association of Insurance Commissioners), and that we deliver periodic financial reports to the bank. The bank has a security interest in substantially all assets of the Company, Services and Finance. In addition, the shares of PDIC are pledged, subject to the rights of policyholders under insurance laws and the rights of insurance regulators.

Based on historical trends, market conditions and our business plans, we believe that our existing resources and sources of funds will be sufficient to meet our short-term and long-term liquidity needs over the next year and beyond. Because economic, market and regulatory conditions may change, however, there can be no assurance that our funds will be sufficient to meet these liquidity needs. In

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addition, competition, pricing, the frequency and severity of losses and interest rates could significantly affect our short-term and long-term liquidity needs.

Critical Accounting Estimates and Judgments

The consolidated financial statements include certain amounts, based upon informed estimates and judgments made by management, for transactions not yet complete or for which the ultimate resolution is not certain. Such estimates and judgments affect the reported amounts in the financial statements. Although management believes that they are making the best decisions based upon information then available, it is possible that as conditions and experience develop, these estimates may change and may be materially different from originally reported in the financial statements. Our reserves for unpaid loss and loss adjustment expenses represent the most critical estimate present within the financial statements.

Forward-Looking Statements:

This discussion and analysis of financial condition and results of operations, and other sections of this report, contain forward-looking statements, including, but not limited to, statements relating to our business objectives and strategy. Such forward-looking statements are based on current expectations, management beliefs, certain assumptions made by our management, and estimates and projections about our industry. Words such as "believes," "estimates," "expects," "forecasts," "intends," "judgment," "objective," "plans," "projects," variations of such words and similar expressions are intended to identify such forward-looking statements. Determination of loss and loss adjustment expense reserves and amounts due from reinsurers are based substantially on estimates and the amounts so determined are inherently forward-looking.

Forward-looking statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict with respect to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may differ materially from those expressed, forecasted, or contemplated by any such forward-looking statements. Other factors, some of which are listed below, also influence our results of operations, financial condition and business:

- future economic conditions and the legal and regulatory environment in the markets served by the Company's subsidiaries;
- reinsurance market conditions, including changes in pricing and availability of reinsurance;
- financial market conditions, including, but not limited to, changes in interest rates and the values of investments;
- inflation;
- credit worthiness of the issuers of investment securities, reinsurers and others with whom the Company and its subsidiaries do business;
- estimates of loss reserves and trends in losses and loss adjustment expenses;
- changing competition;
- our ability to execute our business plan;
- the effects of war and terrorism on investments and reinsurance markets;

changes in financial ratings issued by independent organizations, including A.M. Best, Standard & Poors and Moody's;

our ability to enter new markets successfully and capitalize on growth opportunities; and

changes in the laws, rules and regulations governing insurance holding companies and insurance companies, as well as applicable tax and accounting matters.

Changes in any of these factors, or others, could have an adverse affect on the business, results of operations, or business of the Company or its subsidiaries. Unless required by law, we undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

Item 3. Controls and Procedures

The Company's disclosure controls and procedures, as that term is defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), are designed with the objective of providing reasonable assurance that information required to be disclosed in the Company's reports filed or submitted under the Exchange Act, such as this report, is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission (the "SEC"). In designing and evaluating the Company's disclosure controls and procedures, management recognized that any disclosure controls and procedures, no matter how well designed and operated, can provide only reasonable, rather than absolute, assurance of achieving the desired control objectives.

An evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Vice President of Finance, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this Quarterly Report on Form 10-QSB (the "Evaluation Date"). Based on that evaluation, the Company's management, including the Chief Executive Officer and Vice President of Finance, concluded that the Company's disclosure controls and procedures were designed and effective to ensure that information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic filings with the Securities and Exchange Commission is properly recorded, processed, summarized and reported in a timely manner as of the Evaluation Date. During the last fiscal quarter there was no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 6. Exhibits

Exhibits. The following documents are filed as exhibits to this report on Form 10-QSB:

Exhibit No.	Document
3.1	Amended and Restated Articles of Incorporation. Previously filed as an exhibit to the Company's Registration Statement on Form 10-SB/A filed on July 8, 2002. Here incorporated by reference.
3.2	Amended and Restated Bylaws. Previously filed as an exhibit to the Company's Registration Statement on Form 10-SB/A filed on July 8, 2002. Here incorporated by reference.
31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Vice President of Finance pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This exhibit, except for those portions expressly incorporated by reference in this filing, is furnished for the information of the Commission and is not deemed "filed" as part of this filing.

SIGNATURES

In accordance with the requirements of the Exchange Act, the Company caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PROFESSIONALS DIRECT, INC.

Date: May 13, 2005

/s/ Stephen M. Tuuk

Stephen M. Tuuk, President and Chief Executive Officer (authorized to sign on behalf of Company)

/s/ Stephen M. Westfield

Stephen M. Westfield, Vice President of Finance (principal financial and accounting officer)

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