2002 Annual Report

RTW®

Financial Results

(Dollars in thousands, except per share data)

	Fiscal years ended December 31,				
	2002	2001	2000	1999	1998
Total revenues	$67,146	$35,723	$83,299	$77,812	$90,152
Income (loss) from operations	10,325	(15,761)	(14,780)	8,357	(10,485)
Net income (loss)	14,319	(25,215)	(9,708)	6,167	(7,081)
Basic income (loss) per share	2.78	(4.89)	(1.79)	1.00	(1.19)
Diluted income (loss) per share	2.78	(4.89)	(1.79)	1.00	(1.19)
Premiums in force at year end	54,200	83,700	99,400	87,200	82,100
Total assets	223,834	218,307	194,535	176,511	172,934
Notes payable	1,250	4,500	7,000	—	2,461
Total shareholders' equity	29,810	14,222	38,736	55,565	52,618

Corporate Profile

RTW, Inc. and its wholly owned insurance subsidiary, American Compensation Insurance Company (ACIC) provide disability management services to employers. We have developed two proprietary management systems: (i) the RTW Solution®, designed to lower employers' workers' compensation costs and return injured employees to work as soon as possible, and (ii) the ID15® system, designed to identify those injured employees who are likely to become inappropriately depndent on the workers' compensation system. We currently provide workers' compensation management services to employers insured through our insurance subsidiary and to self-insured employers on a fee-for-service basis. During 2002, we operated primarily in Minnesota, Colorado, and Michigan.

Dear Shareholders,

We declared two Company goals for 2002 as outlined in the 2001 Letter to Shareholders. The first was to achieve profitability every quarter; the second was to enter the "fee for service" business. I am pleased to report that we accomplished both goals.

We earned $14.3 million in 2002. Our return to profitability is a result of a number of factors:

- We continued to increase rates reflecting our commitment to write the right business at the right price.
- The industry continues to operate in a "hard market" characterized by increased rates and limited coverage availability.
- We completed "re-underwriting" our business reflecting a decrease in the frequency of claims.
- We successfully completed our exit from two unprofitable regions.
- We had very strong claim closure rates. We finished the year with 1,100 fewer open claims than existed at the beginning of the year. We decreased our average lost time claims by over four days.
- We aggressively managed expenses. Every area of the Company experienced an expense decrease.

We entered the "fee for service" business late in 2002. By year-end we wrote service contracts with three self-insured customers. Our reception in this marketplace has been very positive. I am encouraged by these early results. We intend to make our services division an important profit center for the Company in future years.

We are well positioned to take advantage of the favorable workers' compensation insurance market and grow our service business as we gain traction and momentum in that sector.

We continue to be fully committed to our core competency: exceptional workers' compensation claims management. Through this commitment and executing our plan, RTW will continue to grow and prosper.

Sincerely,

J. Alexander Fjelstad

President & Chief Executive Officer

Management's Discussion and Analysis of Financial Condition and Results of Operations

OVERVIEW

The Company - RTW, Inc. (RTW) and its wholly owned insurance subsidiary, American Compensation Insurance Company (ACIC), provide disability management services to employers. Collectively, "we," "our" and "us" refer to these entities in this "Management's Discussion and Analysis of Financial Condition and Results of Operations."

We have developed two proprietary management systems: (i) the RTW SOLUTION®, designed to lower employers' workers' compensation costs and return injured employees to work as soon as possible, and (ii) the ID15® system, designed to identify those injured employees who are likely to become inappropriately dependent on the workers' compensation system. We currently provide workers' compensation management services to employers insured through our insurance subsidiary and to self-insured employers on a fee-for-service basis.

During 2002, we operated primarily in Minnesota, Wisconsin, South Dakota, Colorado, Michigan and Indiana. In the fourth quarter of 2001, we closed our regional offices in Missouri (which served Missouri, Illinois and Kansas) and Massachusetts (which served Massachusetts, Connecticut, New Hampshire, Rhode Island and Maine). We did earn premiums from these regional offices in 2002. Collectively, these regional offices had remaining premiums in force totaling $1.4 million at December 31, 2002. We completed running off this business in February 2003.

On February 28, 2002, our A.M. Best financial rating was downgraded from a Secure rating (B+) to an Unsecure rating (B-) as a result of the decrease in statutory surplus in 2001 from $29.3 million at December 31, 2000 to $19.5 million at December 31, 2001 and our adverse development in 2001 and 2000 that resulted in statutory operating losses in those years. Certain insurance carriers that write umbrella policies will not provide coverage to an employer if a portion of the employer's underlying insurance policy, such as the workers' compensation portion, is written by a carrier with an unsecure rating. Additionally, certain of our independent agents may be unwilling to sell our insurance as a result of the downgrade. As a result, we believe that our B- rating from A.M. Best will make it more difficult to provide our products to certain employers. While we believe that the A.M. Best downgrade will result in decreasing premiums in force, the ultimate effect of this downgrade is unknown at this time.

Additional information about RTW is available on our website, www.rtwi.com.

Significant Accounting Policies - Our significant accounting policies are summarized in Note 1 - "Summary of Significant Accounting Policies" to our accompanying consolidated financial statements. Our significant accounting policies include those policies related to our accounting for: (i) premiums earned, (ii) unpaid claim and claim settlement expenses, including reserves for incurred but not reported claims, (iii) policy acquisition costs, and (iv) investments. These accounting policies are further discussed in detail within each section of this "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Financial Summary - This financial summary presents our discussion and analysis of the consolidated financial condition and results of operations of RTW, Inc. This review should be read in conjunction with the Consolidated Financial Statements at December 31, 2002.

The following table provides an overview of our key operating results (000's, except per share amounts):

	Year Ended December 31,		
	2002	2001	2000
Gross premiums earned	**$62,506**	$97,420	$95,878
Premiums earned	**60,264**	86,057	78,154
Total Revenues	**67,146**	95,723	83,299
Claim and claim settlement expenses	**40,533**	80,103	72,429
Net income (loss)	**14,319**	(25,215)	(9,708)
Diluted net income (loss) per share	**$ 2.78**	$ (4.89)	$ (1.79)

RTW reported a decrease in gross premiums earned to $62.5 million in 2002 from $97.4 million in 2001. Total revenues decreased significantly in 2002 to $67.1 million from $95.7 million in 2001 due to a decrease in premiums in force related primarily to our regional office closures.

We reported net income of $14.3 million in 2002 compared to net losses of $25.2 million and $9.7 million in 2001 and 2000, respectively. We reported basic and diluted net income per share of $2.78 in 2002 compared to basic and diluted net losses per share of $4.89 and $1.79 in 2001 and 2000, respectively. The primary factors affecting our 2002 operating results included the following:

- Our gross premiums earned decreased in 2002 from 2001, due primarily to a 31.6% decrease in average premiums in force to $65.1 million for 2002 from $95.2 million in 2001;
- Premiums earned decreased 30.0% in 2002 from 2001. Premiums earned in 2001 were reduced by premiums ceded under a lower layer excess of loss reinsurance agreement, effective for claims occurring on or after July 1, 1998, that was in runoff in 2001. Premiums ceded in 2001 included $7.9 million in premiums ceded under this lower layer excess of loss reinsurance agreement, compared to $13.4 million ceded in 2000. No premiums were ceded under this agreement in 2002. Additionally, 2002 premiums ceded were reduced by $1.4 million resulting from a change in cost related to excess of loss reinsurance in Minnesota;
- Claim and claim settlement expenses decreased significantly to 67.3% of premiums earned for 2002 from 93.1% for 2001. See further discussion under "Claim and Claim Settlement Expenses;"
- In our 2001 Report on Form 10-K/A, we revised the accounting for our contract with St. Paul Re (SPR), which was originally accounted for under reinsurance accounting standards using deposit accounting standards, and restated our 2001 financial statements. We further terminated this contract with SPR in December 2002 and were refunded $28.8 million, resulting in a $1.0 million gain recorded in December 2002. Deposit accounting for this contract required us to record a margin expense at 4.75% of premiums ceded to SPR and interest income on the fund balance at an amount equal to the quarter-end U.S. Treasury Bill rate less 25 basis points. The deposit accounting change caused a decrease in premiums ceded and an increase in investment income, claim and claim settlement expenses,

policy acquisition costs and general and administrative expenses from the amounts originally reported in 2001. As a result, the accounting for this contract increased net income by $354,000 in 2002 after reducing interest income and the gain on termination by the margin expense, and an increase in the 2001 net loss by $1.5 million; and

- At December 31, 2001, we established a $14.5 million valuation allowance against deferred tax assets resulting in a corresponding increase in income tax expense. This valuation allowance decreased to $6.6 million at December 31, 2002. The $7.9 million decrease in the valuation allowance favorably affected our income tax expense in 2002. See further discussion under "Income Taxes."

We expect 2003 premiums in force to increase slightly from levels in 2002. We also anticipate that we will continue to operate in an environment of premium rate increases in 2003; however, these rate increases will be significantly lower than experienced in 2002, 2001 and 2000. We will focus on achieving profitability in our remaining regional markets by: (i) aggressively managing and closing claims, (ii) reviewing policy profitability at renewal and removing unprofitable accounts, and (iii) aggressively managing policy acquisition costs and general and administrative expenses.

In the following pages, we take a look at the 2002, 2001 and 2000 operating results for items in our Consolidated Statement of Operations and also explain key balance sheet accounts in greater detail.

RESULTS OF OPERATIONS

Total revenues: Our total revenues include premiums earned, investment income, net realized investment gains (losses) and other income. The following table summarizes the components of our revenues and premiums in force (000's):

	Year Ended December 31,		
	2002	2001	2000
Gross premiums earned	**$62,506**	$97,420	$95,878
Premiums ceded	**(2,242)**	(11,363)	(17,724)
Premiums earned	**60,264**	86,057	78,154
Investment income	**5,139**	6,415	5,752
Net realized investment gains (losses):			
Realized investment gains	**1,930**	1,225	26
Realized investment losses	**(209)**	(62)	(633)
Net realized investment gains (losses)	**1,721**	1,163	(607)
Other income	**22**	2,088	—
Total revenues	**$67,146**	$95,723	$83,299

Premiums in force by regional office at year-end:			
Minnesota	**$23,000**	$26,700	$33,800
Colorado	**11,800**	13,100	16,000
Missouri	**700**	10,300	13,400
Michigan	**18,000**	21,700	18,600
Massachusetts	**700**	11,900	17,600
Total premiums in force	**$54,200**	$83,700	$99,400

Premiums In Force and Gross Premiums Earned: Premiums on workers' compensation insurance policies are our largest source of revenue. Premiums earned are the gross premiums earned by us on in force workers' compensation policies, net of the effects of ceded premiums under reinsurance agreements.

The premium we charge a policyholder is a function of its payroll, industry and prior workers' compensation claims experience. In underwriting a policy, we receive policyholder payroll estimates for the ensuing year. We record premiums written on an installment basis matching our billing to the policyholder and earn premiums on a daily basis over the life of each insurance policy based on the payroll estimate. We record the excess of premiums billed over premiums earned for each policy as unearned premiums on our balance sheet. When a policy expires, we audit employer payrolls for the policy period and adjust the estimated payroll and the policyholder's premium to its actual value. The result is a "final audit" adjustment recorded to premiums earned when the adjustment becomes known. Final audit premiums recognized during the period include billed final audit premiums plus (or minus) the change in estimate for premiums on unexpired and expired unaudited policies.

Our premiums in force decreased 35.2% to $54.2 million at December 31, 2002 from $83.7 million at December 31, 2001 due to decreases in premiums in force in all of our markets, but primarily the result of closing our Missouri and Massachusetts regional offices. Average premiums in force decreased to $65.1 million in 2002 from $95.2 million in 2001 and $90.9 million in 2000. In order to improve profitability, we aggressively targeted policies that did not meet our underwriting profit margin standards for non-renewal or re-underwriting at increased rates at policy expiration in 2002, 2001 and 2000. Our average annual premium per policy increased to $80,400 in 2002 from $56,800 in 2001 and $40,500 in 2000 as a result of the focused aggressive re-underwriting in 2001 and 2000.

Our gross premiums earned decreased 35.8% to $62.5 million in 2002 from $97.4 million in 2001. This decrease resulted primarily from: (i) the decrease in average premiums in force, and (ii) final audit premiums which decreased gross premiums earned by $1.7 million in 2002 and increased gross premiums earned by $1.8 million in 2001.

Gross premiums earned increased 1.6% to $97.4 million in 2001 from $95.9 million in 2000. This increase resulted from: (i) the increase in average premiums in force, offset by (ii) a decrease in final audit premiums that increased gross premiums earned by $1.8 million in 2001 compared to $5.5 million in 2000.

In 2002, 2001 and 2000, we were able to increase premium rates on renewing policies an average of 9.0%, 18.5% and 11.7%, respectively. We have been able to increase premium rates in our markets due to the following:

- Many workers' compensation insurers have withdrawn from the markets in which we write premiums as profitability diminished in the workers' compensation insurance line;
- Reinsurance rates for workers' compensation insurers have increased due to: (i) reductions in reinsurer's surplus as a result of the September 11, 2001 terrorist acts against the United States, (ii) recent

unprofitability resulting from highly competitive reinsurance pricing, and (iii) settlements related to certain reinsurance treaties written in the late 1990's. These rate increases have resulted in increased costs for workers' compensation insurers. Insurers, including RTW, have raised premium rates to offset these increases in reinsurance premiums; and

- A number of workers' compensation insurers' financial ratings have decreased due to reserve adjustments recorded in 2002, 2001 and 2000.

Premiums Ceded: Reinsurance agreements allow us to share certain risks with other insurance companies. We purchase reinsurance to protect us from potential losses in excess of the level we are willing to accept. We expect the companies to which we have ceded reinsurance to honor their obligations. In the event that these companies are unable to honor their obligations to us, we will be required to pay these obligations ourselves. We are not aware of any developments with respect to our reinsurers that would result in uncollectible reinsurance balances.

Under our excess of loss reinsurance policies, we pay reinsurers to limit our per-incident exposure and record this cost to premiums ceded as a reduction of gross premiums earned. In Minnesota, we are required to purchase excess of loss coverage for our Minnesota policies from the Minnesota Workers' Compensation Reinsurance Association (WCRA). In 2002, we ceded Minnesota claims in excess of $350,000 per occurrence to the WCRA; in 2001 and 2000, we ceded Minnesota claims in excess of $330,000 and $310,000, respectively to the WCRA. The per-occurrence coverage level increased to $360,000 in 2003. In our non-Minnesota states, we maintained excess of loss coverage with a per-incident exposure of $300,000 since 1999. We purchased this non-Minnesota coverage from a single reinsurer. In 2002, the non-Minnesota excess of loss coverage no longer included statutory limit coverage and was capped at $20.0 million per occurrence and further excluded claims resulting from acts of terrorism. In 2003, our non-Minnesota per-incident excess of loss coverage increased to $360,000, continues to be capped at $20.0 million per occurrence and further excludes claims resulting from acts of terrorism. We further decreased our retention to $200,000 per-incident in all our regions in 2003 by purchasing increased excess of loss reinsurance in order to further reduce volatility in our results. This coverage was purchased from three reinsurers.

For claims occurring after June 30, 1998 through policy termination on December 31, 2000, and on a runoff basis into 2001, we further limited our per incident exposure by purchasing excess of loss coverage for losses from $25,000 to the lesser of $300,000 or the WCRA selected retention level in Minnesota and from $25,000 to $300,000 in other states from a single reinsurer. This agreement was finalized after its effective date and activity occurring from July 1, 1998 through September 30, 1998 was recorded on a retrospective basis resulting in the deferral of a gain totaling $2.0 million at December 31, 1998. We amortized $400,000 of the deferred gain as a reduction of claim and claim settlement expenses in each of 2002, 2001 and 2000 and $740,000 in 1999 resulting in an un-amortized deferred gain of $49,000 at December 31, 2002. The deferred gain is being amortized into income using the effective interest rate inherent in the amounts paid to the reinsurer and the estimated timing and amounts of recoveries from the reinsurer. Activity occurring on or after October 1, 1998 is recorded prospectively. This contract was terminated effective December 31, 2000; however the policy remained in effect in 2001 for policies in force at December 31, 2000 through expiration, not to exceed fifteen months after the effective termination date. Policies written or renewing after December 31, 2000 are not covered under this lower-level excess of loss reinsurance policy.

The following table summarizes the components of premiums ceded (000's):

	Year Ended December 31,		
	2002	2001	2000
Premiums ceded, net:			
Excess of loss reinsurance premiums:			
$25,000 to $300,000 excess of loss policy	**$ —**	$ (7,297)	$(13,442)
WCRA and other non-Minnesota excess of loss policies	**(2,242)**	(4,066)	(4,282)
Premiums ceded	**$(2,242)**	$(11,363)	$(17,724)

Premiums ceded to reinsurers decreased to $2.2 million in 2002 from $11.4 million in 2001. The decrease in premiums ceded, resulted primarily from: (i) a $7.3 million reduction in premiums ceded under our $25,000 to $300,000 excess of loss reinsurance policy, (ii) a $1.4 million reduction in excess of loss premiums ceded resulting from a change in estimated reinsurance cost for Minnesota excess of loss reinsurance, and (iii) a decrease in gross premiums earned offset by an increase in non-Minnesota excess of loss costs in 2002.

Premiums ceded to reinsurers decreased to $11.4 million in 2001 from $17.7 million in 2000. The decrease in premiums ceded resulted primarily from the run-off of premiums ceded under our $25,000 to $300,000 policy.

2003 Outlook: The 2003 outlook for premiums in force, gross premiums earned and premiums ceded include the following factors:

- We expect that our B- A.M. Best rating and the final runoff of in force premiums in our Massachusetts and Missouri regions will put downward pressure on premiums in force in 2003. Premium rates are expected to be relatively flat on new and renewing policies as we filed our rates at the high end in each region in which we operate in 2002, leaving little room to further increase rates in 2003. Premium rate increases realized in 2002 will continue to favorably affect profitability on each account in 2003 as we earn more premium on those policies. We expect to further improve our agency relationships in 2003 resulting in new business increases primarily in our Minnesota and Michigan regions. Overall, we expect premiums in force to increase only slightly;
- Our 2002 gross premiums earned include $7.9 million in premiums earned from our Missouri and Massachusetts regions that were in runoff in 2002. Premiums earned in these regions are expected to be less than $100,000 in 2003. Additionally, we expect our average premiums in force to decrease significantly in 2003 compared to 2002. Overall, we expect gross premiums earned to decrease significantly in 2003; and

- Premiums ceded under excess of loss policies will increase significantly as a percent of gross premiums earned when compared to the results attained for 2002. This increase is the result of two factors: (i) our cost for excess of loss reinsurance coverage in our non-Minnesota regions increased substantially for 2003 while our Minnesota cost decreased only slightly, and (ii) we decreased our retention to $200,000 in all our regions in 2003 by purchasing increased excess of loss coverage in order to further reduce volatility in our results.

Investment Income and Net Realized Investment Gains (Losses): Our investment income includes earnings on our investment portfolio and interest on our deposit receivable. Our net realized investment gains (losses), displayed separately on our accompanying Consolidated Statements of Operations, include gains and losses from sales of securities. Through January 2001, we invested entirely in U.S. domiciled investment-grade taxable and tax-exempt fixed maturity investments. In February 2001, we repositioned our portfolio, sold our tax-exempt securities, and purchased taxable securities to take advantage of our net operating loss carry-forward generated in 2000 and to maximize the after-tax yield of our investment portfolio. We realized investment gains totaling $1.1 million as a result of this repositioning. In February 2002, we sold certain securities within the portfolio and realized investment gains totaling $1.5 million to increase statutory surplus. In September 2002, we sold our corporate securities to further reduce risk in our portfolio and realized net investment gains of $354,000 in the third quarter of 2002. Further recognition of realized investment gains and losses will depend on sales of our investments, if any, to meet our short-term cash requirements or as we replace securities to manage our portfolio returns. We currently invest entirely in U.S. domiciled investment-grade taxable fixed maturity investments and classify our investments as available-for-sale. We intend to hold our available-for-sale investments to maturity, but may sell them before maturity in response to tax planning considerations, changes in interest rates, changes in prepayment risk and changes in funding sources or terms, or to address liquidity needs. Our primary investment objective is to maintain a diversified, high-quality, fixed-investment portfolio structured to maximize our after-tax investment income without taking inappropriate credit risk. For further discussion of investments, see the "Investments" section of this Management's Discussion and Analysis.

Investment income decreased to $5.1 million in 2002 from $6.4 million in 2001. Investment income decreased as our invested assets decreased to $81.4 million at December 31, 2002 from $89.2 million at December 31, 2001 and our investment yields decreased as we moved out of corporate securities in 2002 and reinvested in lower yielding securities due to changes in market interest rates and our desire to lower risk by buying higher rated government and mortgage-backed securities. This decrease was partially offset by an increase in interest earned on our deposit receivable to $736,000 in 2002 from $518,000 in 2001. Our invested assets decreased due to decreases in operating cash flow in 2002 and 2001, resulting primarily from: (i) reduced premiums in force and premiums written, (ii) timing differences between paying premiums ceded and recovering paid claim and claim settlement expenses, (iii) the receipt of premiums and the payment of claim and claim settlement expenses, and (iv) net cash provided by lower investment income. Investment yields decreased to 4.9% for 2002 from 6.1% for 2001. The investment yields realized in future periods will be affected by yields attained on new investments.

Investment income increased to $6.4 million in 2001 from $5.8 million in 2000. Investment income increased as a result of repositioning our portfolio entirely into taxable securities that earn a higher pre-tax rate of return offset by a reduction in our invested assets to $89.2 million at December 31, 2001 from $96.8 million at December 31, 2000 and further includes interest on our deposit receivable totaling $518,000 for 2001. Invested assets decreased due to decreased operating cash flow, resulting primarily from: (i) the difference in timing between the receipt of premiums, the payment of premiums ceded under our reinsurance agreements, the payment of claim and claim settlement expenses and the recovery of paid claim and claim settlement expenses under our reinsurance programs, and (ii) net cash provided by investment income. Tax-adjusted investment yields were 6.1% in 2001 compared to 6.6% in 2000. The investment yields realized in future periods will be affected by yields attained on new investments.

Net realized investment gains were $1.7 million in 2002 that resulted from sales of securities in February 2002 as well as repositioning out of corporate securities in September 2002. Net realized investment gains were $1.2 million in 2001 and resulted primarily from our portfolio repositioning out of taxable securities in February 2001. Net realized investment losses were $607,000 in 2000 and included $500,000 for the write-down of a security whose decrease in value was deemed other than temporary.

2003 Outlook: Barring significant changes in interest rates or operational cash flows, we expect that income from our investment portfolio for 2003 will be affected by the following:

- The increase in our funds available for investment as a result of the $28.8 million of cash received in December 2002 from terminating the St. Paul Re contract;
- We earned $736,000 in interest on our deposit receivable in 2002. There will be no interest earned on the deposit in 2003 due to our terminating the St. Paul Re contract;
- Funds from our operating cash flows and investment cash flows historically provided growth in our investment portfolio; however, these net cash flows will decrease as we focused on closing claims from prior years, years in which premiums were higher and more claims were reported, paying to close those claims. Cash flows for 2003 are expected to be adversely affected by decreases in cash flows resulting from claim payments on claims from 2002 and prior years exceeding cash flows from our premiums as we reduce our premiums earned in 2003;
- Further recognition of realized investment gains and losses will depend on sales of our investments, if any, to meet our short-term cash requirements or as we replace securities to manage our portfolio returns; and

- New and renegotiated reinsurance treaties may affect our future cash flow and future investment income.

Other Income: We recorded and received a refund totaling $2.1 million from the WCRA in 2001. The WCRA periodically reviews its surplus position and refunds excess surplus to its members. This refund represents our share of the excess surplus of the WCRA at December 31, 2000. No such refund was received in 2002. We do, however, expect that fee-for service revenues will increase substantially in 2003 from the $22,000 realized in 2002.

Total Expenses: Our expenses include claim and claim settlement expenses, policy acquisition costs, general and administrative expenses, interest expense and income taxes.

Claim and Claim Settlement Expenses: Claim expenses refer to medical and indemnity benefits that we paid or expect to pay to claimants for events that have occurred. The costs of investigating, resolving and processing these claims are referred to as claim settlement expenses. We record these expenses, net of amounts recoverable under reinsurance contracts, to claim and claim settlement expenses in the accompanying Consolidated Statements of Operations.

Claim and claim settlement expenses are our largest expense and result in our largest liability. We establish reserves that reflect our estimates of the total claim and claim settlement expenses we will ultimately have to pay under our workers' compensation insurance policies. These include claims that have been reported but not settled and claims that have been incurred but not yet reported to us. For further discussion of reserve determination, see the "Unpaid Claim and Claim Settlement Expenses and Reinsurance Recoverables" section of this Management's Discussion and Analysis.

We experienced a significant decrease in the estimated number of ultimate claims for 2002 compared to 2001 and 2000. The number of estimated ultimate claims by accident year decreased to approximately 11,500 in 2002 from 22,100 in 2001 and 28,300 in 2000. The net decrease correlates directly to: (i) the decrease in premiums in force, and (ii) the re-underwriting that we completed with respect to our in force policies in 2000 and 2001. The gross and net average estimated cost per claim totaled approximately $5,500 and $4,900 in 2002 compared to $4,500 and $3,400 in 2001 and $4,000 and 2,400 in 2000, respectively. The increases in gross and net average estimated cost per claim are primarily the result of increases in severity (i.e., the average cost of a claim) caused mainly by inflationary pressures. The trend of increasing severity is attributable to a combination of factors that include increasing medical costs and increasing indemnity payments (reimbursements to injured workers for lost wages) per claim. We have also observed a decline in the number of claims being reported over the last several years. The declining frequency of claims contributes to the increasing severity trend because the frequency decline has been concentrated in less expensive claims (claims involving less time-off from work and less severe injuries).

The number of claims reported but unpaid (open claims) and the approximate average gross and net reserves on these claims each period was: 2002 - 1,381 claims, $9,700 average gross reserve, $9,000 average net reserve; 2001 - 670 claims, $26,900 average gross reserve, $17,500 average net reserve; and 2000 - 344 claims, $46,400 average gross reserve, $9,600 average net reserve. The average gross and net reserves per claim are less in 2002 than in 2001 and 2000 as the open claims include newly reported claims from the later half of 2002, including many with much lower severity that have not had time to close, as well as new claims that are anticipated but not yet reported. The remaining open claims from 2001 and 2000 are primarily claims with significant injury characteristics resulting in the increase in outstanding average gross and net reserves per claim.

Claim and claim settlement expenses decreased significantly to $40.5 million in 2002 from $80.1 million in 2001. As a percent of premiums earned, claim and claim settlement expenses decreased to 67.3% in 2002 from 93.1% in 2001. These changes are due to the following:

- Gross premiums earned decreased significantly due to: (i) decreased premiums in force, and (ii) final audit premium reductions totaling $1.7 million in 2002 compared to an increase in premiums earned due to final audits of $1.8 million in 2001, resulting in corresponding decreases in claim and claim settlement expenses and a distorted percent of gross premiums earned;
- The 2002 results include an $8.4 million decrease in prior years' reserves for unpaid claim and claim settlement expenses compared to the 2001 results which include a $7.7 million increase in prior years' reserves for unpaid claim and claim settlement expenses. Our estimate for unpaid claim and claim settlement expenses decreased in 2002 due to the following: (i) in March 2002, the Minnesota State legislature changed the way the commissioner will assess self-insured employers and insurers for estimated liabilities and administrative expenses of the State's Special Compensation Fund (SCF). The assessment changed from being paid by the insurer on indemnity payment basis to an assessment charged on premium to the policyholder. We decreased our recorded accrual to reflect this legislative change, (ii) the frequency of claims reported in 2002 for 2001 and prior years was less than anticipated when we determined our liability in 2001, (iii) we overestimated the liability for our mandatory participation in state and national assigned risk pool operating results for states in which we operate in 2001 and reversed that excess in 2002, and (iv) our estimate of the liability for unpaid claim and claim settlement expenses is difficult and volatile due to our relatively limited historical claim data and small claim population;
- We recorded estimates of ceded paid and unpaid claim and claim settlement expenses under our $25,000 to $300,000 excess of loss reinsurance agreement totaling $15.2 million in 2001 resulting in a corresponding reduction in 2001 claim and claim settlement expenses. No such benefit was recorded in 2002;
- We increased renewal premium rates an average of 9.0% in 2002 and 18.5% in 2001 compared to premium rates for the same periods in 2001 and 2000, respectively, reversing a trend of continued rate declines during years prior to 2000. Increases in premium rates have the effect of reducing the ratio of claim and claim settlement expenses to gross premiums earned as losses do not increase

with premium rate increases; and

- Claim costs continued to reflect increasing medical and indemnity costs in accident year 2002 as compared to accident year 2001 resulting from inflationary pressures.

Claim and claim settlement expenses increased to $80.1 million in 2001 from $72.4 million in 2000. As a percent of premiums earned, claim and claim settlement expenses increased slightly to 93.1% in 2001 from 92.7% in 2000. These changes are due to the following:

- The 2001 results include a $7.7 million increase in prior years' reserves for unpaid claim and claim settlement expenses compared to the 2000 results which include a $15.9 million increase in prior years' reserves for unpaid claim and claim settlement expenses. Our estimate for unpaid claim and claim settlement expenses increased in 2001 due to the following: (i) we increased the estimated liability for second injury funds and our mandatory participation in state and national assigned risk pool operating results for states in which we operate, (ii) our estimate of the liability for unpaid claim and claim settlement expenses is difficult and volatile due to our relatively limited historical claim data and small claim population, and (iii) we increased the estimated liability for claims in our closed Missouri and Massachusetts regions;
- We recorded estimates of ceded paid and unpaid claim and claim settlement expenses under our $25,000 to $300,000 excess of loss reinsurance agreement totaling $15.2 million in 2001 including $400,000 amortized from a deferred retrospective reinsurance gain resulting in a corresponding reduction in 2001 claim and claim settlement expenses. These amounts compare to our 2000 results which include an estimate of ceded paid and unpaid claim and claim settlement expenses totaling $21.8 million and $400,000 amortized from the deferred retrospective reinsurance gain;
- We increased renewal premium rates an average of 18.5% in 2001 and 11.7% in 2000 compared to premium rates for the same periods in 2000 and 1999, respectively, reversing a trend of continued rate declines during years prior to 2000. Increases in premium rates have the effect of reducing the ratio of claim and claim settlement expenses to gross premiums earned as losses do not increase with premium rate increases; and
- Claim costs continued to increase in 2001, 2000 and 1999 due to increasing medical and indemnity costs. These increases were offset somewhat by the effects of provider agreements that we negotiated during 1998.

2003 Outlook: We expect that claim and claim settlement expenses will be affected by the following factors:

- Claim costs will continue to be affected by: (i) increases in medical and indemnity costs resulting from inflationary changes, (ii) severity experienced in future periods in our policy holder base, (iii) changes resulting from increases in operating efficiency and effectiveness realized through enhancements to our internal processes and procedures, including changes to our proprietary computer systems, and (iv) legislative changes that affect benefits payable under workers' compensation laws;

- Increases in premium rates, if any in 2003, will result in increasing premiums earned without a corresponding increase in claim and claim settlement expenses, ultimately decreasing claim and claim settlement expense as a percent of premiums earned. Changes in premium rates due to legislative changes in estimated loss costs, increased competition and improving customer loss experience may offset rate improvements; and
- Continued application of our claims management technology and methods to all open claims.

The ultimate result of the above factors on 2003 claim and claim settlement expenses as a percent of premiums earned is unknown at this time.

Policy Acquisition Costs: Policy acquisition costs are costs directly related to writing an insurance policy and consist of commissions, state premium taxes, underwriting personnel costs and expenses, sales and marketing costs and other underwriting expenses less ceding commissions from our reinsurers. Ceding commissions are amounts that reinsurers pay to us for placing reinsurance with them. Under our 1992 to 1994 quota share reinsurance agreement, the ceding commission is adjusted to the extent that actual claim and claim settlement expenses vary from levels specified in the agreements.

The following table summarizes policy acquisition costs (000's):

	Year Ended December 31,		
	2002	2001	2000
Commission expense	**$ 4,321**	$ 7,378	$ 7,537
Premium tax expense	**1,048**	1,888	1,933
Other policy acquisition costs	**935**	4,463	4,207
Ceding commissions resulting from adjustments to claim and claim settlement estimates for our 1992 to 1994 accident years	**—**	261	460
Policy acquisition costs	**$ 6,304**	$13,990	$14,137

Policy acquisition costs decreased to $6.3 million in 2002 from $14.0 million in 2001 and $14.1 million in 2000. As a percent of gross premiums earned, policy acquisition costs decreased to 10.1% in 2002 compared to 14.4% in 2001 and 14.7% in 2000. The decrease in 2002 reflects the following:

- Gross premiums earned decreased significantly in 2002 compared to 2001 and 2000 resulting in corresponding decreases in policy acquisition costs;
- Commission expense decreased to 6.9% of gross premiums earned in 2002 from 7.6% in 2001 and 7.9% in 2000. The decreased commission percentages in 2002 and 2001 are the result of: (i) a focus on reducing commissions paid on new business in our non-Minnesota regions, and (ii) increased renewal premiums on which we pay lower commission rates in all our states. In 2002, our renewal business, on which we pay lower commission rates, significantly outpaced our new business. In all of our markets, we believe the commission rates we pay are marketplace competitive;
- Premium tax expense decreased slightly to 1.7% of gross premiums earned in 2002 from 1.9% of gross premiums earned in 2001 and 2.0% in 2000;
- Other policy acquisition costs decreased to 1.5% of gross premiums earned in 2002 compared to 4.6% in 2001 and 4.4% in 2000. Other policy acquisition costs reflect the benefit of the following:

(i) improvements in our underwriting organizational structure resulting in a $1.1 million decrease in personnel costs, overhead costs and marketing costs, (ii) an $851,000 reduction in an estimated accrual for second injury funds compared to recording an adjustment for those funds in 2001, and (iii) a general decrease related to the decrease in gross premiums earned; and

- We incurred ceding commission expense resulting from adjustments to claim and claim settlement expense estimates for 1992 to 1994 totaling $260,000 in 2001 and $460,000 in 2000. No such expense was recorded in 2002.

2003 Outlook: We expect that policy acquisition costs in 2003 will increase as a percent of gross premiums earned to levels consistent with 2001 and 2000 as we expect no second injury fund accrual reversals in 2003.

General and Administrative Expenses: Our general and administrative expenses include personnel costs, office rent, certain state administrative charges based on premiums and other costs and expenses not specific to claim and claim settlement expenses or policy acquisition costs.

Our general and administrative expenses decreased to $10.0 million in 2002 from $17.4 million in 2001 and $11.5 million in 2000. As a percent of gross premiums earned, general and administrative expenses decreased to 16.0% in 2002 from 17.9% in 2001 and increased from 12.0% in 2000. General and administrative expenses decreased in 2002 as follows: (i) general and administrative expenses included costs related to operating our Missouri and Massachusetts offices in 2001; no such expense was recorded in 2002, (ii) we recorded $1.4 million in margin expenses related to our St. Paul Re contract offset by a $1.0 million gain recorded on the termination of the contract in 2002 compared to $2.0 million recorded in margin expenses in 2001 on the contract, (iii) we recorded $2.0 million in restructuring charges related to closing our regional offices in Missouri and Massachusetts and closing satellite offices in Brainerd, Minnesota and Overland Park, Kansas in 2001; no such costs were recorded in 2002, (iv) assessments by state Insurance Guarantee Associations (IGA) totaling $266,000 in 2002 compared to $1.1 million in 2001 and $236,000 in 2000, (v) we incurred one-time business repositioning costs totaling $470,000 in 2001, (vi) we recorded bonuses of $864,000 in 2002 compared to $204,000 in 2001, and (vi) we expensed $270,000 in leasehold improvement write-offs related to rebuilding our Minnesota and home office leased space in 2002. After adjusting for these items, general and administrative expenses increased as a percent of gross premiums earned to 13.1% in 2002 from 11.9% in 2001 and 11.8% in 2000. These increases reflect:

- General and administrative expenses increased as a percent of premiums earned, after adjusting for restructuring charges, IGA assessments and one-time charges as we had less revenue relative to our fixed operating costs and expenses. We aggressively managed personnel and other operating costs and expenses during 2002 to appropriately align operating expenses with revenues. All expenses continue to be managed aggressively and reduced where appropriate;

- A reduction and renegotiation of our Corporate and Minnesota office space that resulted in a decrease in related office expenses beginning in October 2002; and
- During the fourth quarter of 2001, we recorded pre-tax restructuring charges totaling $2.0 million to general and administrative expenses in the Consolidated Statements of Operations. These charges included costs associated with our decision to close our Missouri and Massachusetts regional offices, as well as our Brainerd, Minnesota and Overland Park, Kansas satellite offices. We anticipated that 38 employees in our regional offices, 17 employees in our satellite offices and 2 employees in our Home Office would be affected by these closures. The restructuring charge amount included $715,000 of severance pay and benefits of which $106,000 was paid in 2001 and the remainder was paid in 2002. Additionally, the restructuring charge included office and equipment lease costs totaling $684,000 of which $80,000 was paid in 2001 and an additional $195,000 was paid in 2002, and furniture and equipment disposals and other costs totaling $600,000, of which $53,000 was disposed in 2001 and the remainder was disposed in 2002. The remaining accrual balance for severance pay and benefits, office and equipment lease costs and furniture and equipment disposals and other costs was $409,000 and $1.8 million at December 31, 2002 and 2001 respectively.

2003 Outlook: We expect that general and administrative expenses will be affected by the following:

- We have historically managed personnel and other operating costs and expenses to keep operating expenses in line with revenues. All expenses will continue to be aggressively managed and reduced where appropriate;
- We have no plans to open additional state offices in 2003 and expect to further reduce overhead costs in 2003 as a result of our office closures in 2001 and runoff in 2002. We will continually monitor reported claim counts for 2003 and re-examine staffing needs as necessary; and
- We reduced and renegotiated lease costs for our Corporate and Minnesota office space and expect that related office expenses will decrease in 2003.

Interest Expense: We incurred interest charges on our Term Loan in 2002, 2001 and 2000.

The Term Loan accrues interest, payable quarterly. We may elect to pay an adjusted LIBOR or bank reference rate on the Term Loan. We paid interest at rates ranging from 4.61% to 5.33% on the outstanding balance of our Term Loan in 2002 compared to 6.50% to 8.83% in 2001. Interest expense decreased to $163,000 in 2002 from $511,000 in 2001 as a result of the decrease in interest rates, $3.3 million in principal payments in 2002 and $2.5 million in principal payments in 2001.

We paid interest at rates ranging from 6.50% to 8.83% on the outstanding balance of our Term Loan in 2001 compared to 8.68% to 9.34% in 2000. Interest expense decreased to $511,000 in 2001 from $667,000 in 2000 as a result of the change in interest rates and $2.5 million in principal payments on the note in 2001.

2003 Outlook: Interest expense is expected to decrease in 2003 as a result of the $3.3 million in principal payments made in 2002. Total interest expense is expected to decrease to approximately $55,000 in 2003 from $163,000 in 2002 as a result of principal reductions in 2002. The remaining principal is due in 2003.

Income Taxes: We incur federal income taxes on our combined service organization (RTW) operations and insurance (ACIC) operations. We incur state income taxes on the results of our service organization's operations and incur premium taxes in lieu of state income taxes for substantially all of our insurance operations. In certain instances, we may incur state income taxes on our insurance operations. Additionally, certain provisions of the Internal Revenue Code adversely affect our taxable income by accelerating recognition and payment of income taxes. Adjustments to book income generating current tax liabilities include limitations on the deductibility of unpaid claim and claim settlement expenses, limitations on the deductibility of unearned premium reserves and limitations on deductions for bad debt reserves.

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. We consider recent operating results, the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. At December 31, 2001, we established a $14.5 million valuation allowance (allowance) against deferred tax assets resulting in a corresponding increase in income tax expense as a result of this analysis. This allowance decreased by $7.9 million to $6.6 million at December 31, 2002 as a result of the income we earned in 2002 and federal tax refunds totaling $3.8 million resulting from a change in Federal tax law. We expect any remaining deferred tax assets, net of the allowance, at December 31, 2002, to be realized as a result of the future income and the reversal of existing taxable temporary differences. No allowance was provided against the deferred tax assets in 2000.

Under the first provision of the Job Creation and Worker Assistance Act of 2002, signed into law in March 2002, we were allowed to carry-back our 2001 net operating loss for five years, to 1996, instead of two years under previous law. We filed our tax return in September 2002, and received a refund totaling approximately $3.3 million as a result of this Federal legislative change from carrying-back our 2001 loss. An additional $475,000 receivable was recorded that related to the carry back that resulted from revising our financial statements for 2001.

Income tax benefit for the year ended December 31, 2002 included the following: (i) a $3.8 million benefit from carrying back our 2001 loss five years under the tax law change, (ii) a $4.0 million benefit resulting from reducing the allowance as we realized favorable claim reserve development in 2002, and (iii) a further benefit as we offset current year earnings by losses carried forward from 2000. The income tax benefit for 2002 included the items recorded in the third quarter as well as a $1.0 million benefit from reducing the allowance related to recognizing a $3.0 million benefit from the SCF. After excluding the effects of the benefits from reducing the allowance, income tax expense was $3.8 million for 2002 compared to an income tax benefit of $5.6 million for 2001. As a percent of income before income taxes, the income tax expense before any benefit from reducing the allowance was 37.1% of the income before income taxes in 2002 compared to 34.5% and 37.2% of the net loss before income taxes in 2001 and 2000, respectively.

2003 Outlook: Income tax expense will vary based on: (i) the income from operations we recognize for 2003, and (ii) the changes in our analysis of the valuation allowance necessary during 2003. The ultimate change is unknown at this time.

INVESTMENTS

Our portfolio of fixed maturity securities at December 31, 2002 included only U.S. government securities (59.0%), mortgage-backed securities (39.8%), and asset-backed securities (1.2%). Our portfolio is managed by an independent investment manager to maximize our after-tax investment income without taking inappropriate credit risk. In September 2002 we sold our corporate securities to reduce risk in our portfolio resulting in a $354,000 gain. In February 2002, we sold select securities within the portfolio and realized an additional investment gain totaling $1.5 million to increase our statutory surplus. In February 2001, we recognized gains totaling $1.1 million as we repositioned our portfolio by selling our tax-exempt securities and repurchased taxable fixed maturity investments to increase our after-tax yield. We conservatively manage our fixed maturity portfolio, investing only in investment grade (BBB or better rating from Standard and Poor's) securities of U.S. domiciled issuers. All securities in our portfolio were rated AAA at December 31, 2002. We do not invest in derivative securities.

Operating cash flows consist of the deficit or excess of premiums collected over claim and claim settlement expenses paid reduced by payments for reinsurance premiums as well as other operating expenses paid. Investment cash flows consist of income on existing investments and proceeds from sales and maturities of investments. Prior to 1999, we generated positive net cash flows from operations due, in part, to timing differences between the receipt of premiums and the payment of claim and claim settlement expenses. These net cash flows decreased significantly in 2001, 2000 and 1999 as we focused on closing old claims by paying earlier to close those claims. Combined with relatively flat premiums in force in 1998, 1999 and 2000 and decreasing premiums since that time, our cash flows from differences in timing have decreased. Additionally, as we lowered our reinsurance retention levels to $25,000 in mid-1998, we decreased our current period cash flows as a result of "pre-funding" quarterly reinsurance premiums under that agreement. Reinsurance reimbursements from our $25,000 to $300,000 excess of loss reinsurance agreement offset similar payments to claimants for those years in 2002. Our investment portfolio decreased $7.8 million to $81.4 million at December 31, 2002 from $89.2 million at December 31, 2001, as a result of these factors. The cash balance at December 31, 2002 included $28.8 million received from St. Paul Re from terminating the contract late in December 2002. We invested this cash in January 2003. We expect that cash will decrease in 2003 as we pay claims for 2002 and prior years, years in which we earned higher premiums and incurred a higher number of claims reported while 2003 premiums earned are expected to decrease.

We record investments on our balance sheet at fair value, with the corresponding appreciation or depreciation from amortized cost recorded in shareholders' equity as other comprehensive income, net of taxes. Because value is based on the relationship between the portfolio's stated yields and prevailing market yields at any given time, interest rate fluctuations can have a swift and significant impact on the carrying value of these securities. As a result of classifying our securities as available-for-sale, and thus carrying them at fair value, we expect to encounter adjustments in shareholders' equity as market interest rates and other factors change. In 2000, we recorded a $500,000 write-down of a security held in our portfolio as we deemed its decline in fair value to be other than temporary in nature. This security was sold in January 2002 and the proceeds exceeded the adjusted cost basis resulting in a net realized gain of $300,000. Prevailing market interest rates decreased since December 31, 2001, and when combined with the sale of select securities to realize gains to increase statutory surplus, resulted in a $3.4 million unrealized gain on investments in 2002 compared to a $1.4 million unrealized gain in 2001.

UNPAID CLAIM AND CLAIM SETTLEMENT EXPENSES AND REINSURANCE RECOVERABLES

At December 31, 2002, the liability for unpaid claim and claim settlement expenses totaled $181.3 million and reinsurance recoverables on unpaid claim and claim settlement expenses totaled $91.8 million, resulting in net reserves totaling $89.4 million. The net reserve at December 31, 2001 totaled $91.2 million and included the liability for unpaid claim and claim settlement expenses totaling $181.3 million net of reinsurance recoverables on unpaid claim and claim settlement expenses of $90.1 million. Accounting for workers' compensation insurance operations requires us to estimate the liability for unpaid claim and claim settlement expenses ("reserves") and the related reinsurance recoverables, (together, the "net reserves") at each balance sheet date. Our reserves represent the estimated total unpaid cost of claim and claim settlement expenses, which cover events that occurred in 2002 and prior years. These reserves reflect our estimates of the total costs of claims that were reported, but not yet paid, and the cost of claims incurred but not yet reported (IBNR). For reported claims, we establish reserves on a "case" basis. For IBNR claims, we calculate the difference between: (i) projected ultimate claim and claim settlement expenses as determined using generally accepted actuarial standards, and (ii) case reserves and carry the difference as the IBNR reserve. By using both estimates of reported claims and IBNR claims, we estimate the ultimate net reserves for unpaid claim and claim settlement expenses.

The amount by which estimated net reserves, measured subsequently by reference to payments and additional estimates, differ from those originally reported for a period is known as "development." Development is unfavorable (or deficient) when losses ultimately settle for more than the levels at which they were reserved or subsequent estimates indicate a basis for reserve increases on open claims. Development is favorable (redundant) when losses ultimately settle for less than the amount reserved or subsequent estimates indicate a basis for reducing loss reserves on open claims. Favorable or unfavorable development of loss reserves is reflected in earnings in the year realized.

Both internal and independent external actuaries review net reserves for adequacy on a periodic basis. This review assumes that past experience, adjusted for the effects of current events and anticipated trends, is an appropriate basis for predicting future events. When reviewing net reserves, actuaries analyze historical data and estimate the effect of various factors on estimated ultimate reserves including: (i) trends in general economic conditions, including the effects of inflation; (ii) estimates of trends in claims frequency and severity; (iii) our and industry historical loss experience; and (iv) legislative enactments, legal developments and changes in social and political attitudes. Variables in the reserve estimation process can be affected by both internal and external events, including changes in claims handling procedures, economic inflation, legal trends and legislative changes. Many of these items are not directly quantifiable, particularly on a prospective basis. There is no precise method for subsequently evaluating the effect of any specific factor on the adequacy of reserves because the eventual deficiency or redundancy is affected by many factors. Additionally, there may be significant reporting lags between the occurrence of the loss and the time it is actually reported to the insurer. Due to our commencing operations in 1992, we have limited historical data to estimate our reserves for unpaid claim and claim settlement expenses and, accordingly, we supplement our experience with external industry data, as adjusted, to reflect anticipated differences between our results and the industry.

Estimating the effect that inflation will have on the ultimate cost of claims is a major risk factor in our workers' compensation reserve estimates. Future earnings will be affected by reserve development associated with any changes in our inflation assumptions. Estimates for the 2002 and 2001 accident years represent the majority of the uncertainty because these claims have the lowest proportionate amount of paid loss as of December 31, 2002. Our reserve estimates are most sensitive to changes in the assumption about inflation for the 2002 and 2001 accident years. Each one percent (1%) increase or decrease in the inflation rate for both of these accident years would increase or decrease our loss reserve estimates at December 31, 2002 and 2001 by approximately $348,000 and $290,000, respectively.

Our independent actuary provides management with an opinion regarding the acceptable range for adequate statutory reserves based on generally accepted actuarial guidelines. We record our net reserves by considering a range of estimates bounded by the high and low point of the range. Within that range, we record our best estimate. We focus in our decision process on improving our financial strength ratings and expect to remain a market for workers' compensation insurance in all market conditions. In 2002, we established recorded reserves in the upper half of the actuary's range. The ultimate actual liability may be higher or lower than reserves established.

Our reserves are primarily undiscounted; however, we discounted reserves for selected claims that have fixed and determinable future payments at rates ranging from 3.5% to 8.0% in 2002 and 2001. The discount rates in 2002 and 2001 are subject to change as market interest rates change. We use the same rates for Generally Accepted Accounting Principles as we do for Statutory Accounting in determining our liability. We also reduce the unpaid claim and claim settlement expenses for estimated amounts of subrogation.

We continually monitor loss development trends and data to establish adequate premium rates and reasonable loss reserve estimates. Loss reserves, which are based on estimates, are inherently uncertain and represent a significant risk to the business that we attempt to mitigate by continually improving and refining our workers' compensation claims processing practices and by employing actuarial estimation methods.

After taking into account all relevant factors, we believe our reserves for unpaid claim and claim settlement expenses and reinsurance recoverables on unpaid claim and claim settlement expenses at December 31, 2002 are adequate to cover the ultimate net costs of claim and claim settlement expenses at that date. The ultimate cost of claim and claim settlement expenses may differ materially from the established reserves, particularly when claims may not be settled for many years. Establishing appropriate reserves is an inherently uncertain process and there can be no certainty that currently established reserves will prove adequate in light of subsequent actual experience. See Notes 1 and 5 in the accompanying Consolidated Financial Statements. The following two tables reconcile the beginning and ending insurance reserves, displayed individually for each of the last three years.

The following table sets forth reserves on a gross (before reinsurance) basis (000's):

	Year Ended December 31,		
	2002	2001	2000
Gross Reserves for Claim and Claim Settlement Expenses:			
Gross reserves for claim and claim settlement expenses, beginning of year	**$181,310**	$128,841	$ 99,831
Provision increases for claim and claim settlement expenses:			
Current year	**56,117**	97,510	87,203
Prior years	**3,593**	31,224	17,930
Total provision	**59,710**	128,734	105,133
Payments for claim and claim settlement expenses:			
Current year	**13,715**	27,024	30,190
Prior years	**46,043**	49,241	45,933
Total payments	**59,758**	76,265	76,123
Gross reserves for claim and claim settlement expenses, end of year	**$181,262**	$181,310	$128,841

The following table sets forth reserves on a net (after reinsurance) basis (000's):

	Year Ended December 31,		
	2002	2001	2000
Net Reserves for Claim and Claim Settlement Expenses:			
Net reserves for claim and claim settlement expenses, beginning of year	**$ 91,195**	$ 66,996	$ 58,652
Plus: Deferred retrospective reinsurance gain, beginning of year	**449**	849	1,249
Provision increases (decreases) for claim and claim settlement expenses:			
Current year	**49,621**	73,557	56,900
Prior years	**(8,356)**	7,731	15,929
Write-off of reinsurance recoverable	**(332)**	(785)	—
Amortization of deferred retrospective reinsurance gain	**(400)**	(400)	(400)
Total provision	**40,533**	80,103	72,429
Payments for claim and claim settlement expenses:			
Current year	**13,715**	25,062	28,154
Prior years	**28,973**	31,242	36,331
Total payments	**42,688**	56,304	64,485
Less: Deferred retrospective reinsurance gain, end of year	**(49)**	(449)	(849)
Net reserves for claim and claim settlement expenses, end of year	**$ 89,440**	$ 91,195	$ 66,996

The following loss reserve development table sets forth the change, over time, of reserves established for claim and claim settlement expenses at the end of the last ten years. The following loss reserve development table is cumulative and, therefore, ending balances should not be added since the amount at the end of each calendar year includes activity for both current and prior years (000's):

	December 31										
	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992
Loss Reserve Development:											
Gross reserves for unpaid claim and claim settlement expenses	**$181,262**	$181,310	$128,841	$99,831	$97,269	$ 61,069	$49,256	$37,138	$28,165	$13,279	$ 2,688
Reinsurance recoverables	**91,822**	90,115	61,845	41,179	21,403	5,374	6,183	8,312	13,902	9,593	1,886
Net reserves for unpaid claim and claim settlement expenses	**$ 89,440**	$ 91,195	$ 66,996	$ 58,652	$75,866	$ 55,695	$43,073	$28,826	$14,263	$ 3,686	$ 802
Paid (cumulative) as of:											
One year later		$ 30,285	$ 32,028	$ 35,932	$34,380	$ 27,737	$19,439	$ 8,595	$ 4,639	$ 1,436	$ 583
Two years later			43,823	48,069	49,958	42,046	28,173	12,894	6,476	2,150	678
Three years later				54,360	56,376	49,671	33,438	15,521	7,863	2,348	815
Four years later					60,453	53,814	36,904	16,869	8,569	2,654	856
Five years later						56,140	38,919	18,020	9,046	2,816	925
Six years later							39,770	18,714	9,396	2,847	951
Seven years later								19,200	9,564	2,932	920
Eight years later									9,738	2,985	928
Nine years later										2,972	951
Ten years later											885
Reserves re-estimated as of:											
End of year	**$ 89,440**	$ 91,195	$ 66,996	$ 58,652	$75,866	$ 55,695	$43,073	$28,826	$14,263	$ 3,686	$ 802
One year later		82,839	74,727	74,181	67,753	66,674	39,988	20,751	12,789	3,784	1,075
Two years later			71,202	76,502	77,205	61,075	43,484	18,469	9,318	3,416	1,008
Three years later				75,321	78,331	68,065	41,451	19,796	8,984	2,782	950
Four years later					78,772	69,474	45,959	19,389	9,669	2,861	912
Five years later						69,595	47,147	21,254	9,692	2,972	949
Six years later							47,126	22,568	10,330	2,927	964
Seven years later								22,388	11,675	3,106	926
Eight years later									11,234	3,818	945
Nine years later										3,555	951
Ten years later											949
Initial reserves in excess of (less than) re-estimated reserves											
Amount		$ 8,356	$ (4,206)	$(16,669)	$ (2,906)	$(13,900)	$ (4,053)	$ 6,438	$ 3,029	$ 131	$ (147)
Percent		9.2%	(6.3%)	(28.4%)	(3.8%)	(25.0%)	(9.4%)	22.3%	21.2%	3.6%	(18.3%)

The table on the previous page represents the development of balance sheet net reserves for 1992 through 2002. The top three rows of the table reconcile gross reserves to net reserves for unpaid claim and claim settlement expenses recorded at the balance sheet date for each of the indicated years.

The upper portion of the table shows the cumulative amount paid with respect to the previously recorded reserves as of the end of each succeeding year.

The lower portion of the table shows the re-estimated amount of the previously recorded net reserves, based on experience as of the end of each succeeding year. The estimate is either increased or decreased as more information becomes known about the frequency and severity of claims for individual years. For example, for the 1998 calendar year valued as of December 31, 2002, we paid $60.5 million of the currently estimated $78.8 million of claim and claim settlement expenses that were incurred through the end of 1998; thus, the difference, an estimated $18.3 million of claim and claim settlement expenses incurred through 1998, remained unpaid as of December 31, 2002.

The “initial reserves in excess of (less than) re-estimated reserves” rows represent the aggregate change in the estimates over all prior years. For example, the 1998 reserve developed a $2.9 million net deficiency over the course of the succeeding years. The net amount has been included in income and the changes have been recorded in the period identified. The cumulative net deficiencies in 2000 and 1999 are the result of reserve development inherent in the uncertainty in establishing reserves and anticipated loss trends. As discussed above, due to our relatively limited historical claim data and small claim population, our estimate of the liability for net reserves is difficult and volatile. As discussed further below, the reserve redundancy in 2001 is the result of accrual reversals resulting from changes in methods of assessing second injury funds, lower frequency in claims reported from the estimate at December 31, 2001, and reductions in amounts expected to be incurred for our participation in mandatory state and national assigned risk pools.

In evaluating this information, it should be noted that each amount includes the total of all changes in amounts for prior periods. For example, the amount of redundancy to losses settled in 2002, but incurred in 1999, will be included in the cumulative redundancy (deficiency) amounts in 1999, 2000, and 2001. This table does not present accident or policy year development data, which certain readers may be more accustomed to analyzing. Conditions and trends that have affected development of the reserves in the past may not necessarily occur in the future. Accordingly, it may not be appropriate to extrapolate redundancies or deficiencies based on this table.

The following table is derived from the loss reserve development table and summarizes the effect of reserve re-estimates, net of reinsurance, on calendar year operations for the same ten-year period ended December 31, 2002. The total of each column details the amount of reserve re-estimates made in the indicated calendar year and shows the accident years to which the re-estimates are applicable. The amounts in the total accident year column represent the cumulative reserve re-estimates for the indicated accident year (000’s):

	Effect of Reserve Re-estimates on Calendar Year Operations:										Cumulative Re-estimates for each Accident Year
	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992
Accident Year:											
1992	**$ 2**	$ (6)	$ (19)	$ 38	$ (15)	$ (37)	$ 38	$ 58	$ 67	$ (273)	$ (147)
1993	**261**	(706)	(160)	7	(96)	(42)	596	310	(165)		5
1994	**178**	(633)	(459)	(68)	(574)	413	2,837	1,106			2,800
1995	**(261)**	31	(1,227)	430	(642)	1,948	4,604				4,883
1996	**(159)**	126	(2,643)	1,626	(2,169)	803					(2,416)
1997	**(142)**	(221)	(2,482)	3,566	(7,483)						(6,762)
1998	**(320)**	283	(2,462)	2,514							15
1999	**1,622**	(1,195)	(6,077)								(5,850)
2000	**2,344**	(5,410)									(3,066)
2001	**4,831**										4,831
Total	**$ 8,356**	$ (7,731)	$(15,529)	$ 8,113	$(10,979)	$ 3,085	$ 8,075	$ 1,474	$ (98)	$ (273)	$ (5,507)

The 2002 results include an $8.4 million decrease in prior years' reserves for unpaid claim and claim settlement expenses compared to the 2001 results which include a $7.7 million increase in prior years' reserves for unpaid claim and claim settlement expenses. Our estimate for unpaid claim and claim settlement expenses decreased in 2002 due to the following: (i) in March 2002, the Minnesota State legislature changed the way the commissioner will assess self-insured employers and insurers for estimated liabilities and administrative expenses of the State's Special Compensation Fund (SCF). The assessment changed from being paid by the insurer on indemnity payment basis to an assessment charged on premium to the policyholder. We decreased our recorded accrual to reflect this legislative change, (ii) the frequency of claims reported in 2002 for 2001 and prior years was less than anticipated when we determined our liability in 2001, (iii) we overestimated the liability for our mandatory participation in state and national assigned risk pool operating results for states in which we operate in 2001 and reversed that excess in 2002, and (iv) our estimate of the liability for unpaid claim and claim settlement expenses is difficult and volatile due to our relatively limited historical claim data and small claim population.

The 2001 results include a $7.7 million increase in prior years' reserves for unpaid claim and claim settlement expenses compared to the 2000 results which include a $15.9 million increase in prior years' reserves for unpaid claim and claim settlement expenses. Our estimate for unpaid claim and claim settlement expenses increased in 2001 due to the following: (i) we increased the estimated liability for second injury funds and our mandatory participation in state and national assigned risk pool operating results for states in which we operate, (ii) our estimate of the liability for unpaid claim and claim settlement expenses is difficult and volatile due to our relatively limited historical claim data and small claim population, and (iii) we increased the estimated liability for claims in our closed Missouri and Massachusetts regions.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity refers to our ability to generate sufficient cash flows to meet the short- and long-term cash requirements of our operations. Capital resources represent those funds deployed or available to be deployed to support our business operations.

Our primary sources of cash from operations are premiums collected and investment income. Our investment portfolio is also a source of liquidity, through the sale of readily marketable fixed maturity investments. Our primary cash requirements consist of payments for: (i) claim and claim settlement expenses, (ii) reinsurance, (iii) policy acquisition costs, (iv) general and administrative expenses, (v) capital expenditures, (vi) income taxes, and (vii) debt service or principal repayment on our Term Loan. Prior to 1999, we generated positive net cash from operations due, in part, to timing differences between the receipt of premiums and the payment of claim and claim settlement expenses. As we lowered our reinsurance retention levels to $25,000 beginning in mid-1998 through runoff in 2001, we decreased our current period cash flows as a result of "pre-funding" quarterly premiums under that agreement. In 2002, the reinsurance reimbursements from our $25,000 to $300,000 excess of loss reinsurance agreement offset similar payments to claimants for those years. This trend will continue into 2003. Cash decreased for the remainder of 2002 as: (i) we paid claims for 2002 and prior years, years in which we earned higher premiums and incurred a higher number of claims reported while 2002 premiums in force and premiums earned decreased, and (ii) amounts paid under our St. Paul Re contract resulted in net cash outflows for most of 2002 until contract termination in December 2002. In 2003, we expect that cash and investments will decrease from levels at December 31, 2002 as we pay claims for 2002 and prior years, years in which we earned higher premiums and incurred a higher number of claims reported while 2003 premiums earned are expected to decrease. Available cash is invested in either short-term cash and cash equivalents or longer-term available-for-sale securities pending future payments for such expenses as medical and indemnity benefits and other operating expenses. Cash and cash equivalents consist of cash and a money market fund that invest primarily in short-term government securities.

Cash provided by operating activities for 2002 was $25.4 million. This is primarily a result of net income of $14.3 million and a decrease in deposits receivable of $17.6 million and depreciation and amortization expense of $962,000 offset by realized capital gains totaling $1.7 million, and a decrease of $4.2 million in accrued expenses and other liabilities. Net cash provided by investing activities was $10.8 million due to $75.5 million in proceeds from sales of securities offset by $64.3 million in purchases of securities and $630,000 in purchases of fixed assets. Net cash used in financing activities was $3.3 million due to principal payments on our note payable in 2002.

Our need for additional capital is primarily the result of regulations that require certain ratios of regulatory or statutory capital to premiums written in our insurance subsidiary as defined by state regulatory bodies and insurance rating agencies. Raising additional permanent capital, while difficult in the current environment in which we operate, would stabilize our ratio of premium to capital and provide a solid base for the future growth of our insurance subsidiary. As an alternative to raising additional permanent capital, quota-share reinsurance or other additional reinsurance on an interim basis would have the effect of reducing the ratio of premiums to capital and could be used to satisfy state regulatory requirements.

State insurance regulations limit distributions, including dividends, from our insurance subsidiary to us. The maximum amount of dividends that can be paid by ACIC to us in any year is equal to the greater of: (i) 10% of ACIC's statutory surplus as of the end of the previous fiscal year, or (ii) the statutory net gain from operations (not including realized capital gains) of ACIC in its most recent fiscal year. Based on this limitation, the maximum dividend that ACIC could pay to us in 2003, without regulatory approval, is approximately $2.7 million. (See Note 9 of Notes to Consolidated Financial Statements.) ACIC has never paid a dividend to us and we intend to retain capital in the insurance subsidiary.

On September 15, 1998, our Board of Directors approved a share repurchase program authorizing us to repurchase, from time to time, up to $4,000,000 of RTW, Inc. common stock. We repurchased 41,324 shares in 2002 for approximately $78,000, 5,000 shares in 2001 for approximately $9,000 and 329,750 shares for approximately $2.7 million through 2000. We repurchased these shares on the open market or through private transactions based upon market conditions and availability. The repurchased shares will be used for employee stock option and purchase plans and other corporate purposes.

Investments held as statutory deposits and pledged as collateral do not have an adverse effect on our liquidity. We believe that cash flow generated by our operations and our cash and investment balances will be sufficient to fund continuing operations, principal and interest payments and capital expenditures for the next 12 months.

INTEREST RATE RISK

Our fixed maturity investments are subject to interest rate risk. Increases and decreases in prevailing interest rates generally translate into decreases and increases in the fair value of these instruments. Also, fair values of interest rate sensitive instruments may be affected by the credit worthiness of the issuer, prepayment options, relative values of alternative instruments, the liquidity of the instrument and other general market conditions. We regularly evaluate interest rate risk in order to evaluate the appropriateness of our investments.

An increase of 100 basis points in prevailing interest rates would reduce the fair value of our interest rate sensitive instruments by approximately $3.6 million.

The effect of interest rate risk on potential near-term fair value was determined based on commonly used models. The models project the impact of interest rate changes on factors such as duration, prepayments, put options and call options. Fair value was determined based on the net present value of cash flows or duration estimates, using a representative set of likely future interest rate scenarios.

NAIC RISK-BASED CAPITAL STANDARDS

The National Association of Insurance Commissioners (NAIC) has risk-based capital standards to determine the capital requirements of a property and casualty insurance carrier based upon the risks inherent in its operations. These standards require computing a risk-based capital amount that is compared to a carrier's actual total adjusted capital. The computation involves applying factors to various financial data to address four primary risks: asset risk, insurance underwriting risk, credit risk and off-balance sheet risk. These standards provide for regulatory intervention when the percent of total adjusted capital to authorized control level risk-based capital is below certain levels. Based upon the risk-based capital standards, our percent of total adjusted capital is in excess of authorized control level risk-based capital.

REGULATION

Our insurance subsidiary is subject to substantial regulation by governmental agencies in the states in which we operate, and will be subject to such regulation in any state in which we provide workers' compensation products and services in the future. State regulatory agencies have broad administrative power with respect to all aspects of our business, including premium rates, benefit levels, policy forms, dividend payments, capital adequacy and the amount and type of investments. These regulations are primarily intended to protect covered employees and policyholders rather than the insurance company. Both the legislation covering insurance companies and the regulations adopted by state agencies are subject to change. At December 31, 2002, our insurance subsidiary was licensed to do business in Minnesota, South Dakota, Wisconsin, Colorado, Missouri, Illinois, Kansas, Michigan, Indiana, Massachusetts, Connecticut, Rhode Island, Pennsylvania, Tennessee, Maryland, Arkansas, Iowa, Florida, Georgia, New Jersey, North Carolina, Texas and Oklahoma.

In March 1998, the NAIC adopted the Codification of Statutory Accounting Principles (the Codification). The Codification is intended to standardize regulatory accounting and reporting to state insurance departments and became effective January 1, 2001. Statutory accounting principles, however, will continue to be established by individual state laws and permitted practices. The State of Minnesota required adoption of the Codification for preparing statutory financial statements for financial periods occurring on or after January 1, 2001. Adoption of the Codification increased our statutory capital and surplus by approximately $1.9 million on January 1, 2001.

EFFECT OF RECENT ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board (FASB) has issued SFAS No. 141, "Business Combinations"; SFAS No. 142, "Goodwill and Other Intangible Assets"; SFAS No. 143, "Accounting for Asset Retirement Obligations"; SFAS No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets"; SFAS No. 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statements No. 13, and

Technical Correction"; and SFAS No. 146 "Accounting for Costs Associated with Exit or Disposal Activities" since July 2001. After reviewing these pronouncements, we have determined that adoption of these statements is not expected to have an effect on our consolidated results of operations and financial position.

FORWARD-LOOKING STATEMENTS

Information included in this Report on Form 10-K which can be identified by the use of forward-looking terminology such as "may," "will," "expect," "anticipate," "estimate," or "continue" or the negative thereof or other variations thereon or comparable terminology constitutes forward-looking information. The following important factors, among others, in some cases have affected and in the future could affect our actual results and could cause our actual financial performance to differ materially from that expressed in any forward-looking statement: (i) our ability to retain renewing policies and write new business with a B- (Unsecure) rating from A.M. Best; (ii) our ability to continue to increase pricing in the markets in which we remain; (iii) the ability of our reinsurers to honor their obligations to us; (iv) our ability to accurately predict claim development; (v) our ability to manage both our existing claims and new claims in an effective manner; (vi) our experience with claims frequency and severity; (vii) competition and the regulatory environment in which we operate; (viii) general economic and business conditions; (ix) our ability to obtain and retain reinsurance at a reasonable cost; (x) changes in workers' compensation regulation by states, including changes in mandated benefits or insurance company regulation; (xi) interest rate changes; and (xii) other factors as noted in our other filings with the SEC. This discussion of uncertainties is by no means exhaustive but is designed to highlight important factors that may impact our future performance.

Report of Independent Auditors

The Board of Directors and Shareholders
RTW, Inc.
Minneapolis. Minnesota

We have audited the accompanying consolidated balance sheets of RTW, Inc. (the Company) as of December 31, 2002 and 2001, and the related consolidated statements of operations, stockholders' 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. The financial statements of the Company for the year ended December 31, 2000, were audited by other auditors whose report dated February 9, 2001 (March 28, 2001 as to Note 6) expressed an unqualified opinion on those statements and included an emphasis paragraph that stated the establishment of claim and claim settlement expense reserves is an inherently uncertain process.

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

In our opinion, the 2002 and 2001 financial statements referred to above present fairly, in all material respects, the consolidated financial position of RTW, Inc. at December 31, 2002 and 2001, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

/s/ ERNST & YOUNG LLP

March 25, 2003
Minneapolis, Minnesota

Report of Independent Auditors

To the Board of Directors and Shareholders
RTW, Inc.
Minneapolis, Minnesota

We have audited the accompanying consolidated statements of operations, shareholders' equity, and cash flows of RTW, Inc. and subsidiary (the Company) for the year ended December 31, 2000. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

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

As described in Note 5, the establishment of claim and claim settlement expense reserves is an inherently uncertain process.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the results of operations and cash flows of the Company for the year ended December 31, 2000, in conformity with accounting principles generally accepted in the United States of America.

/s/ DELOITTE & TOUCHE LLP

Minneapolis, Minnesota
February 9, 2001
(March 28, 2001 as to Note 6)

Consolidated Balance Sheets

December 31, 2002 and 2001
(In Thousands, Except Share Data)

	2002	2001
ASSETS		
Investments at fair value, amortized cost of $77,994 and $87,809	**$ 81,410**	$ 89,166
Cash and cash equivalents	**36,288**	3,425
Accrued investment income	**695**	1,133
Premiums receivable, less allowance of $220 and $436	**3,537**	6,665
Deposit receivable	**—**	17,635
Reinsurance recoverables:		
On unpaid claim and claim settlement expenses	**91,822**	90,115
On paid claim and claim settlement expenses	**2,109**	3,039
Deferred policy acquisition costs	**736**	1,214
Furniture and equipment, net	**1,619**	1,824
Other assets	**5,618**	4,091
Total assets	**$223,834**	$218,307
LIABILITIES AND SHAREHOLDERS' EQUITY		
Unpaid claim and claim settlement expenses	**$181,262**	$181,310
Unearned premiums	**7,130**	9,738
Accrued expenses and other liabilities	**4,382**	8,537
Notes payable	**1,250**	4,500
Total liabilities	**194,024**	204,085
Commitments and contingencies	**—**	—
Shareholders' equity:		
Undesignated stock, no par value; authorized 4,750,000 shares; none issued or outstanding	**—**	—
Series A Junior Participating Preferred Stock, no par value; authorized 250,000 shares; none issued or outstanding	**—**	—
Common stock, no par value; authorized 12,500,000 shares; issued and outstanding 5,115,000 and 5,151,000 shares	**20,619**	20,688
Retained earnings (deficit)	**6,971**	(7,348)
Accumulated other comprehensive income	**2,220**	882
Total shareholders' equity	**29,810**	14,222
Total liabilities and shareholders' equity	**$223,834**	$218,307

See notes to consolidated financial statements.

Consolidated Statements of Operations

Years Ended December 31, 2002, 2001 and 2000
(In Thousands, Except Share and Per Share Data)

	2002	2001	2000
Revenues:			
Gross premiums earned	**$ 62,506**	$ 97,420	$ 95,878
Premiums ceded	**(2,242)**	(11,363)	(17,724)
Premiums earned	**60,264**	86,057	78,154
Investment income	**5,139**	6,415	5,752
Net realized investment gains (losses):			
Realized investment gains	**1,930**	1,225	26
Realized investment losses	**(209)**	(62)	(633)
Net realized investment gains (losses)	**1,721**	1,163	(607)
Other income	**22**	2,088	—
Total revenues	**67,146**	95,723	83,299
Expenses:			
Claim and claim settlement expenses	**40,533**	80,103	72,429
Policy acquisition costs	**6,304**	13,990	14,137
General and administrative expenses	**9,984**	17,391	11,513
Total expenses	**56,821**	111,484	98,079
Income (loss) from operations	**10,325**	(15,761)	(14,780)
Interest expense	**163**	511	667
Income (loss) before income taxes	**10,162**	(16,272)	(15,447)
Income tax (benefit) expense	**(4,157)**	8,943	(5,739)
Net income (loss)	**$ 14,319**	$(25,215)	$ (9,708)
Income (loss) per share:			
Basic income (loss) per share	**$ 2.78**	$ (4.89)	$ (1.79)
Diluted income (loss) per share	**$ 2.78**	$ (4.89)	$ (1.79)
Weighted average shares outstanding:			
Basic shares outstanding	**5,146,000**	5,152,000	5,428,000
Diluted shares outstanding	**5,154,000**	5,152,000	5,428,000

See notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity

Years Ended December 31, 2002, 2001 and 2000
(In Thousands)

	Common Stock	Comprehensive Income (Loss)	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at January 1, 2000	$ 30,808		$ 27,575	$ (2,818)	$ 55,565
Comprehensive loss:					
Net loss	—	$ (9,708)	(9,708)	—	(9,708)
Other comprehensive income, net of tax:					
Change in unrealized investment gains	—	3,022	—	3,022	3,022
Comprehensive loss		$ (6,686)			
Retirement of common stock	(10,268)		—	—	(10,268)
Issuance of shares under ESPP	125		—	—	125
Balance at December 31, 2000	20,665		17,867	204	38,736
Comprehensive loss:					
Net loss	—	$ (25,215)	(25,215)	—	(25,215)
Other comprehensive income, net of tax:					
Change in unrealized investment gains	—	678	—	678	678
Comprehensive loss		$ (24,537)			
Retirement of common stock	(10)		—	—	(10)
Issuance of shares under ESPP	33		—	—	33
Balance at December 31, 2001	20,688		(7,348)	882	14,222
Comprehensive income:					
Net income	—	$ 14,319	14,319	—	14,319
Other comprehensive income, net of tax:					
Change in unrealized investment gains	—	1,338	—	1,338	1,338
Comprehensive income		$ 15,657			
Retirement of common stock	(79)		—	—	(79)
Issuance of shares under ESPP	10		—	—	10
Balance at December 31, 2002	**$ 20,619**		**$ 6,971**	**$ 2,220**	**$ 29,810**

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Years Ended December 31, 2002, 2001 and 2000
(In Thousands)

	2002	2001	2000
Cash flows from operating activities:			
Net income (loss)	**$ 14,319**	$(25,215)	$ (9,708)
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Net realized investment (gains) losses	**(1,721)**	(1,163)	607
Depreciation and amortization	**963**	1,690	1,397
Deferred income taxes	**—**	8,776	(1,371)
Changes in assets and liabilities:			
Deposit receivable	**17,635**	(17,635)	—
Amounts due from reinsurers	**(777)**	(29,014)	(20,638)
Unpaid claim and claim settlement expenses	**(48)**	52,469	29,010
Unearned premiums, net of premiums receivable	**520**	744	(1,002)
Other, net	**(5,511)**	2,832	(7,167)
Net cash provided by (used in) operating activities	**25,380**	(6,516)	(8,872)
Cash flows from investing activities:			
Maturities of investments	**—**	—	510
Purchases of available-for-sale investments	**(64,320)**	(83,341)	—
Proceeds from sales of available-for-sale investments	**75,482**	92,839	14,594
Purchases of furniture and equipment	**(630)**	(379)	(1,015)
Disposals of furniture and equipment	**270**	872	51
Net cash provided by investing activities	**10,802**	9,991	14,140
Cash flows from financing activities:			
Proceeds from notes payable	**—**	—	8,000
Payments on notes payable	**(3,250)**	(2,500)	(1,000)
Issuance of common stock under ESPP	**10**	33	125
Retirement of common stock	**(79)**	(10)	(10,268)
Net cash used in financing activities	**(3,319)**	(2,477)	(3,143)
Net increase in cash and cash equivalents	**32,863**	998	2,125
Cash and cash equivalents at beginning of year	**3,425**	2,427	302
Cash and cash equivalents at end of year	**$ 36,288**	$ 3,425	$ 2,427
Supplemental disclosure of cash flow information:			
Cash paid (received) during the year for:			
Interest	**$ 138**	$ 641	$ 458
Income tax (refunds) payments	**$ (2,976)**	$ (1,559)	$ 802

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Years ended December 31, 2002, 2001 and 2000

NOTE 1 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization - RTW, Inc. (RTW) provides workers' compensation products and services to employers on an insured and fee-for-service basis. Insurance policies are written for employers through RTW's wholly owned insurance subsidiary, American Compensation Insurance Company (ACIC). Collectively, "we," "our" and "us" will refer to these entities in these Notes to Consolidated Financial Statements.

We benefit from our ability to reduce workers' compensation costs and provide employers the ability to control their workers' compensation programs. Our insurance subsidiary is domiciled in Minnesota and is licensed in Minnesota, Colorado, Missouri, Michigan, Massachusetts, Illinois, Kansas, Connecticut, Wisconsin, Rhode Island, Florida, Iowa, Indiana, Arkansas, Pennsylvania, Tennessee, South Dakota, Maryland, Georgia, New Jersey, North Carolina, Texas and Oklahoma. We wrote policies primarily in Minnesota, Colorado and Michigan during 2002. In the fourth quarter of 2001, we announced that we would close our regional offices in Missouri and Massachusetts. Beginning February 2002, we began to non-renew all insurance policies in our Missouri and Massachusetts regions and will run off any remaining expiring policies in these regions through March 2003. We operate in a single business segment, workers' compensation products and services.

The following explain the accounting policies we use to arrive at some of the more significant amounts in our financial statements.

Accounting Principles - We prepare our financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP).

Consolidation - Our consolidated financial statements include RTW and ACIC. We eliminate all inter-company accounts and transactions in consolidation.

Use of Estimates - We make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the financial statement date and the recorded amounts of revenues and expenses during the reporting period. Our most significant estimates are those relating to our reinsurance recoverables on unpaid claim and claim settlement expenses, income taxes and accrual for premium adjustments. We continually review our estimates and assumptions and make adjustments as necessary, but actual results could vary significantly from these estimates.

Investments - We invest entirely in fixed maturity investments and classify our investments as available-for-sale.

Available-for-Sale Investments: Our available-for-sale investments are carried at fair value with changes in unrealized gains or losses, net of deferred taxes, reported as other comprehensive income. The fair values of our investments are determined based upon quoted market prices as obtained through commercial pricing services or brokers who provide estimated fair values.

Realized Investment Gains and Losses: Net realized investment gains and losses are identified separately in our Consolidated Statements of Operations. Cost of investments sold is determined by the specific identification method.

We continually monitor the difference between investment cost and fair value for each of our securities. If any security experienced a decline in value that is determined to be other than temporary, we would reduce the security's carrying value for the decline and record a realized loss in the Consolidated Statements of Operations. In 2000, we recorded $500,000 against a security whose decline in value was determined to be other than temporary. No securities were reduced for declines in fair value in 2002 or 2001.

***Cash and Cash Equivalents* -** We consider all highly liquid investments with maturities of three months or less when purchased to be cash equivalents.

***Fair Value of Financial Instruments* -** A number of our significant assets and liabilities (including reinsurance recoverables, deferred policy acquisition costs, furniture and equipment and unpaid claim and claim settlement expenses) are not considered financial instruments for disclosure purposes. Our premiums receivable and other assets and liabilities that are considered financial instruments are generally of a short-term nature. Our term loan bears a floating interest rate. The carrying values of these instruments approximate their fair values. The carrying values and fair values of investments are disclosed in Note 3.

***Deferred Policy Acquisition Costs* -** The costs directly related to writing an insurance policy are referred to as policy acquisition costs and consist of commissions, state premium taxes and other direct underwriting expenses. Although these costs arise when we issue a policy, we defer certain costs, principally commissions and state premium taxes. These costs are amortized to expense as premium revenue is recognized and are reported net of ceding commissions in the Statement of Operations. If deferred policy acquisition costs were to exceed the sum of unearned premiums net of reinsurance and related anticipated investment income less expected claim and claim settlement expenses, we would immediately expense the excess costs.

***Depreciation* -** We depreciate furniture and equipment on a straight-line basis over the estimated useful lives of the assets (five to ten years). Accumulated depreciation was $4.0 million at December 31, 2002 and $3.7 million at December 31, 2001.

***Unpaid Claim and Claim Settlement Expenses* -** Claim expenses refer to amounts that we paid or expect to pay to claimants for insured events that have occurred. The costs of investigating, resolving and processing these claims are referred to as claim settlement expenses. We record these expenses, net of amounts recoverable under reinsurance contracts, as "Claim and claim settlement expenses" in the Consolidated Statements of Operations.

Our "Unpaid claim and claim settlement expenses" represent reserves established for the estimated total unpaid cost of claim and claim settlement expenses for insured events that occurred on or prior to each balance sheet date. The reserves are primarily undiscounted; however, we discounted selected claims that have fixed or determinable future payments by $438,000 in 2002 and $482,000 in 2001 using discount factors ranging from 3.5% to 8.0%. These reserves reflect our estimates of the total cost of claims that were reported, but not yet paid, and the cost of claims incurred but not yet reported. Our estimates consider such variables as past loss experience, current claim trends and prevailing social, economic and legal environments. We have a limited amount of historical data to use in estimating our reserves for unpaid claim and claim settlement expenses because we commenced operations in 1992. As a result, we supplement our experience with external industry data, as adjusted to reflect anticipated differences between our results and the industry. We reduce the unpaid claim and claim settlement expenses for estimated amounts of subrogation.

We believe our reserves for unpaid claim and claim settlement expenses are adequate to cover the ultimate costs of claim and claim settlement expenses. The ultimate cost of claim and claim settlement expenses may differ from the established reserves, particularly when claims may not be settled for many years. Reserves for unpaid claim and claim settlement expenses and assumptions used in their development are continually reviewed. We record adjustments to prior estimates of unpaid claim and claim settlement expenses, which may be material, in operations in the year in which the adjustments are made.

Premiums Earned - Premiums on workers' compensation insurance policies are our largest source of revenue. The premium we charge a policyholder is a function of its payroll, industry and prior workers' compensation claims experience. In underwriting a policy, we receive policyholder payroll estimates for the ensuing year. We record premiums written on an installment basis, matching billing to the policyholder, and earn premiums on a daily basis over the life of each insurance policy based on the payroll estimate. We record the excess of premiums billed over premiums earned for each policy as unearned premiums on our balance sheet. When a policy expires, we audit employer payrolls for the policy period and adjust the estimated payroll and the policyholder's premium to its actual value. The result is a "final audit" adjustment recorded to premiums earned when the adjustment becomes known. We also estimate the final audit amount to be billed on unexpired and expired unaudited policies and record a final audit receivable included in premiums receivable on the balance sheet. Final audit premiums recognized during the period include billed final audit premiums plus (or minus) the change in estimate for final audit premiums on unexpired and expired unaudited policies.

NOTE 2 — INCOME PER SHARE

Basic income (loss) per share (IPS) is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Diluted IPS is computed by dividing net income (loss) by the weighted average number of common shares and dilutive securities outstanding for the period. Dilutive securities consist of stock options. Dilutive securities are considered outstanding from the date of grant, after applying the treasury stock method for determining the dilutive effect.

The following is a reconciliation of the numerators and denominators of basic and diluted income (loss) per share:

	2002	2001	2000
Net income (loss) per share	**$ 14,319**	$ (25,215)	$ (9,708)
Basic weighted average shares outstanding	**5,146,000**	5,152,000	5,428,000
Effect of dilutive stock options	**8,000**	—	—
Diluted weighted average shares outstanding	**5,154,000**	5,152,000	5,428,000
Basic income (loss) per share	**$ 2.78**	$ (4.89)	$ (1.79)
Diluted income (loss) per share	**$ 2.78**	$ (4.89)	$ (1.79)

Options to purchase 1.5 million shares of common stock at prices ranging from $1.98 to $38.67 were outstanding during 2001 and options to purchase 1.2 million shares of common stock at prices ranging from $5.33 to $38.67 were outstanding in 2000 but excluded from the computation of diluted IPS due to our 2001 and 2000 net losses. Diluted weighted average shares outstanding would have increased by 4,000 shares and 8,000 shares in 2001 and 2000, respectively, had these shares not been anti-dilutive in the computation.

NOTE 3 — INVESTMENTS

Valuation of Investments - The following tables present amortized cost, gross unrealized gains and losses and estimated fair values of our available-for-sale securities (000's):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
2002				
U.S. government securities	$45,463	$ 2,581	$ (21)	$48,023
Asset-backed securities	1,009	6	—	1,015
Mortgage-backed securities	31,522	861	(11)	32,372
Total investments	$77,994	$ 3,448	$ (32)	$81,410
2001				
U.S. government securities	25,921	524	(108)	26,337
Corporate securities	16,908	317	(67)	17,158
Asset-backed securities	506	4	—	510
Mortgage-backed securities	44,474	812	(125)	45,161
Total investments	$87,809	$ 1,657	$(300)	$89,166

Statutory Deposits - Included in investments are U.S. government securities on deposit with various regulatory authorities, as required by law, with a fair value of $27.7 million and $18.6 million at December 31, 2002 and 2001, respectively.

Additionally, included in investments are U.S. government securities pledged as collateral against a letter of credit provided to an insurer, with a fair value of $4.3 million and $2.6 million at December 31, 2002 and December 31, 2001.

Fixed Maturities by Maturity Date - The following table presents the amortized cost and fair value of investments by contractual maturity at December 31, 2002. Actual maturities may differ from those stated as a result of calls and prepayments (000's):

Maturing In:	Amortized Cost	Estimated Fair Value
One year or less	$ 5,663	$ 5,754
Over one year through five years	16,821	17,446
Over five years through ten years	10,834	11,529
Over ten years	13,154	14,309
Mortgage-backed securities with various maturities	31,522	32,372
Total investments	$77,994	$81,410

Investment Income - Investment income includes income from the following sources (000's):

	2002	2001	2000
Fixed maturity	**$ 4,221**	$ 5,599	$5,519
Interest on deposit receivable	**736**	518	—
Short-term investments	**144**	286	185
Other	**38**	12	48
Investment income	**$ 5,139**	$ 6,415	$5,752

NOTE 4 — REINSURANCE

Our financial statements reflect the effects of ceded reinsurance transactions. We purchase reinsurance to protect us from potential losses in excess of the level we are willing to accept. Our primary reinsurance is excess of loss coverage that limits our per-incident exposure.

We report reinsurance related balances on a "gross" basis on the balance sheet, resulting in reinsurance recoverable amounts on paid and on unpaid claim and claim settlement expenses recorded as assets. We estimate amounts recoverable from reinsurers in a manner consistent with the claim liability associated with the reinsured policy.

We ceded Minnesota claims in excess of $350,000, $330,000 and $310,000 per occurrence during 2002, 2001 and 2000, respectively, to the Minnesota Workers' Compensation Reinsurance Association (WCRA). In our non-Minnesota states, our per-incident exposure was $300,000 in 2002, 2001 and 2000. We purchased this non-Minnesota coverage from a single reinsurer.

For claims occurring after June 30, 1998, we further limited our per incident exposure by purchasing excess of loss coverage for losses from $25,000 to the lesser of $300,000 or the WCRA selected retention level in Minnesota and from $25,000 to $300,000 in other states from a single reinsurer. This agreement was finalized after its effective date and activity occurring from July 1, 1998 through September 30, 1998 was recorded on a retrospective basis resulting in the deferral of a gain totaling $2.0 million at December 31, 1998. We amortized $400,000 of the deferred gain as a reduction of claim and claim settlement expenses in each of 2002, 2001 and 2000 and $740,000 in 1999 resulting in an un-amortized deferred gain of $49,000 at December 31, 2002. The deferred gain is being amortized into income using the effective interest rate inherent in the amounts paid to the reinsurer and the estimated timing and amounts of recoveries from the reinsurer. Activity occurring on or after October 1, 1998 is recorded prospectively. This contract was terminated effective December 31, 2000; however, the policy was effective in 2001 for policies in force at December 31, 2000 through expiration, not to exceed fifteen months after the effective termination date. Policies written or renewing after December 31, 2000 are not covered under this lower level excess of loss reinsurance policy.

Reinsurance contracts do not relieve us from our obligations to policyholders. We expect reinsurers to which we have ceded reinsurance to honor their obligations. Failure of these reinsurers to honor their obligations could result in losses to us. We do not anticipate any such losses and accordingly, no provision for amounts deemed uncollectible are included in our financial statements. We attempt to minimize our exposure to significant losses from reinsurer insolvency by monitoring the financial condition of our reinsurers. The reinsurance recoverable on unpaid claim and claim settlement expenses associated with reinsurers are as follows (000's):

	2002	2001
Excess of loss reinsurance through various reinsurers	**$ 91,822**	$ 90,115

The effect of ceded reinsurance on premiums written and claim and claim settlement expenses are as follows (000's):

	2002	2001	2000
Premiums written:			
Direct	**$ 59,898**	$ 94,703	$ 95,566
Ceded	**(2,242)**	(11,363)	(17,724)
Net premiums written	**$ 57,656**	$ 83,340	$ 77,842
Claim and claim settlement expenses:			
Direct	**$ 60,109**	$128,734	$105,133
Ceded	**(19,576)**	(48,631)	(32,704)
Net premiums written	**$ 40,533**	$ 80,103	$ 72,429

The reinsurance recoverable on paid claim and claim settlement expenses consists primarily of receivables from paid claim and claim settlement expenses that were submitted to but not yet reimbursed by reinsurers at December 31, 2002 and 2001.

NOTE 5 — UNPAID CLAIM AND CLAIM SETTLEMENT EXPENSES

As described in Note 1, we establish unpaid claim and claim settlement expense reserves on reported and unreported claims for insured losses. The establishment of appropriate reserves is an inherently uncertain process. Furthermore, estimating ultimate reserves is difficult due to our relatively limited historical claim data and small claim population. Estimates are further complicated by the extended periods of time that elapse between the date the loss occurs and the date the loss is reported and ultimately settled. Reserve estimates are regularly reviewed and updated, using the most current information available. Any resulting adjustments, which may be material, are reflected in current operations.

The following table represents a reconciliation of beginning and ending unpaid claim and claim settlement expense reserves for each of the last three years (000's):

	2002	2001	2000
Balance at January 1	**$181,310**	$128,841	$ 99,831
Less reinsurance recoverables	**(90,115)**	(61,845)	(41,179)
Plus deferred gain on retrospective reinsurance	**449**	849	1,249
Net balance at January 1	**91,644**	67,845	59,901
Incurred related to:			
Current year	**49,621**	73,557	56,900
Prior years	**(8,356)**	7,731	15,929
Write-off of reinsurance recoverable	**(332)**	(785)	—
Amortization of deferred retrospective reinsurance gain	**(400)**	(400)	(400)
Total incurred	**40,533**	80,103	72,429
Paid related to:			
Current year	**13,715**	25,062	28,154
Prior years	**28,973**	31,242	36,331
Total paid	**42,688**	56,304	64,485
Net balance at December 31	**89,489**	91,644	67,845
Plus reinsurance recoverables	**91,822**	90,115	61,845
Plus deferred gain on retrospective reinsurance	**(49)**	(449)	(849)
Balance at December 31	**$181,262**	$181,310	$128,841

Changes in estimates of unpaid claim and claim settlement expenses for prior years decreased the provision for claim and claim settlement expenses by $8.4 million in 2002 and increased the provision for claim and claim settlement expenses by $7.7 million in 2001 and by $15.9 million in 2000.

Our estimate for unpaid claim and claim settlement expenses decreased in 2002 due to the following: (i) in March 2002, the Minnesota State legislature changed the way the commissioner will assess self-insured employers and insurers for estimated liabilities and administrative expenses of the State's Special Compensation Fund (SCF). The assessment changed from being paid by the insurer on indemnity payments to an assessment charged on premium to the policyholder. We decreased our recorded accrual to reflect this legislative change, (ii) the frequency of claims reported in 2002 for 2001 and prior years was less than anticipated when we determined our liability in 2001, (iii) we overestimated the liability for our mandatory participation in state and national assigned risk pool operating results for states in which we operate in 2001 and reversed that excess in 2002, and (iv) our estimate of the liability for unpaid claim and claim settlement expenses is difficult and volatile due to our relatively limited historical claim data and small claim population.

NOTE 6 — NOTES PAYABLE

In March 2000, we borrowed $8.0 million under a term loan agreement to fund the repurchase of common stock from certain of our shareholders. We paid $1.0 million in principal on the term loan in 2000, an additional $2.5 million in 2001 and $3.3 million in 2002. The term loan accrues interest, payable quarterly. We may elect to pay an adjusted LIBOR or bank reference rate on the term loan (adjusted LIBOR was 4.66% and 8.22% at December 31, 2002 and 2001, respectively). The remaining term loan is payable in 2003.

The amended term loan is collateralized by the stock of ACIC and is subject to restrictive financial covenants that require maintaining minimum financial ratios, including (i) debt coverage, (ii) net worth, (iii) statutory surplus, (iv) net earnings, (v) risk based capital and (vi) investment grade ratings. The agreement also restricts dividends, purchases and redemptions or retirements of common stock.

At December 31, 2002, we failed to meet a financial covenant of the term loan. We paid an additional $250,000 in principal in March 2003 and the covenant was waived in March 2003. Under the waiver, term loan principal payments were adjusted for a waiver of the financial covenant under the term loan agreement. The remaining term loan balance is due in 2003.

NOTE 7 — INCOME TAXES

We compute all income tax amounts using the liability method. Under this method, deferred tax assets and liabilities are recognized for the expected tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts using presently enacted tax rates. Deferred tax assets are recognized for tax credit and net operating loss carry-forwards, reduced by a valuation allowance which is established when it is "more likely than not" that some portion or all of the deferred tax assets will not be realized. The effect on deferred tax assets and liabilities of a change in tax rates or regulations is recognized in income in the period that includes the enactment date.

Income tax expense (benefit) consists of the following (000's):

	2002	2001	2000
Current:			
Federal	**$ (3,521)**	$ —	$ (320)
State	**85**	242	100
Total current tax (benefit) expense	**$ (3,436)**	$ 242	$ (220)
Deferred:			
Federal	**$ (721)**	$8,585	$(5,558)
State	**—**	116	39
Total deferred tax (benefit) expense	**$ (721)**	$8,701	$(5,519)
Income tax (benefit) expense	**$(4,157)**	$8,943	$(5,739)

Our income tax (benefit) expense differs from the federal statutory rate as follows (000's):

	2002	2001	2000
Federal income tax expense (benefit) at 35%	**$ 3,557**	$ (5,695)	$(5,406)
Increase (reduction) in income tax expense (benefit) resulting from:			
State income taxes, net of federal tax benefit	**242**	228	58
Non-deductible investment amortization and tax-exempt investment income	**18**	(48)	(814)
Deferred income tax valuation allowance	**(7,927)**	14,560	—
Other	**(47)**	(102)	423
Income tax (benefit) expense	**$(4,157)**	$ 8,943	$(5,739)

Differences between the tax basis of assets and liabilities and their reported amounts in the Consolidated Financial Statements that will result in taxable or deductible amounts in future years are called temporary differences. The tax effects of temporary differences that gave rise to net deferred tax assets, included within other assets, are as follows (000's):

	2002	2001
Unpaid claim and claim settlement expenses	**$6,452**	$6,038
Net operating loss carry-forward	**2,598**	6,925
Accrued second injury funds	**483**	2,670
Unearned premiums	**889**	935
Office closure costs	**145**	380
Retrospective insurance	**17**	158
Other	**235**	652
Deferred tax assets	**10,819**	17,758
Net unrealized gain on securities	**(1,196)**	(475)
Deferred policy acquisition costs	**(756)**	(427)
Depreciation	**(234)**	(296)
Deferred tax liabilities	**(2,186)**	(1,198)
Net deferred tax assets before valuation allowance	**8,633**	16,560
Valuation allowance	**(6,633)**	(14,560)
Net deferred tax asset	**$2,000**	$2,000

In assessing the realizability of deferred tax assets, we consider recent operating results, the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies. At December 31, 2001, we established a $14.5 million valuation allowance against deferred tax assets resulting in a corresponding adjustment to income tax expense as a result of this analysis. In 2002, the valuation allowance decreased to $6.6 million as we were able to carry back our 2001 operating loss five years resulting in a tax refund and the reversal of certain deferred tax items and utilization of the 2000 operating loss carry forward to offset income in 2002. We expect the remaining deferred tax asset, net of the valuation allowance, at December 31, 2002 to be realized as a result of income and the reversal of existing taxable temporary differences in the future. Deferred tax assets are included in other assets on the Consolidated Balance Sheet.

We have net operating loss carry-forwards available totaling approximately $7.6 million that expire in 2020.

Income taxes receivable were approximately $793,000 and $83,000 at December 31, 2002 and 2001, respectively, and are included in other assets.

NOTE 8 — EMPLOYEE BENEFITS AND PLANS

Stock Based Compensation - We account for our stock-based compensation plans, the RTW, Inc. 1995 Employee Stock Purchase Plan and Trust (ESPP) and the 1994 Stock Plan, using Accounting Principles Board Opinion No. 25 (APB 25), "Accounting for Stock Issued to Employees," and related Interpretations. Under APB 25, compensation cost for stock options is measured as the excess, if any, of the quoted market price of our stock at the date of the grant over the amount an employee must pay to acquire the stock.

1995 Employee Stock Purchase Plan - The ESPP provides employees the opportunity to purchase shares of our stock at 85% of the fair value based on the lesser of the beginning or ending share price for each plan year as set forth in the plan. In May 1998, the shares reserved for distribution under the plan were increased from 37,500 to 100,000 shares. The ESPP terminates in ten years and will be carried out in phases, each consisting of one year or a different period of time approved by the Board of Directors. Any employee completing two weeks of service prior to commencing a phase of the plan may participate. Employees may elect to contribute from $10 to 10% of monthly salary to the plan through payroll withholdings. The following summarizes shares purchased and purchase prices for each phase in the most recent three years completed through 2002:

Phase:	Shares Purchased	Purchase Price
Beginning April 1999, expiring April 2000	19,577	$6.38
Beginning April 2000, expiring April 2001	9,490	3.40
Beginning April 2001, expiring April 2002	5,047	1.90

The eighth one-year phase began in April 2002 and expires in April 2003.

Our liability for employee contributions withheld at December 31, 2002 and 2001 for the purchase of shares in April 2003 and April 2002 under the ESPP was $51,000 and $39,000, respectively.

1994 Stock Plan - The 1994 Stock Plan provides for awards of qualified and non-qualified stock options. In July 1998, the Board of Directors increased the shares reserved for distribution under the plan to 1,000,000. Option price, option term, vesting provisions and other limits and restrictions are determined at the time of grant by the Board of Directors or, if established, by a separate committee. The exercise price for all options granted was the market price of the common stock at the date of grant.

Options granted, exercised, canceled and outstanding under the 1994 Stock Plan are as follows:

	Qualified		Non-Qualified	
	Option Shares	Weighted Average Exercise Price	Option Shares	Weighted Average Exercise Price
Balance, January 1, 2000	511,772	$13.36	263,226	$13.31
Granted	77,750	10.26	—	—
Canceled	(268,792)	13.42	—	—
Balance, December 31, 2000	320,730	12.56	263,226	13.31
Granted	46,000	4.93	217,500	1.98
Canceled	(74,340)	10.71	—	—
Balance, December 31, 2001	292,390	11.83	480,726	8.19
Granted	25,500	2.48	112,500	2.40
Canceled	(180,819)	12.24	(266,351)	12.60
Balance, December 31, 2002	137,071	$ 9.54	326,875	$ 2.60

Each of the qualified stock options expires ten years from the date of grant and substantially all are subject to continued employment with us. Each of the non-qualified options expires ten years from the date of grant. Certain of the options are subject to vesting provisions that restrict exercise of the option.

The following table summarizes the options outstanding and exercisable at December 31, 2002:

	Options Outstanding			Options Exercisable	
		Weighted Average			
Exercise Price Range	Number of Options	Contractual Life	Exercise Price	Number of Options	Weighted Average Exercise Price
Qualified stock options:					
$21.50 – $38.67	4,375	3.7 years	$28.86	4,375	$28.86
14.00 – 17.33	39,696	5.4 years	15.15	39,696	15.15
8.75 – 10.75	38,000	7.1 years	10.55	25,585	10.54
2.20 – 4.50	55,000	8.9 years	3.25	9,833	3.91
$ 2.20 – $38.67	137,071	7.2 years	$ 9.54	79,489	$13.03
Non-qualified stock options:					
$31.75	5,000	4.1 years	$31.75	5,000	$31.75
1.98 – 5.33	321,875	9.0 years	2.15	126,041	2.17
$ 1.98 – $31.75	326,875	8.9 years	2.60	131,041	$ 3.30

Pro Forma Information - Had we calculated compensation expense for our option grants under the 1994 Stock Plan and stock issuances under the ESPP based on the fair value method described in SFAS No. 123, "Accounting for Stock-Based Compensation," our net (loss) income and basic and dilutive net (loss) income per share would approximate the following pro forma amounts (in 000's, except per share data):

	2002	2001	2000
Net income (loss):			
As reported	**$14,319**	$(25,215)	$(9,708)
Pro forma	**13,998**	(25,705)	(10,507)
Basic net income (loss) per share:			
As reported	**2.78**	(4.89)	(1.79)
Pro forma	**2.72**	(4.99)	(1.94)
Dilutive net income (loss) per share:			
As reported	**2.78**	(4.89)	(1.79)
Pro forma	**2.72**	(4.99)	(1.94)

The weighted average fair value of options granted under the ESPP and 1994 Stock Plan during 2002, 2001 and 2000 is estimated at $2.94, $2.19 and $4.48, respectively, on the date of grant using the Black-Scholes option-pricing model with the following assumptions: no dividend yield; volatility of 125.6% in 2002, 182.8% in 2001 and 64.6% in 2000; risk-free interest rates ranging from 1.66% to 7.70%; and an expected life of 1 to 5 years.

Employment Contracts - We entered into one-year employment agreements with our Chairman, David C. Prosser, President and Chief Executive Officer, J. Alexander Fjelstad, and Executive Vice President, Alfred L. LaTendresse beginning December 13, 2001. Under these agreements, each receives a base salary, subject to review annually for increase by our Board of Directors. Mr. Prosser receives $250,000 which includes $30,000 for his services as Chairman of the Board and $220,000 in base salary. Mr. Fjelstad receives a base salary of $275,000 and Mr. LaTendresse a base salary of $200,000. In addition to base salary, each is eligible for bonuses and expense reimbursements. We also provide these individuals with health, dental, life and disability insurance consistent with that provided to other officers and employees. Additionally, Mr. Fjelstad and Mr. LaTendresse were each granted 100,000 non-qualified options at $1.98 per share on December 13, 2001. Mr. Prosser was granted 100,000 non-qualified options on February 6, 2002 at $2.42 per share.

Employment agreements with Carl B. Lehmann, our former President and Chief Executive Officer expired during 2001 and Mr. Lehmann terminated his employment with us on December 12, 2001. Under supplemental agreements with Mr. Lehmann in 2000 and 2001, we paid him “stay bonuses” of $200,000 on January 15, 2001 and $100,000 on June 30, 2001.

Combined Retirement Plan - We combine our 401(k) Retirement Plan and Employee Stock Ownership Plan (ESOP) into a single KSOP retirement plan. The KSOP retains the features of each separate component except for eligibility and vesting provisions. Under the plan, employees become eligible to participate in the plan on the first day of the month after beginning employment and attaining age 21.

401(k) Retirement Component - We sponsor a defined contribution retirement component under Section 401(k) of the Internal Revenue Code for eligible employees. Our contributions are discretionary and are based on contributions made by employees. Expense recognized for 2002, 2001 and 2000 was $220,000, $316,000 and $152,000, respectively.

Employee Stock Ownership Component - We maintain an ESOP for our qualified employees. Our contributions are discretionary. We may contribute cash or shares of our common stock. No expense was recorded in 2002, 2001 or 2000.

Other Employee Benefit Plans - We maintained bonus plans in 2002, 2001 and 2000 under which all employees, including officers, were eligible for a bonus based, in part, on our operating results. These bonuses aggregated $864,000, $204,000 and $951,000 in 2002, 2001 and 2000, respectively.

NOTE 9 — SHAREHOLDERS' EQUITY

On November 7, 2002 our Board of Directors approved a one-for-two reverse stock split in order to remedy the minimum bid requirement for continued listing on the Nasdaq National Market. The reverse stock split was effective to shareholders of record on the close of business on November 22, 2002. All share and per share amounts in these financial statements have been adjusted to reflect the effect of the stock splits.

On September 15, 1998, our Board of Directors approved a share repurchase program authorizing the repurchase of up to $4.0 million of RTW, Inc. common stock. We may repurchase shares on the open market or through private transactions depending upon market conditions and availability. Through December 31, 2002 we repurchased approximately 376,000 shares for $2.7 million. We will use the repurchased shares for employee stock option and purchase plans and other corporate purposes.

On March 28, 2000, we repurchased 709,285 shares, outside the share repurchase program, from a group consisting of David C. Prosser, RTW's founder and who at the time was a director, certain members of his family, and J. Alexander Fjelstad, who at the time was a former director and former executive of RTW (together, the Prosser Selling Group). We paid $10.38 per share, as well as legal and other costs, totaling approximately $7.7 million to repurchase the shares. After completing the transaction, the combined ownership of Mr. Prosser, members of his family and Mr. Fjelstad was reduced from approximately 52% to 46%. In December 2001, Mr. Fjelstad returned to RTW as President and Chief Executive Officer and a director (see Note 8).

In connection with the repurchase, Mr. Prosser retired from the Company, resigned as Chairman and was paid $225,000 as a termination benefit. He remained a member of our Board of Directors. In December 2001, Mr. Prosser returned to RTW as Chairman of the Board (see Note 8).

Shareholder Rights Plan - In April 1997, we adopted a shareholder rights plan and declared a dividend of one right for each outstanding share of common stock to shareholders of record at the close of business on June 30, 1997. The rights become exercisable only after any person or group (the Acquiring Person) becomes the beneficial owner of 15% or more of the voting power of our common stock. Certain shares held by our Chairman, David C. Prosser, and his wife are excluded from the computation for determining whether a person is an Acquiring Person. Each right entitles its registered holder to purchase from us one one-hundredth share of a new Series A Junior Participating Preferred Stock, no par value, at a price of $85 per one one-hundredth share, subject to adjustment. If any Acquiring Person acquires beneficial ownership of 15% or more of our voting power, each right will entitle its holder (other than such Acquiring Person) to purchase, at the then current purchase price of the right, that number of shares of our common stock having a market value of two times the purchase price of the right, subject to certain possible adjustments. In addition, if we are acquired in a merger or other business combination transaction, each right will entitle its holder to purchase, at the then current purchase price of the right, that number of common shares of the acquiring company having a market value of two times the purchase price of the right. Following the acquisition of a beneficial ownership of 15% or more of our outstanding common stock by any Acquiring Person and prior to an acquisition by any Acquiring Person of 50% or more of our outstanding common stock, our Board of Directors may exchange the outstanding rights (other than rights owned by such Acquiring Person), in whole or in part, at an exchange ratio of one share of common stock, or one one-hundredth share of Preferred Stock (or equivalent securities) per right, subject to adjustment. We may redeem the rights, in whole, at $.001 per right, at any time prior to an acquisition by any Acquiring Person of 15% or more of our outstanding common stock and prior to the expiration of the rights. The rights expire on April 17, 2007, unless extended or earlier redeemed by us.

Dividend Restrictions - Dividends are paid as determined by our Board of Directors. No cash dividends have ever been paid by us.

Our ability to pay cash dividends to shareholders may depend upon the amount of dividends received from our insurance subsidiary. ACIC's ability to pay dividends is restricted by law or subject to approval of the insurance regulatory authorities of Minnesota.

Under Minnesota insurance law regulating the payment of dividends by ACIC, any such payments must be an amount deemed prudent by ACIC's Board of Directors and, unless otherwise approved by the Commissioner of the Minnesota Department of Commerce (Commissioner), must be paid solely from the adjusted earned surplus of ACIC. Adjusted earned surplus means the earned surplus as determined in accordance with statutory accounting practices (unassigned funds), less 25% of the amount of such earned surplus that is attributable to unrealized capital gains. Further, without approval of the Commissioner, ACIC may not pay a dividend in any calendar year which, when combined with dividends paid in the preceding twelve months, exceeds the greater of (i) 10% of ACIC's statutory capital and surplus at the prior year end or (ii) 100% of ACIC's statutory net gain from operations (not including realized capital gains) for the prior calendar year. For 2002, dividends in excess of approximately $2.7 million would require prior consent of the Commissioner.

Statutory Surplus and Statutory Net Income (Loss) - Our insurance subsidiary is required to file financial statements with state regulatory agencies. The accounting principles used to prepare the statutory financial statements follow prescribed accounting practices that differ from GAAP. Statutory policyholders' surplus at December 31, 2002 and 2001, and statutory net income (loss) for the years ended December 31, 2002, 2001 and 2000 are as follows (000's):

	Statutory Policyholders Surplus	Statutory Net Income(Loss)
2002	$26,820	$12,064
2001	19,542	(14,074)
2000		(16,600)

In March 1998, the National Association of Insurance Commissioners adopted the Codification of Statutory Accounting Principles (the Codification). The Codification standardized regulatory accounting and reporting to state insurance departments and became effective January 1, 2001. Statutory accounting principles, however, will continue to be established by individual state laws and permitted practices. The State of Minnesota required adoption of the Codification for preparing statutory financial statements for financial periods occurring on or after January 1, 2001. Adoption of the Codification increased our statutory capital and surplus by approximately $1.9 million at December 31, 2001.

NOTE 10 — COMMITMENTS AND CONTINGENCIES

Operating Leases - We conduct our operations in leased office facilities under operating lease agreements. The agreements provide for monthly base lease payments plus contingent rentals based on an allocable portion of certain operating expenses incurred by the lessor.

Future minimum (base) rental payments required under the leases, as of December 31, 2002, are as follows (000's):

2003	$1,260
2004	1,276
2005	1,147
2006	933
2007	583

Rent expense, including contingent rentals, was $1.3 million, $2.0 million and $2.1 million for 2002, 2001 and 2000, respectively.

In the ordinary course of administering our workers' compensation programs, we are routinely involved in the adjudication of claims resulting from workplace injuries. We are not involved in any legal or administrative claims that we believe are likely to have a material adverse effect on our financial condition or results of operations.

NOTE 11 — ACCUMULATED OTHER COMPREHENSIVE INCOME

Our comprehensive income (loss) includes only unrealized gains and losses on investments classified as available-for-sale. Changes in accumulated other comprehensive income (loss) and other comprehensive income (loss) were as follows (000's):

	2002	2001	2000
Accumulated other comprehensive income (loss), beginning of year	**$ 882**	$ 204	$(2,818)
Changes in comprehensive income (loss) arising during the year:			
Net unrealized investment gains	**3,780**	2,211	3,972
Less: Adjustment for net realized investment gains (losses)	**1,721**	1,163	(607)
Change in net unrealized investment gains	**2,059**	1,048	4,579
Income tax expense	**721**	370	1,557
Other comprehensive income for the year	**1,338**	678	3,022
Accumulated other comprehensive income, end of year	**$2,220**	$ 882	$ 204

NOTE 12 — RESTRUCTURING CHARGES

During 2001, we recorded pre-tax restructuring charges totaling $2.0 million to general and administrative expenses in the Consolidated Statement of Operations. These charges included costs associated with our decision to close our Missouri and Massachusetts regional offices, as well as our Brainerd, Minnesota and Overland Park, Kansas satellite offices. We anticipated that 38 employees in our regional offices, 17 employees in our satellite offices and 2 employees in our Home Office would be affected by these closures. The restructuring charge included $715,000 of severance pay and benefits, of which $106,000 was paid by December 31, 2001 and the remainder of which was paid, primarily early, in 2002. Additionally, the restructuring charge included office and equipment lease costs totaling $684,000 of which $80,000 was paid by December 31, 2001 with an additional $195,000 paid in 2002 and furniture and equipment disposals and other costs totaling $600,000 of which $53,000 had been disposed of by December 31, 2001, the remainder of which was disposed of in 2002. At December 31, 2001, the remaining accrual for severance pay and benefits, office and equipment lease costs and furniture and equipment disposals and other costs was $1.8 million. The accrual decreased to $409,000 at December 31, 2002 and primarily included amounts related to future lease payments.

NOTE 13 — TERMINATION OF DEPOSIT CONTRACT

In June 2001, we entered into an agreement with St. Paul RE (SPR) effective January 1, 2001. Key provisions of this agreement included ceding 50% of the subject net earned premium to SPR in exchange for various levels of paid claim reimbursement through several loss corridors as defined in the agreement. In December 2002, we negotiated the termination of this agreement with SPR. In connection with the termination, we received $28.8 million in cash in December 2002 representing a return of all deposits made under the agreement less claim reimbursements for claims paid through December 2002. In 2002, we recorded a gain on the termination totaling $1.0 million representing the difference between the deposit receivable balance and the amount received from SPR.

NOTE 14 — QUARTERLY RESULTS OF OPERATIONS (Unaudited)

Quarterly revenues are affected by (i) premiums in force at the beginning of the quarter, (ii) new policies written in the quarter, (iii) final audit premiums recognized during the quarter, and (iv) our policy renewal rate in the quarter. Historically, a majority of new policies written and policy renewals have occurred in the first, second and fourth quarters.

The following tables present unaudited quarterly results of operations for the eight quarters ended December 31, 2002:

2002	First Quarter (Revised)	Second Quarter (Revised)	Third Quarter	Fourth Quarter
	(In thousands, except per share data)			
Premiums in force	$68,800	$59,100	$60,200	$54,200
Revenues:				
Gross premiums earned	$17,843	$14,367	$15,668	$14,628
Premiums ceded	(878)	14	(562)	(816)
Premiums earned	16,965	14,381	15,106	13,812
Investment income	1,423	1,403	1,227	1,086
Net realized investment gains (losses)	1,451	(12)	354	(72)
Other income	—	—	—	22
Total revenues	19,839	15,772	16,687	14,848
Expenses:				
Claim and claim settlement expenses	11,681	11,330	10,255	7,267
Policy acquisition costs	2,186	1,608	1,814	696
General and administrative expenses	3,230	2,413	2,386	1,955
Total expenses	17,097	15,351	14,455	9,918
Income from operations	$ 2,742	$ 421	$ 2,232	$ 4,930
Net income	$ 2,659	$ 208	$ 3,393	$ 8,059
Basic income per share	$ 0.52	$ 0.04	$ 0.66	$ 1.57
Diluted income per share	$ 0.52	$ 0.04	$ 0.66	$ 1.57

The following represent pre-tax adjustments recorded during each quarter of 2002 that affected reported net income:

Changes in estimated reinsurance costs	$ —	$ 669	$ 350	$ —
Realized gains on repositioning our investment portfolio	1,451	—	354	—
Changes in estimates for unpaid claim and claim settlement expenses on claims reported in prior years	3,000	—	1,250	4,106
Second injury fund accrual adjustments	—	—	—	851
Gain recorded on termination of St. Paul Re contract	—	—	—	957
Change in recorded deferred income tax valuation allowance	—	—	1,296	6,001

2001	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(In thousands, except per share data)			
Premiums in force	$104,100	$ 99,400	$ 89,400	$ 83,700
Revenues:				
Gross premiums earned	$ 26,123	$ 25,803	$ 23,419	$ 22,075
Premiums ceded	(4,114)	(3,238)	(2,476)	(1,535)
Premiums earned	22,009	22,565	20,943	20,540
Investment income	1,457	1,736	1,594	1,628
Net realized investment losses	1,079	28	25	31
Other income	2,088	—	—	—
Total revenues	26,633	24,329	22,562	22,169
Expenses:				
Claim and claim settlement expenses	18,990	19,828	16,032	25,253
Policy acquisition costs	3,626	3,565	3,147	3,652
General and administrative expenses	2,816	4,339	3,776	6,460
Total expenses	25,432	27,732	22,955	35,365
Income (loss) from operations	$ 1,201	$ (3,403)	$ (393)	$(13,166)
Net income (loss)	$ 777	$ (2,335)	$ (339)	$(23,318)
Basic income (loss) per share	$ 0.15	$ (0.45)	$ (0.07)	$ (4.53)
Diluted income (loss) per share	$ 0.15	$ (0.45)	$ (0.07)	$ (4.53)

The following represent pre-tax adjustments recorded during each quarter of 2001 that affected reported net income:

Realized gains on repositioning the investment portfolio	$ 1,079	$ —	$ —	$ 1,079
Refund received from the Minnesota WCRA	2,088	—	—	2,088
Changes in estimates for unpaid claim and claim settlement expenses on claims reported in prior years	(3,550)	(1,905)	—	(2,276)
Change in estimate for unpaid claim and claim settlement expenses on claims reported in the current year	—	(2,142)	—	(8,124)
Restructuring charge for Missouri and Massachusetts regional office closures	—	—	—	(1,999)
Deferred income tax valuation allowance	—	—	—	(14,560)

QUARTERLY STOCK PRICE COMPARISON AND DIVIDENDS

Our shares are publicly traded on The Nasdaq Stock Market under the symbol RTWI. We effected a one-for-two reverse split of our common stock on November 22, 2002. The table below sets forth the range of high and low sales prices for our stock for each quarter during the past two years. We had approximately 2,000 shareholders of our common stock at the close of trading on March 1, 2003.

Fiscal Year:	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2002				
High	$2.70	$3.74	$2.70	$2.54
Low	0.72	1.16	0.94	1.20
2001				
High	11.88	5.28	3.84	11.24
Low	4.25	2.00	1.36	0.50

We have never paid cash dividends on our common stock. We currently intend to retain any and all income for use in our business and do not anticipate paying cash dividends in the foreseeable future. Any future determination as to payment of dividends will depend on our financial condition and results of our operations and such other factors deemed relevant by the Board of Directors.

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