NATIONAL SECURITY GROUP INC
Form 10-K/A
May 04, 2011

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

FORM 10-K/A
Amendment No. 3

x ANNUAL REPORT PURSUANT TO SECTION 13 or 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Fiscal Year Ended December 31, 2009

OR

TRANSITION REPORT PURSUANT TO SECTION 13 or 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Transition Period From ________ to_________

Commission File Number 0-18649

The National Security Group, Inc.
(Exact name of registrant as specified in its charter)

Delaware	63-1020300
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)
661 East Davis Street Elba, Alabama	36323
(Address of principal executive offices)	(Zip-Code)

Registrant's Telephone Number including Area Code (334) 897-2273

Securities registered pursuant to Section 12 (b) of the Act:

None

Securities registered pursuant to Section 12 (g) of the Act:

Common Stock, par value $1.00 per share The NASDAQ Global Market (EXCHANGE)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No x

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of “large accelerated filler,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller Reporting Company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No x

The aggregate market value of the voting stock held by non-affiliates of the Registrant as of the last business day of the registrant’s most recently completed second fiscal quarter, based upon the bid price of these shares on NASDAQ on such date, was $15,850,514

Indicate the number of shares outstanding of each of the issuer’s classes of Common Stock, as of the close of the period covered by this report.

Class	Outstanding March 26, 2010
Common Stock, $1.00 par value	2,466,600 shares

Documents Incorporated by Reference

Annual Report of The National Security Group, Inc. on Form 10-K for the fiscal year ended December 31, 2009, as filed with the Securities and Exchange Commission on March 26, 2010

Explanatory Note

This Amendment number 3 on Form 10-K/A amends the annual report of The National Security Group, Inc. (the "Company") on Form 10-K/A -2 for the fiscal year ended December 31, 2009, as filed with the Securities and Exchange Commission on March 31, 2011. This amendment is being filed primarily to include the Company's CFO certification found in exhibit 31.2, to revise the form reference in exhibits 31.1 and exhibit 31.2 to reflect Form 10-K/A and to revise the certification in exhibit 32 to reference the annual period 12/31/2009.

The previously filed Amendment number 2 on Form 10-K/A amended the annual report of The National Security Group, Inc. (the "Company") on Form 10-K/A -1 for the fiscal year ended December 31, 2009, as filed with the Securities and Exchange Commission on March 4, 2011. The amendment was filed primarily to include the Company's audited consolidated financial statements for the year ended December 31, 2008 and accompanying report of Warren, Averett, Kimbrough & Marino, LLC (WAKM), which references their audit of the Company's 2008 consolidated financial statements.

Due to the predecessor auditor's refusal to reissue their audit report, registrant engaged its current auditor, WAKM to audit its 2008 consolidated financial statements. Registrant filed Amendment number 2 to the 2009 10-K to include its audited consolidated financial statements for the year ended December 31, 2008. There were no significant reclassifications or adjustments resulting from the audit of the 2008 consolidated financial statements.

Except as otherwise expressly set forth herein and in registrant's amendment on Form 10-K/A-2 filed with the SEC on March 31, 2011, all of the information in this Form 10-K/A-3 is consistent with filing dated March 26, 2010, the date the Company originally filed the 2009 10-K with the SEC. This Form 10-K/A-3 continues to speak as of the date of the 2009 10-K and does not reflect any subsequent information or events other than as expressly set forth otherwise in this Form 10-K/A-3. Accordingly, this Form 10-K/A-3 should be read in conjunction with our filings made with the SEC subsequent to the filing of the 2009 10-K, including any amendments to those filings. Among other things, forward-looking statements made in the 2009 10-K have not been revised to reflect events, results or developments that occurred or facts that became known to us after the date of the 2009 10-K, other than this amendment.

Except as amended by the Form 10-K/A-1, Form 10K/A-2 and this Form 10-K/A-3, the information contained in the 2009 10-K is significantly unchanged and may be reviewed in conjunction with the filing made on March 26, 2010.

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Item 6. Selected Financial Data

Five-Year Financial Information:
(Amounts in thousands, except per share)

Operating results	2009	2008	2007	2006	2005
Net premiums earned	$ 59,594	$ 56,264	$ 62,250	$ 58,874	$ 53,563
Net investment income	5,289	4,368	4,749	4,463	3,964
Net realized investment (losses) gains	357	(1,049)	1,493	2,565	3,493
Other income	764	1,107	1,071	1,211	1,416
Total revenues	$ 66,004	$ 60,690	$ 69,563	$ 67,113	$ 62,436
Net income (loss)	$ 4,224	$ (5,204)	$ 6,040	$ 4,250	$ 1,558
Net income (loss) per share	$ 1.71	$ (2.11)	$ 2.45	$ 1.72	$ 0.63

Other Selected Financial Data	2009	2008	2007	2006	2005
Total shareholders' equity	$ 41,168	$ 34,648	$ 48,447	$ 45,379	$ 43,556
Book value per share	$ 16.69	$ 14.04	$ 19.64	$ 18.39	$ 17.66
Dividends per share	$ 0.600	$ 0.900	$ 0.900	$ 0.885	$ 0.865
Net change in unrealized capital gains (net of tax)	$ 3,520	$ (6,147)	$ (664)	$ (244)	$ (2,544)
Total assets	$ 131,396	$ 124,890	$ 135,585	$ 134,911	$ 139,226

Quarterly Information:

	Premiums	Investment & Other Income	Realized Investment Gains (Losses)	Claims and Benefit Payments	Net Income (Loss)	Net Income (Loss) Per Share
2009						
1st QTR	$ 15,220	$ 1,378	$ 1	$ 7,792	$ 1,481	$ 0.60
2nd QTR	15,373	1,566	(231)	11,314	92	0.04
3rd QTR	14,357	1,584	79	9,131	651	0.26
4th QTR	14,644	1,525	508	7,602	2,000	0.81
	$ 59,594	$ 6,053	$ 357	$ 35,839	$ 4,224	$ 1.71
2008						
1st QTR	$ 16,586	$ 1,642	$ 66	$ 10,560	$ 782	$ 0.32
2nd QTR	13,968	1,593	82	10,812	(36)	(0.01)

3rd QTR	11,707	1,586	(1,452)	15,795	(6,945)	(2.82
4th QTR	14,003	654	255	7,579	995	0.40
	$ 56,264	$ 5,475	$ (1,049)	$ 44,746	$ (5,204)	$ (2.11

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Item 8. Financial Statements and Supplementary Data

Index to Financial Statements

All other Schedules are not required under related instructions or are not applicable and therefore have been omitted.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
The National Security Group, Inc.
Elba, Alabama

We have audited the accompanying consolidated balance sheets of The National Security Group, Inc. as of December 31, 2009 and 2008, and the related consolidated statements of operations, shareholders' equity and cash flows for the years then ended. The Company's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). 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. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement and financial statement schedules presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The National Security Group, Inc. as of December 31, 2009 and 2008, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the financial statement schedules listed in the accompanying index appearing under Item 8, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

/s/ Warren, Averett, Kimbrough & Marino, LLC

Birmingham, Alabama
March 31, 2011

The National Security Group, Inc.

CONSOLIDATED BALANCE SHEETS

	(Dollars in thousands)			
	December 31,			
ASSETS		2009		2008
Investments				
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2009 - $6,080; 2008 - $10,995)	$	5,942	$	10,952
Fixed maturities available-for-sale, at estimated fair value (cost: 2009 - $69,796; 2008- $61,796)		70,269		58,107
Equity securities available-for-sale, at estimated fair value (cost: 2009 - $5,851 2008 - $5,467)		9,035		7,569
Trading securities		374		253
Receivable for securities		96		513
Mortgage loans on real estate, at cost		1,041		502
Investment real estate, at book value (accumulated depreciation: 2009 - $18; 2008 - $18)		4,815		4,754
Policy loans		1,018		968
Company owned life insurance		5,197		1,957
Other invested assets		3,933		4,557
Total Investments		101,720		90,132
Cash		4,686		3,027
Accrued investment income		802		804
Policy receivables and agents' balances, less allowance (2009 - $0; 2008 - $59)		9,700		9,179
Reinsurance recoverable		784		4,146
Deferred policy acquisition costs		10,210		9,825
Property and equipment, net		2,537		2,844
Deferred income tax asset		-		1,839
Accrued income tax recoverable		-		2,321
Other assets		957		773
Total Assets	$	131,396	$	124,890

See accompanying notes to consolidated financial statements

The National Security Group, Inc.

CONSOLIDATED BALANCE SHEETS

	(Dollars in thousands) December 31,	
LIABILITIES AND SHAREHOLDERS' EQUITY	2009	2008
Property and casualty benefit and loss reserves	$ 12,646	$ 14,436
Accident and health benefit and loss reserves	1,612	1,222
Life and annuity benefit and loss reserves	28,579	28,045
Unearned premiums	27,381	27,764
Policy and contract claims	535	503
Other policyholder funds	1,347	1,344
Long-term debt	12,372	12,372
Accrued income taxes	111	-
Deferred income tax liability	61	-
Other liabilities	5,584	4,556
Total Liabilities	90,228	90,242
Contingencies	-	-
Shareholders' Equity		
Preferred stock, $1 par value, 500,000 shares authorized, none issued or outstanding	-	-
Class A common stock, $1 par value, 2,000,000 shares authorized, none issued or outstanding	-	-
Common stock, $1 par value, 3,000,000 and 10,000,000 shares authorized, respectively,		
2,466,600 shares issued and outstanding	2,467	2,467
Additional paid-in capital	4,951	4,951
Accumulated other comprehensive income (loss)	2,265	(1,511)
Retained earnings	31,485	28,741
Total Shareholders' Equity	41,168	34,648
Total Liabilities and Shareholders' Equity	$ 131,396	$ 124,890

See accompanying notes to consolidated financial statements

The National Security Group, Inc.

CONSOLIDATED STATEMENTS OF OPERATIONS

	(Dollars in thousands except per share amounts) Year Ended December 31,	
	2009	2008
REVENUES		
Net premiums earned	$ 59,594	$ 56,264
Net investment income	5,289	4,368
Net realized investment gains (losses)	357	(1,049)
Other income	764	1,107
	66,004	60,690
BENEFITS AND EXPENSES		
Policyholder benefits paid or provided	35,839	44,746
Amortization of deferred policy acquisition costs	3,673	4,344
Commissions	7,863	8,262
General and administrative expenses	10,396	8,558
Taxes, licenses and fees	1,631	1,447
Interest expense	1,126	1,147
	60,528	68,504
Income (Loss) Before Income Tax Expense (Benefit)	5,476	(7,814)
INCOME TAX EXPENSE (BENEFIT)		
Current	1,136	(1,725)
Deferred	116	(885)
	1,252	(2,610)
Net Income(Loss)	$ 4,224	$ (5,204)
Net Earnings (Loss) Per Common Share	$ 1.71	$ (2.11)

See accompanying notes to consolidated financial statements

THE NATIONAL SECURITY GROUP, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(Dollars in thousands)

	Total	Comprehensive Income (Loss)	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Common Stock	Paid-in Capital
Balance at December 31, 2007	$ 48,447	$ -	$ 36,165	$ 4,864	$ 2,467	$ 4,951
Comprehensive loss:						
Net loss for 2008	(5,204)	(5,204)	(5,204)	-	-	-
Other comprehensive loss, net of tax						
Unrealized loss on securities, net of reclassification adjustment of ($978)	(6,147)	(6,147)	-	(6,147)	-	-
Unrealized loss on interest rate swap	(228)	(228)	-	(228)	-	-
Comprehensive loss		(11,579)				
Cash dividends ($0.90 per share)	(2,220)		(2,220)	-	-	-
Balance at December 31, 2008	34,648		28,741	(1,511)	2,467	4,951
Comprehensive income:						
Net income for 2009	4,224	4,224	4,224	-	-	-
Other comprehensive income, net of						

tax						
Unrealized gain on securities, net of reclassification adjustment of $282	3,520	3,520	-	3,520	-	-
Unrealized gain on interest rate swap	256	256	-	256	-	-
Comprehensive income		8,000				
Cash dividends ($0.60 per share)	(1,480)		(1,480)	-	-	-
Balance at December 31, 2009	$ 41,168		$ 31,485	$ 2,265	$ 2,467	$ 4,951

See accompanying notes to consolidated financial statements.

The National Security Group, Inc.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)

	Year ended December 31, 2009	Year ended December 31, 2008
Cash flows from operating activities:		
Net income (loss)	$ 4,224	$ (5,204)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation expense and amortization/accretion, net	229	409
Increase in cash surrender of company owned life insurance	(740)	543
Net realized (gains) losses on investments	(357)	1,049
Deferred income taxes	116	(885)
Amortization of deferred policy acquisition costs	3,673	4,344
Changes in assets and liabilities:		
Change in receivable for securities	417	(513)
Change in accrued investment income	2	(10)
Change in reinsurance recoverable	3,362	(3,229)
Policy acquisition costs deferred	(4,058)	(5,176)
Change in accrued income taxes	2,432	(3,400)
Change in prepaid reinsurance premiums	(10)	(2)
Change in net policy liabilities and claims	(1,738)	8,105
Change in other liabilities	1,284	(2,204)
Other, net	(113)	405
Net cash provided by (used in) operating activities	8,723	(5,768)
Cash flows from investing activities:		
Purchases of:		
Available-for-sale securities	(30,594)	(22,514)
Trading securities and short-term investments	(141)	(909)
Real estate held for investment	(66)	(446)
Company owned life insurance	(2,500)	(2,500)
Other invested assets	(108)	(3,170)
Property and equipment	(116)	(368)
Proceeds from sale or maturities of:		
Held-to-maturity securities	4,926	6,377
Available-for-sale securities	22,830	28,938
	20	1,795

Trading securities and short-term investments				
Real estate held for investment		19		720
Other invested assets		732		716
Other		(589)		(58)
Net cash (used in) provided by investing activities		(5,587)		8,581
Cash flows from financing activities:				
(Repayment of) Proceeds from short-term debt		-		(900)
Change in other policyholder funds		3		35
Dividends paid		(1,480)		(2,220)
Net cash used in financing activities		(1,477)		(3,085)
Net increase (decrease) in cash		1,659		(272)
Cash at beginning of year		3,027		3,299
Cash at end of year	$	4,686	$	3,027

See accompanying notes to consolidated financial statements.

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NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation
The accompanying consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary - Omega One Insurance Company (Omega) . The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). All significant intercompany transactions and accounts have been eliminated.

The significant accounting policies followed by the Company and subsidiaries that materially affect financial reporting are summarized below.

Description of Business
NSIC is licensed in the states of Alabama, Florida, Georgia, Mississippi, South Carolina and Texas and was organized in 1947 to provide life and burial insurance policies to the home service market. Business is now produced by both company and independent agents. Primary products include ordinary life, accident and health, supplemental hospital, and cancer insurance products.

NSFC is licensed in Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, Oklahoma, South Carolina, Tennessee and West Virginia. In addition, NSFC operates on a surplus lines basis in Louisiana, Missouri, and Texas. NSFC operates in various property and casualty lines, the most significant of which are dwelling property fire and extended coverage, homeowners, mobile homeowners, ocean marine, private passenger automobile physical damage and liability and commercial auto liability.

Omega is licensed in the states of Alabama and Louisiana. Omega operates in property and casualty lines, the most significant of which are homeowners and private passenger automobile physical damage and liability.

The Company is incorporated under the laws of the State of Delaware. Its Common Stock is traded on the NASDAQ Global Market under the ticker symbol NSEC. Pursuant to the regulations of the United States Securities and Exchange Commission (SEC), the Company is considered a "Smaller Reporting Company" as defined by SEC Rule 12b-2 of the Exchange Act. The Company has elected to comply with the new scaled disclosure requirements of Regulation S-K and only two years of financial statements are included herein. The Company previously used a non-accelerated filer status.

Use of Estimates
The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Among the more significant estimates included in these financial statements are reserves for future policy benefits, liabilities for losses and loss adjustment expenses, reinsurance recoverable asset on associated loss and loss adjustment expense liabilities, deferred policy acquisition costs, deferred income tax assets and liabilities, and assessments of other than temporary impairments on investments. Actual results could differ from those estimates.

Concentration of Risk
The Company's property and casualty segment is licensed or operates on a surplus lines basis in 13 states. However, over 60% of segment revenue is generated in the states of Alabama, Mississippi and Louisiana, subjecting the

Company to significant geographic concentration. Consequently, adverse weather conditions or changes in the legal, regulatory or economic environment could adversely impact the Company.

The Company's life, accident and health insurance segment, composing nearly 12% of consolidated revenues, is licensed in six states. However, over 75% of segment revenue is generated in the states of Alabama and Georgia. Consequently, changes in the legal, regulatory or economic environment could adversely impact the Company.

For the year ended December 31, 2009 and 2008, there was one agency in the property and casualty segment that individually produced greater than 5% of the Company's direct written premium.

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Investments
The Company's securities are classified as follows:

- Securities Held-to-Maturity. Bonds, notes and redeemable preferred stock for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts which are recognized in interest income using methods which approximate level yields over the period to maturity.

- Securities Available-for-Sale. Bonds, notes, common stock and non-redeemable preferred stock not classified as either held-to-maturity, or trading are reported at fair value, and adjusted for other-than-temporary declines in fair value.

- Trading Securities. Trading securities are classified as such on the balance sheet and reported at fair value.

Unrealized gains and losses on investments, net of tax, on securities available-for-sale are reflected directly in shareholders' equity as a component of accumulated other comprehensive income, and accordingly, have no effect on net income until realized.

Changes in fair value of trading securities are recognized in net income.

Realized gains and losses on the sale of investments available-for-sale are determined using the specific-identification method and include write downs on available-for-sale investments considered to have other than temporary declines in market value.

When a fixed maturity security has a decline in value, where fair value is below amortized cost, an other-than-temporary impairment (OTTI) is triggered in circumstances where:

- the Company has the intent to sell the security

- it is more likely-than-not that the Company will be required to sell the security before recovery of its amortized cost basis

- the Company does not expect to recover the entire amortized cost basis of the security.

If the Company intends to sell the security or if it is more-likely-than not the Company will be required to sell the security before recovery, an OTTI is recognized as a realized loss in the income statement equal to the difference between the security's amortized cost and its fair value. If the Company does not intend to sell the security or it is not more-likely-than not that the Company will be required to sell the security before recovery, the OTTI is separated into an amount representing the credit loss, which is recognized as a realized loss in the income statement, and the amount related to all other factors, which is recognized in other comprehensive income.

When an equity security has a decline in value, where fair value is below cost, that is deemed to be other than temporary, the Company reduces the book value of the security to its current fair value, recognizing the decline as a realized loss in the income statement. Any future increases in the market value of investments written down are reflected as changes in unrealized gains as part of accumulated other comprehensive income within stockholders' equity.

Interest on fixed income securities is credited to income as it accrues on the principal amounts outstanding adjusted for amortization of premiums and accretion of discounts computed utilizing the effective interest rate method. Premiums and discounts on mortgage backed securities are amortized or accreted using anticipated prepayments with changes in anticipated prepayments accounted for prospectively. The model used to determine anticipated prepayment assumptions for mortgage backed securities uses separate home sale, refinancing, curtailment and pay-off assumptions derived from a variety of industry sources. Mortgage-backed security valuations are subject to prospective adjustments in yield due to changes in prepayment assumptions. The utilization of the prospective method will result in a recalculated effective yield that will equate the carrying amount of the investment to the present value of the projected future cash flows. The recalculated yield is used to accrue income on investments for subsequent periods.

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Mortgage loans and policy loans are stated at the unpaid principal balance of such loans.

Investment real estate is reported at cost, less allowances for depreciation computed on the straight-line basis. Investment real estate consists primarily of timberland and undeveloped commercial real estate. Real estate is carried at cost.

Other investments consist primarily of investments in notes and equity investments in limited liability companies and company owned life insurance. The Company has no influence or control over the operating or financial policies of the investee limited liability companies and consequently, these investments are accounted for using the cost method.

The Company owns life insurance contracts on certain management employees. The life insurance contracts are carried at their current cash surrender value. Changes in cash surrender values are included in income in the current period. Death proceeds from the contracts are recorded when the proceeds become payable under the terms of the policy.

Cash and short-term investments are carried at cost, which approximates market value.

Investments with other than temporary impairment in value are written down to estimated realizable values and losses recognized in the determination of net income. The fair value of the investment becomes its new cost basis.

Fair Values of Financial Instruments
The Company uses the following methods and assumptions to estimate fair values:

Investments – Fixed income security fair values are based on quoted market prices when available. If not available, fair values are based on values obtained from investment brokers and independent pricing services.

Equity security fair values are based on quoted market prices.

Multiple observable inputs are not available for certain of our investments, primarily private placements and limited partnerships. Management values these investments either using non-binding broker quotes or pricing models that utilize market based assumptions that have limited observable inputs.

Receivables and reinsurance recoverable – The carrying amounts reported approximate fair value.

Interest rate swaps – The estimated fair value of the interest rate swaps is based on valuations received from financial institution counterparties.

Trust preferred securities obligations and line of credit obligations – The carrying amounts reported for these instruments are equal to the principal balance outstanding and approximate their fair value.

Policy Receivables
Receivable balances are reported at unpaid balances, less a provision for credit losses.

Accounts Receivable

Accounts receivable are reported at net realizable value. Management determines the allowance for doubtful accounts based on historical losses and current economic conditions. On a continuing basis, management analyzes delinquent receivables and, once these receivables are determined to be uncollectible, they are written off through a charge against an existing allowance account or against earnings.

Property and Equipment

Property and equipment is carried at cost less accumulated depreciation and includes expenditures that substantially increase the useful lives of existing property and equipment. Significant costs incurred for internally developed software are capitalized and amortized over estimated useful lives of 3 years. Maintenance, repairs, and minor renovations are charged to expense as incurred. Upon sale or retirement of property and equipment, the costs and related accumulated depreciation are eliminated from the respective account and the resulting gain or loss is included in the results of operations. The Company provides for depreciation of property and equipment using the straight-line method designed to amortize costs over estimated useful lives. Estimated useful lives range up to 40 years for buildings and from 3-8 years

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

for electronic data processing equipment and furniture and fixtures. Property and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

Statement of Cash Flows
For purposes of reporting cash flows, cash includes cash-on-hand, demand deposits with banks and overnight investments.

Premium Revenue
Life insurance premiums are recognized as revenues when due. Property and casualty insurance premiums include direct writings plus reinsurance assumed less reinsurance ceded and are recognized on a pro rata basis over the terms of the policies. Unearned premiums represent that portion of direct premiums written that are applicable to the unexpired terms of policies in force and is reported as a liability. Prepaid reinsurance premiums represent the unexpired portion of premiums ceded to reinsurers and is reported as an asset.

Deferred Policy Acquisition Costs
The costs of acquiring new insurance business are deferred and amortized over the lives of the policies. Deferred costs include commissions, premium taxes, other agency compensation and expenses, and other underwriting expenses directly related to the level of new business produced.

Acquisition costs relating to life contracts are amortized over the premium paying period of the contracts, or the first renewal period of term policies, if earlier. Assumptions utilized in amortization are consistent with those utilized in computing policy liabilities.

The method of computing the deferred policy acquisition costs for property and casualty policies limits the amount deferred to a percentage of related unearned premiums.

Policy Liabilities
The liability for future life insurance policy benefits is computed using a net level premium method including the following assumptions:

Years of Issue	Interest Rate
1947 - 1968	4%
1969 - 1978	6% graded to 5%
1979 - 2003	7% graded to 6%
2004 - 2009	5.25%

Mortality assumptions include various percentages of the 1955-60 and 1965-70 Select and Ultimate Basic Male Mortality Table. Withdrawal assumptions are based on the Company’s experience.

Claim Liabilities
The liability for unpaid claims represents the estimated liability for claims reported to the Company and its subsidiaries plus claims incurred but not yet reported and the related loss adjustment expenses. The liabilities for claims and related adjustment expenses are determined using case-basis evaluations and statistical analyses and represent estimates of the ultimate net cost of all losses incurred through December 31 of each year. Although considerable variability is inherent in such estimates, management believes that the liabilities for unpaid claims and related loss adjustment expenses are adequate. The estimates are continually reviewed and adjusted as necessary; such adjustments are included in the period in which they are determined.

Earnings Per Share
Earnings per share of common stock is based on the weighted average number of shares outstanding during each year. The adjusted weighted average shares outstanding were 2,466,600 (2,466,600 in 2008).

Reinsurance
In the normal course of business, NSFC seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. In 2009, NSFC maintained a catastrophe reinsurance agreement to cover losses from catastrophic events, primarily hurricanes.

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Under the catastrophe reinsurance program, the Company retains the first $3.5 million in losses from each event. Reinsurance is maintained in four layers as follows:

Layer	Reinsurers' Limits of Liability
First Layer	95% of $6,500,000 in excess of $3,500,000
Second Layer	95% of $7,500,000 in excess of $10,000,000
Third Layer	100% of $25,000,000 in excess of $17,500,000
Fourth Layer	100% of $30,000,000 in excess of $42,500,000

Layers 1-3 cover events occurring from January1-December 31 of the contract year. The Company placed the fourth layer in July allowing an interim review of exposure and projected storm patterns for the current contract year. The fourth layer covers events occurring from July 1-June 30 of the contract year. All significant reinsurers under the program carry A.M. Best ratings of A- (Excellent) or higher.

Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policy. Amounts paid for prospective reinsurance contracts are reported as prepaid reinsurance premiums and amortized over the remaining contract period.

In the normal course of business, NSIC seeks to limit its exposure to loss on any single insured and to recover a portion of benefits paid by ceding reinsurance to other insurance enterprises or reinsurers under excess coverage contracts. NSIC retains a maximum of $50,000 of coverage per individual life. The cost of reinsurance is amortized over the contract period of the reinsurance.

Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Deferred income taxes arise from the recognition of temporary differences between financial statement carrying amounts and the tax bases of the Company’s assets and liabilities and operating loss carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A valuation allowance is provided when it is more likely than not that some portion of the deferred tax asset will not be realized. The effect of a change in tax rates is recognized in the period the new rate is enacted.

The Company evaluates all tax positions taken on its U.S. federal income tax return. No material uncertainties exist for any tax positions taken by the Company

Contingencies

Liabilities for loss contingencies arising from, but not limited to, litigation, claims, assessments, fines and penalties are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated.

Reclassifications

Certain 2008 amounts have been reclassified from the prior year financial statements to conform to the 2009 presentation.

Advertising

The Company expenses advertising costs as incurred. Advertising costs charged to expense were $109,000 for the year ended December 31, 2009 ($186,000 for the year ended December 31, 2008). Advertising cost consists primarily of agent convention expense and print media.

Concentration of Credit Risk

The Company maintains cash depository accounts which, at times, may exceed federally insured limits. These amounts represent actual account balances held by financial institutions at the end of the period, and unlike the balance reported in the financial statements, the account balances do not reflect timing delays inherent in reconciling items such as outstanding checks and deposits in transit. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents.

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Policy receivables are reported at unpaid balances. Policy receivables are generally offset by associated unearned premium liabilities and are not subject to significant credit risk. Receivables from agents, less provision for credit losses, are composed of balances due from independent agents. At December 31, 2009 the single largest balance due from one agent totaled $525,000.

Reinsurance contracts do not relieve the Company of its obligations to policyholders. A failure of a reinsurer to meet their obligation could result in losses to the insurance subsidiaries. Allowances for losses are established if amounts are believed to be uncollectible. At December 31, 2009 and 2008, no amounts were deemed uncollectible. The Company, at least annually, evaluates the financial condition of all reinsurers and evaluates any potential concentrations of credit risk. At December 31, 2009, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

Recently Issued Accounting Standards

In April 2009, a new accounting standard was issued which amends the recognition guidance for other-than-temporary impairments (OTTI) of debt securities and expands the financial statement disclosures for OTTI on debt and equity securities.

- This new accounting standard states that an OTTI write-down of debt securities, where fair value is below amortized cost, is triggered in circumstances where (1) an entity has the intent to sell a security, (2) it is more-likely-than-not that the entity will be required to sell the security before recovery of its amortized cost basis, or (3) the entity does not expect to recover the entire amortized cost basis of the security. If an entity intends to sell a security or if it is more-likely-than-not the entity will be required to sell the security before recovery, an OTTI write-down is recognized in earnings equal to the difference between the security’s amortized cost and its fair value. If an entity does not intend to sell the security or it is not more-likely-than-not that it will be required to sell the security before recovery, the OTTI write-down is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to all other factors, which is recognized in other comprehensive income.

- This new accounting standard requires that companies record, as of the beginning of the interim period of adoption, a cumulative-effect adjustment to reclassify the noncredit component of a previously recognized OTTI loss from retained earnings to other comprehensive income if the Company does not intend to sell the security and it is more-likely-than-not that the Company will not be required to sell the security before recovery of its amortized cost basis. The adoption had no impact on our financial position or results of operations. The Company had no cumulative-effect adjustment upon adoption at the beginning of the second quarter.

In April 2009, a new accounting standard was issued related to determining fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not orderly. Our adoption of this new accounting standard was effective April 1, 2009. The new accounting standard reaffirms that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions. The new accounting standard also reaffirms the need to use judgment in determining if a formerly active market has become inactive and in determining fair values when the market has become inactive. The implementation of the new guidance did not have a significant impact on our financial statements.

In April 2009, a new accounting standard was issued related to interim disclosures about fair value of financial instruments. The new accounting standard requires disclosing qualitative and quantitative information about the fair value of all financial instruments on a quarterly basis, including methods and significant assumptions used to estimate fair value during the period. These disclosures were previously only done annually. The disclosures required by the new accounting standard were effective for the quarter ending June 30, 2009. The implementation of the new guidance did not have a significant impact on our financial statements.

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

In June 2009, a new accounting standard was issued related to the accounting for transfers of financial assets, which updates accounting for securitizations and special-purpose entities. The new accounting standard is a revision of previously issued accounting standards related to accounting for transfers and servicing of financial assets and extinguishments of liabilities, and will require additional information regarding financial asset transfers, including securitization transactions, and the presence of continuing exposure around the risks related to transferred financial assets. In addition, the new accounting standard removes the concept of a qualifying special-purpose entity and changes the requirements for de-recognizing financial assets. The new accounting standard was effective January 1, 2010. We do not expect the implementation of this new accounting standard to have a significant impact on our financial statements.

In June 2009, new consolidation guidance was issued which replaces the quantitative-based risks and rewards calculation for determining whether an enterprise is the primary beneficiary in a variable interest entity with an approach that is primarily qualitative, requires ongoing assessments whether an enterprise is the primary beneficiary of a variable interest entity, and requires additional disclosure about an enterprise’s involvement in variable interest entities. This guidance is effective for financial statements issued for fiscal years beginning after November 15, 2009. We do not expect the adoption of this guidance to have a material impact on our financial statements.

Effective July 1, 2009, the Financial Accounting Standards Board (FASB) issued the Accounting Standards Codification (ASC), which combined and superseded all existing non-SEC accounting and reporting standards under GAAP and became the single official source for authoritative GAAP guidance combined with guidance issued by the U.S. Securities and Exchange Commission (SEC). The FASB no longer issues new standards in the previous formats. Instead, amendments to the Codification are made by issuing “Accounting Standards Updates” (ASU). The Codification did not change existing GAAP. Accordingly, the issuance of the codification did not impact the Company’s consolidated results of operations or financial condition.

In August 2009, the FASB issued ASU 2009-05 “Measuring Liabilities at Fair Value” (“ASU 2009-05”). ASU 2009-05 updated ASC Section 820-10 (“Fair Value Measurements”) to provide additional guidance on how to measure liabilities at fair value for which a quoted price in an active market is not available. In this situation a company can either use the quoted price of an identical liability when traded as an asset or the quoted price of similar liabilities when traded as assets. As of December 31, 2009, the only liability measured at fair value was an interest rate swap discussed in Note 7. The new guidance was effective for the company on October 1, 2009. The implementation of the new guidance did not have a significant impact on our financial statements.

NOTE 2 – VARIABLE INTEREST ENTITIES

The Company holds a passive interest in a limited partnership that is considered to be a Variable Interest Entity (VIE) under the provisions of FIN 46(R). The Company is not the primary beneficiary of the entity and is not required to consolidate under FIN 46(R). The entity is a private placement investment fund formed for the purpose of investing in private equity investments. The Company owns less than 1% of the limited partnership. The carrying value of the investment totals $325,000 and is included as a component of Other Invested Assets.

In December 2005, the Company formed National Security Capital Trust I, a statutory trust created under the Delaware Statutory Trust Act, for the sole purpose of issuing, in private placement transactions, $9,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase $9,300,000 of variable rate subordinated debentures issued by the Company. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of $9,005,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the trust. The Subordinated Debentures, disclosed in Note 9, are reported in the accompanying Consolidated Balance Sheets as a component of long-term debt. The Company's equity investments in the Trust total $279,000 and are included in Other Assets.

NOTE 2 – VARIABLE INTEREST ENTITIES – CONTINUED

In June 2007, the Company formed National Security Capital Trust II for the sole purpose of issuing, in private placement transactions, $3,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase $3,093,000 unsecured junior subordinated deferrable interest debentures. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of $2,995,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the Trust. The Subordinated Debentures, disclosed in Note 9, are reported in the accompanying Consolidated Balance

Sheets as a component of long-term debt. The Company's equity investments in the Trust total $93,000 and are included in Other Assets.

NOTE 3 – STATUTORY ACCOUNTING PRACTICES

The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) which vary in certain respects from reporting practices prescribed or permitted by insurance regulatory authorities. The significant differences for statutory reporting include: (a) acquisition costs of acquiring new business are charged to operations as incurred, (b) life policy liabilities are established utilizing interest and mortality factors specified by regulatory authorities, (c) the Asset Valuation Reserve (AVR) and the Interest Maintenance Reserve (IMR) are recorded as liabilities, and (d) non-admitted assets (furniture and equipment, agents' debit balances and prepaid expenses) are charged directly to surplus.

Statutory net gains (losses) from operations and capital and surplus, excluding intercompany transactions, are summarized as follows:

	2009	2008
NSIC - including realized capital gains (losses) of $234 and $(1,509), respectively	$ 1,314	$ (442)
NSFC - including realized capital gains of $198 and $615, respectively	$ 4,179	$ (5,730)
Omega - including realized capital (losses) of $(78) and $(231), respectively	$ 246	$ (344)
Statutory risk-based adjusted capital:		
NSIC - including AVR of $517 and $191, respectively	$ 9,642	$ 8,396
NSFC	$ 28,742	$ 26,783

Omega	$ 9,568	$ 9,087

The above amounts exclude allocation of overhead from the Company. NSIC, NSFC and Omega are in compliance with statutory restrictions with regard to minimum amounts of surplus and capital.

NOTE 4 – INVESTMENT SECURITIES

The amortized cost and aggregate fair values of investments in securities are as follows:

	(Dollars in thousands) December 31, 2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
Corporate debt securities	$ 26,786	$ 1,557	$ 519	$ 27,824
Mortgage backed securities	8,203	282	165	8,320
Private label mortgage backed securities	9,634	72	810	8,896
Obligations of states and political subdivisions	15,641	211	336	15,516
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	9,532	261	80	9,713
Total fixed maturities	69,796	2,383	1,910	70,269
Equity securities	5,851	3,990	806	9,035
Total	$ 75,647	$ 6,373	$ 2,716	$ 79,304
Held-to-maturity securities:				
Mortgage backed securities	$ 3,175	$ 101	$ 25	3,251
Private label mortgage backed securities	187	5	-	192
Obligations of states and political subdivisions	2,139	51	8	