

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

Global Market (EXCHANGE)

The NASDAQ

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

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

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 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 filer," "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

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

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.

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) |

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| | | | | | | |
|---------|-----------|----------|-------------|-----------|-------------|----------|
| 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 |

Item 8. Financial Statements and Supplementary Data

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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

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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

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| 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)

| | | | Accumulated Other | | | |
|--|-----------|--------------------------------|----------------------|--------------------------------|-----------------|--------------------|
| | Total | Comprehensive Income (Loss) | Retained Earnings | 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 | | \$ 4,951 |
| | | | | \$ 2,265 | \$ 2,467 |

See accompanying notes to consolidated financial statements.

| | | |
|---|-----------|-----------|
| 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.

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:

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

Layers 1-3 cover events occurring from January 1-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 | 2,182 |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 441 | 14 | - | 455 |
| Total | \$ 5,942 | \$ 171 | \$ 33 | \$ 6,080 |

December 31, 2008
Gross Gross

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| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|-------------------|---------------------|----------------------|------------------|
| Available-for-sale securities: | | | | |
| Corporate debt securities | \$ 21,153 | \$ 84 | \$ 2,277 | \$ 18,960 |
| Mortgage backed securities | 11,101 | 257 | 24 | 11,334 |
| Private label mortgage backed securities | 6,590 | 2 | 1,369 | 5,223 |
| Obligations of states and political subdivisions | 13,401 | 81 | 875 | 12,607 |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 9,551 | 433 | 1 | 9,983 |
| Total fixed maturities | 61,796 | 857 | 4,546 | 58,107 |
| Equity securities | 5,467 | 3,130 | 1,028 | 7,569 |
| Total | \$ 67,263 | \$ 3,987 | \$ 5,574 | \$ 65,676 |
| Held-to-maturity securities: | | | | |
| Corporate debt securities | \$ 88 | \$ - | \$ 3 | \$ 85 |
| Mortgage backed securities | 4,087 | 20 | 41 | 4,066 |
| Private label mortgage backed securities | 249 | - | 1 | 248 |
| Obligations of states and political subdivisions | 2,141 | 34 | 14 | 2,161 |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 4,387 | 48 | - | 4,435 |
| Total | \$ 10,952 | \$ 102 | \$ 59 | \$ 10,995 |

NOTE 4 – INVESTMENT SECURITIES – CONTINUED

The amortized cost and aggregate fair value of debt securities at December 31, 2009, by contractual maturity, are as follows. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (Dollars in Thousands) | | |
|--|-----------|-----------|
| | Amortized | Fair |
| Available-for-sale securities: | | |
| | Cost | Value |
| Due in one year or less | \$ 419 | \$ 425 |
| Due after one year through five years | 14,320 | 15,551 |
| Due after five years through ten years | 24,013 | 24,433 |
| Due after ten years | 31,044 | 29,860 |
| Total | \$ 69,796 | \$ 70,269 |
| Held-to-maturity securities: | | |
| Due in one year or less | \$ 303 | \$ 309 |
| Due after one year through five years | 802 | 828 |
| Due after five years through ten years | 1,929 | 1,991 |
| Due after ten years | 2,908 | 2,952 |
| Total | \$ 5,942 | \$ 6,080 |

A summary of securities available-for-sale with unrealized losses as of December 31, 2009 and 2008 along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows:

| (Dollars in thousands) | | | | | | | December 31, 2009 | |
|------------------------|--------|---------------------|--------|------------|--------|------------|-------------------|-------------------------------------|
| Less than 12 months | | 12 months or longer | | | Total | | Gross | Total Securities in a Loss Position |
| Gross | Fair | Unrealized | Fair | Unrealized | Fair | Unrealized | | |
| Value | Losses | Value | Losses | Value | Losses | Losses | | |
| Fixed maturities: | | | | | | | | |
| \$ 1,856 | \$ 21 | \$ 6,772 | \$ 498 | \$ 8,628 | \$ 519 | | 23 | |

| | | | | | | | |
|---|-----------|--------|-----------|----------|-----------|----------|----|
| Corporate debt securities | | | | | | | |
| Mortgage backed securities | 1,443 | 156 | 71 | 9 | 1,514 | 165 | 6 |
| Private label mortgage backed securities | 2,660 | 72 | 4,651 | 738 | 7,311 | 810 | 15 |
| Obligations of state and political subdivisions | 5,889 | 199 | 991 | 137 | 6,880 | 336 | 21 |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | 3,708 | 80 | - | - | 3,708 | 80 | 11 |
| Equity securities | 78 | 13 | 2,283 | 793 | 2,361 | 806 | 13 |
| | \$ 15,634 | \$ 541 | \$ 14,768 | \$ 2,175 | \$ 30,402 | \$ 2,716 | 89 |

NOTE 4 – INVESTMENT SECURITIES – CONTINUED

| | (Dollars in thousands) | | | | | | December 31, 2008 | |
|---|------------------------|-------------------|---------------------|-------------------|------------|-------------------|-------------------------------------|--|
| | Less than 12 months | | 12 months or longer | | Total | | Total Securities in a Loss Position | |
| | Gross | | Gross | | Gross | Unrealized | | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | | |
| Fixed maturities: | | | | | | | | |
| Corporate debt securities | \$ 9,904 | \$ 1,337 | \$ 4,396 | \$ 940 | \$ 14,300 | \$ 2,277 | 45 | |
| Mortgage backed securities | 315 | 5 | 1,868 | 19 | 2,183 | 24 | 9 | |
| Private label mortgage backed securities | 412 | 87 | 4,354 | 1,282 | 4,766 | 1,369 | 11 | |
| Obligations of state and political subdivisions | 3,745 | 332 | 4,812 | 543 | 8,557 | 875 | 25 | |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | 295 | 1 | - | - | 295 | 1 | 1 | |
| Equity securities | 981 | 446 | 731 | 582 | 1,712 | 1,028 | 12 | |
| | \$ 15,652 | \$ 2,208 | \$ 16,161 | \$ 3,366 | \$ 31,813 | \$ 5,574 | 103 | |

For 2009, gross gains of \$1,102,000 (\$2,070,000 for 2008) and gross losses of \$319,000 (\$611,000 for 2008) were realized on sales of available-for-sale-securities.

A summary of securities held-to-maturity with unrealized losses as of December 31, 2009 and 2008 along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows:

| | (Dollars in thousands) | | | | | | December 31, 2009 | |
|--|------------------------|-------------------|---------------------|-------------------|------------|-------------------|-------------------------------------|--|
| | Less than 12 months | | 12 months or longer | | Total | | Total Securities in a Loss Position | |
| | Gross | | Gross | | Gross | Unrealized | | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | | |

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| | Value | Losses | Value | Losses | Value | Losses | Loss Position |
|---|--------|--------|--------|--------|--------|--------|---------------|
| Fixed maturities: | | | | | | | |
| Corporate debt securities | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | - |
| Mortgage backed securities | - | - | 333 | 25 | 333 | 25 | 2 |
| Private label mortgage backed securities | - | - | - | - | - | - | - |
| Obligations of state and political subdivisions | 160 | 4 | 351 | 4 | 511 | 8 | 2 |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | - | - | - | - | - | - | - |
| | \$ 160 | \$ 4 | \$ 684 | \$ 29 | \$ 844 | \$ 33 | 4 |

| (Dollars in thousands) | | | | | | | December 31, 2008 |
|---|-------------------|------------|---------------------|------------|-------------------|-------|-------------------------------------|
| Less than 12 months | | | 12 months or longer | | | Total | |
| Gross | | | Gross | | | Gross | Total Securities in a Loss Position |
| Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | | |
| Corporate debt securities | \$ 84 | \$ 3 | \$ - | \$ - | \$ 84 | \$ 3 | 1 |
| Mortgage backed securities | - | - | 2,408 | 41 | 2,408 | 41 | 7 |
| Private label mortgage backed securities | 249 | 1 | - | - | 249 | 1 | 1 |
| Obligations of state and political subdivisions | - | - | 646 | 14 | 646 | 14 | 2 |
| U.S. Treasury securities and | | | | | | | |

obligations of
U.S.
government
corporations
and agencies

| | | | | | | |
|--------|------|----------|-------|----------|-------|----|
| - | - | - | - | - | - | - |
| \$ 333 | \$ 4 | \$ 3,054 | \$ 55 | \$ 3,387 | \$ 59 | 11 |

NOTE 4 – INVESTMENT SECURITIES – CONTINUED

According to the most recent accounting guidance, for securities in an unrealized loss position, the Company is required to assess whether the Company has the intent to sell the security or more likely than not will be required to sell the security before the anticipated recovery. If either of these conditions is met, the Company is required to recognize an other-than-temporary impairment with the entire unrealized loss reported in earnings. For securities in an unrealized loss position that do not meet these conditions, the Company assesses whether the impairment of a security is other-than-temporary. If the impairment is determined to be other-than-temporary, the Company is required to separate the other-than-temporary impairments into two components: the amount representing the credit loss and the amount related to all other factors. The credit loss is the portion of the amortized book value in excess of the net present value of the projected future cash flows discounted at the effective interest rate implicit in the debt security prior to impairment. The credit loss component of other-than-temporary impairments is reported in earnings, whereas the amount relating to factors other than credit losses are recorded in other comprehensive income, net of taxes.

Management has evaluated each security in a significant unrealized loss position. For the year ended December 31, 2009, the Company realized \$443,000 in other than temporary impairments. The single largest accumulated loss was in the equity portfolio and totaled \$337,000. The second largest loss position was in the bond portfolio and totaled \$332,000. The third largest loss position was in the equity portfolio and totaled \$163,000. Most unrealized losses in the fixed income portfolio are interest rate driven as opposed to credit quality driven and management believes no ultimate loss will be realized. The Company has no material exposure to sub-prime mortgage loans and less than 2% of the fixed income investment portfolio is rated below investment grade. In evaluating whether or not the equity loss positions were other-than-temporary impairments, Management evaluated financial information on each company and reviewed analyst reports from at least two independent sources. Based on a review of the available financial information, the prospect for future earnings of each company and consideration of the Company's intent and ability to hold the securities until market values recovered, it was determined that the remaining securities in an accumulated loss position in the portfolio were temporary impairments.

For the year ended December 31, 2008, \$2,973,000 in other than temporary impairments was realized by the Company. Of the remaining securities in loss positions at December 31, 2008, the most significant securities in a loss position were in the equity portfolio. Six securities were in accumulated loss positions for greater than 12 months. The single largest accumulated loss in the equity portfolio totaled \$128,000. The second and third largest loss positions totaled \$114,000 and \$104,000, respectively. In evaluating whether or not the loss positions in the equity portfolio were other than temporary impairments, Management evaluated financial information on each company and reviewed analyst reports from at least two independent sources. Based on a review of the available financial information, the prospect for future earnings of each company and consideration of the Company's intent and ability to hold the securities until market values recovered, it was determined that the remaining securities in an accumulated loss position in the portfolio were temporary impairments.

NOTE 5 – NET INVESTMENT INCOME

Major categories of investment income are summarized as follows:

| | (Dollars in thousands) | |
|------------------|-------------------------|----------|
| | Year ended December 31, | |
| | 2009 | 2008 |
| Fixed maturities | \$ 4,075 | \$ 4,357 |

| | | |
|---|----------|----------|
| Equity securities | 199 | 364 |
| Mortgage loans on real estate | 62 | 32 |
| Investment real estate | 82 | 65 |
| Policy loans | 73 | 68 |
| Company owned life insurance | 740 | (543) |
| Other, principally short-term investments | 346 | 367 |
| | 5,577 | 4,710 |
| Less: Investment expenses | 288 | 342 |
| Net investment income | \$ 5,289 | \$ 4,368 |

An analysis of investment gains (losses) follows:

| | Year ended December 31, | |
|---|-------------------------|------------|
| | 2009 | 2008 |
| Net realized investment gains (losses): | | |
| Fixed maturities | \$ 548 | \$ 179 |
| Equity securities | 234 | 1,313 |
| Other, principally real estate | 18 | 432 |
| Other than temporary impairments | (443) | (2,973) |
| | \$ 357 | \$ (1,049) |

NOTE 5 – NET INVESTMENT INCOME – CONTINUED

An analysis of the net change in unrealized appreciation on available-for-sale securities follows:

| | (Dollars in thousands) | |
|--|------------------------|------------|
| | Year ended December | |
| | 31, | |
| | 2009 | 2008 |
| Net change in unrealized appreciation on available-for-sale securities before deferred tax | \$ 5,304 | \$ (8,335) |
| Deferred income tax | (1,784) | 2,188 |
| Net change in unrealized appreciation on available-for-sale securities | \$ 3,520 | \$ (6,147) |

NOTE 6 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Our securities available-for-sale consists of fixed maturity and equity securities which are recorded at fair value in the accompanying consolidated balance sheets. The change in the fair value of these investments, unless deemed to be other than temporarily impaired, is recorded as a component of other comprehensive income.

We are permitted to elect to measure financial instruments and certain other items at fair value, with the change in fair value recorded in earnings. We elected not to measure any eligible items using the fair value option.

Accounting standards define fair value as the price that would be received to sell an asset or would be paid to transfer a liability in an orderly transaction between market participants at the measurement date, and establishes a framework to make the measurement of fair value more consistent and comparable. In determining fair value, we primarily use prices and other relevant information generated by market transactions involving identical or comparable assets.

The Company categorizes assets and liabilities carried at their fair value based upon a fair value hierarchy:

Level 1 – Quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.

Level 1 assets and liabilities consist of money market fund deposits and certain of our marketable debt and equity instruments, including equity instruments offsetting deferred compensation, that are traded in an active market with sufficient volume and frequency of transactions.

Level 2 - Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 2 assets include certain of our marketable debt and equity instruments with quoted market prices that are traded in less active markets or priced using a quoted market price for similar instruments. Level 2 assets also include marketable equity instruments with security-specific restrictions that would transfer to the buyer, marketable debt instruments priced using indicator prices which represent non-binding market consensus prices that can be corroborated by observable market quotes, as well as derivative contracts and debt instruments priced using inputs that are observable in the market or can be derived principally from or corroborated by observable market data. Marketable debt instruments in this category generally include commercial paper, bank time deposits, repurchase agreements for fixed-income instruments, and a majority of floating-rate notes, corporate bonds, and municipal bonds.

Level 3 - Unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities.

NOTE 6 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES – CONTINUED

Level 3 assets and liabilities include marketable debt instruments, non-marketable equity investments, derivative contracts, and company issued debt whose values are determined using inputs that are both unobservable and significant to the values of the instruments being measured. Level 3 assets also include marketable debt instruments that are priced using indicator prices that we were unable to corroborate with observable market quotes.

Marketable debt instruments in this category generally include asset-backed securities and certain of our floating-rate notes, corporate bonds, and municipal bonds.

Assets/Liabilities Measured at Fair Value on a Recurring Basis

Financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2009 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

| Description | Fair Value Measurements at Reporting Date Using | | | |
|------------------------------------|---|-----------|-----------|----------|
| | Total | Level 1 | Level 2 | Level 3 |
| Financial Assets | | | | |
| Fixed maturities | | | | |
| available-for-sale | \$ 70,269 | \$ 9,214 | \$ 60,478 | \$ 577 |
| Short-term | | | | |
| investments | - | - | - | - |
| Trading securities | 374 | 374 | - | - |
| Equity securities | | | | |
| available-for-sale | 9,035 | 8,373 | - | 662 |
| Total Financial Assets | | | | |
| | \$ 79,678 | \$ 17,961 | \$ 60,478 | \$ 1,239 |
| Financial Liabilities | | | | |
| Interest rate swap | \$ 60 | \$ - | \$ - | \$ 60 |
| Total Financial Liabilities | | | | |
| | \$ 60 | \$ - | \$ - | \$ 60 |

The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2009:

For the year ended December 31, 2009

Interest

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| (In Thousands) | Fixed Maturities Available for sale | Equity Securities Available for Sale | Rate Swap |
|---|--|---|--------------|
| Beginning balance | \$ 652 | \$ 733 | \$ (316) |
| Total gains or losses (realized and unrealized): | | | |
| Included in earnings | - | - | - |
| Included in other comprehensive income | (75) | (71) | 256 |
| Purchases, sales, issuances and settlements, net | - | - | - |
| Transfers in/(out) of Level 3 | - | - | - |
| Ending balance | \$ 577 | \$ 662 | \$ (60) |
| The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held as of December 31, 2009 | \$ - | \$ - | \$ - |

For the year ended December 31, 2009, there were no assets or liabilities measured at fair values on a nonrecurring basis.

NOTE 6 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES – CONTINUED

Financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2008 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

| Description | Fair Value Measurements at Reporting Date Using | | | |
|------------------------------------|---|---|---|--|
| | 12/31/2008 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial Assets | | | | |
| Fixed maturities | | | | |
| available-for-sale | \$ 58,107 | \$ 9,726 | \$ 47,729 | \$ 652 |
| Short-term | | | | |
| investments | - | - | - | - |
| Trading securities | - | - | - | - |
| Equity securities | | | | |
| available-for-sale | 7,569 | 6,836 | - | 733 |
| Total Financial Assets | | | | |
| | \$ 65,676 | \$ 16,562 | \$ 47,729 | \$ 1,385 |
| Financial Liabilities | | | | |
| Interest rate swap | \$ 316 | \$ - | \$ - | \$ 316 |
| Total Financial Liabilities | | | | |
| | \$ 316 | \$ - | \$ - | \$ 316 |

The table below presents reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2008:

| | For the year ended December 31, 2008 | | |
|--|--|---|-----------------------|
| (In Thousands) | Fixed Maturities Available for sale | Equity Securities Available for Sale | Interest Rate Swap |
| Year ended December 31, 2008 | | | |
| Beginning balance | \$ 702 | \$ 999 | \$ (88) |
| Total gains or losses (realized and unrealized): | | | |
| Included in earnings | - | - | - |
| Included in other comprehensive income | (50) | (266) | (228) |
| Purchases, sales, issuances and settlements, net | - | - | - |
| Transfers in/(out) of Level 3 | - | - | - |
| Ending balance | \$ 652 | \$ 733 | \$ (316) |
| The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held as of December 31, 2008 | \$ - | \$ - | \$ - |

For the year ended December 31, 2008, there were no assets or liabilities measured at fair values on a nonrecurring basis.

The Company is exposed to certain risks in the normal course of its business operations. The primary risk that is managed through the use of derivatives is interest rate risk on floating rate borrowings. This risk is managed through the use of interest rate swaps which are designated as cash flow hedges. For cash flow hedges, the effective portion of the gain or loss on the interest rate swap is included as a component of other comprehensive income and reclassified into earnings in the same period during which the hedged transaction is recognized in earnings. The Company does not hold or issue derivatives that are not designated as hedging instruments. Please see Note 9 for additional information about the interest rate swaps.

The following methods and assumptions were used to estimate fair value of each class of financial instrument for which it is practical to estimate that value:

Cash and cash equivalents—the carrying amount is a reasonable estimate of fair value.

Mortgage receivables—the carrying amount is a reasonable estimate of fair value to the restrictive nature and limited marketability of the mortgage notes.

Other invested assets—the carrying amount is a reasonable estimate of fair value.

Other policyholder funds—the carrying amount is a reasonable estimate of fair value.

Debt—the carrying amount is a reasonable estimate of fair value.

The carrying amount and estimate fair value of the Company's financial instruments as of December 31, are as follows:

| In Thousands of Dollars at December 31, | | | | |
|--|----------------|----------------------|----------------|----------------------|
| | 2009 | | 2008 | |
| | Carrying Value | Estimated Fair Value | Carrying Value | Estimated Fair Value |
| Assets and related instruments | | | | |
| Mortgage loans | \$ 1,041 | \$ 1,041 | \$ 502 | \$ 502 |
| Policy loans | 1,018 | 1,018 | 968 | 968 |
| Company owned life insurance | 5,197 | 5,197 | 1,957 | 1,957 |
| Other invested assets | 3,933 | 3,933 | 4,557 | 4,557 |
| Liabilities and related instruments | | | | |
| Other policyholder funds | 1,347 | 1,347 | 1,344 | 1,344 |
| Long-term debt | 12,372 | 12,372 | 12,372 | 12,372 |

NOTE 7 - PROPERTY AND EQUIPMENT

At December 31, property and equipment consisted of the following:

| | (Dollars in Thousands) | |
|--------------------------------------|------------------------|----------|
| | 2009 | 2008 |
| Building and improvements | \$ 3,196 | \$ 3,196 |
| Electronic data processing equipment | 2,472 | 2,549 |
| Furniture and fixtures | 1,005 | 1,085 |
| | 6,673 | 6,830 |
| Less accumulated depreciation | 4,136 | 3,986 |
| | \$ 2,537 | \$ 2,844 |

Depreciation expense for the year ended December 31, 2009 was \$424,000 (\$454,000 for the year ended December 31, 2008).

NOTE 8 – INCOME TAXES

The Company recognizes tax-related interest and penalties as a component of tax expense. The Company incurred \$-0- and \$52,000 in interest and penalties as of December 31, 2009 and December 31, 2008, respectively. The Company files income tax returns in the U.S. federal jurisdiction and various states. The Company is not subject to examinations by authorities related to its U.S. federal or state income tax filings for years prior to 2006. The Internal Revenue Service completed an examination during 2008 of the Company's 2005 Federal Income Tax Return. No material adjustments were made as a result of this examination. No income tax returns are currently under examination by the Internal Revenue Service or any state or local taxing authority. Tax returns have been filed through the year 2008.

Net deferred tax liabilities are determined based on the estimated future tax effects of differences between the financial statement and tax basis of assets and liabilities given the provisions of the enacted tax laws. Management believes that, based on its historical pattern of taxable income, the Company will produce sufficient income in the future to realize its deferred tax assets. The Company recognized a net deferred tax liability position of \$61,000 in 2009 and a net deferred tax asset position of \$1,839,000 in 2008.

NOTE 8 – INCOME TAXES

The tax effect of significant differences representing deferred tax assets and liabilities are as follows:

| | (Dollars in Thousands) | |
|--|-------------------------|-------------------------|
| | December 31, 2009 | December 31, 2008 |
| General insurance expenses | \$ 1,135 | \$ 769 |
| Unearned premiums | 1,814 | 1,885 |
| Claims liabilities | 298 | 337 |
| Unrealized losses on securities available-for-sale | - | 392 |
| Other than temporary impairments on securities owned | 501 | 734 |
| Deferred tax assets | 3,748 | 4,117 |
| Depreciation | (126) | (118) |
| Deferred policy acquisition costs | (2,291) | (2,160) |
| Unrealized gains on securities available-for-sale | (1,392) | - |
| Deferred tax liabilities | (3,809) | (2,278) |
| Net deferred tax (liability) asset | \$ (61) | \$ 1,839 |

Total income tax expense varies from amounts computed by applying current federal income tax rates to income before income taxes. The reason for these differences and the approximate tax effects are as follows:

| | (Dollars in thousands) | |
|---|----------------------------|------------|
| | Year ended December 31, | |
| | 2009 | 2008 |
| Federal income tax rate applied to pre-tax income | \$ 1,862 | \$ (2,657) |

| | | |
|--|----------|------------|
| Dividends received deduction and tax-exempt interest | (201) | (233) |
| Company owned life insurance | (252) | 185 |
| Small life deduction | (145) | (169) |
| Other, net | (12) | 264 |
| Federal income tax expense (benefit) | \$ 1,252 | \$ (2,610) |

The appropriate income tax effects of changes in temporary differences are as follows:

| | Year ended December 31, | |
|-----------------------------------|----------------------------|-----------|
| | 2009 | 2008 |
| Deferred policy acquisition costs | \$ 131 | \$ 261 |
| Other-than-temporary impairments | 233 | (734) |
| Unearned premiums | 71 | (362) |
| General insurance expenses | (366) | 69 |
| Depreciation | 8 | (40) |
| Claim liabilities | 39 | (79) |
| | \$ 116 | \$ (885) |

NOTE 8 – INCOME TAXES – CONTINUED

Under pre-1984 life insurance company tax laws, a portion of NSIC's gain from operations was not subject to current income taxation, but was accumulated for tax purposes in a memorandum account designated "policyholders' surplus". The aggregate balance in this account, \$2,520,000 at December 31, 2009, would be taxed at current rates only if distributed to shareholders or if the account exceeded a prescribed minimum. The Deficit Reduction Act of 1984 eliminated additions to policyholders' surplus for 1984 and thereafter. Deferred taxes have not been provided on amounts designated as policyholders' surplus. The deferred income tax liability not recognized is approximately \$857,000 at December 31, 2009

NOTE 9 – NOTES PAYABLE AND LONG-TERM DEBT

Long-term debt consisted of the following as of December 31, 2009 and December 31, 2008:

| | (Dollars in thousands) | |
|--|------------------------|----------|
| | 2009 | 2008 |
| Subordinated debentures issued on December 15, 2005 with fixed interest rate of 8.83% each distribution period thereafter until December 15, 2015 when the coupon rate shall equal the 3-month LIBOR plus 3.75% applied to the outstanding principal; maturity December 2035. Interest payments due quarterly. All may be redeemed at any time following the tenth anniversary of issuance. Unsecured. | \$ 9,279 | \$ 9,279 |
| Subordinated debentures issued on June 21, 2007 with a floating interest rate equal to the 3 Month LIBOR plus 3.40% applied to the outstanding principal; maturity June 15, 2037. Interest payments due quarterly. All may be | 3,093 | 3,093 |

redeemed at any time
 following the fifth
 anniversary of
 issuance. Unsecured.

| | | |
|--|-----------|-----------|
| | \$ 12,372 | \$ 12,372 |
|--|-----------|-----------|

The \$9,279,000 of subordinated debentures is due in 2035 and \$3,093,000 of subordinated debentures is due in 2037.

The subordinated debentures (debentures) have the same maturities and other applicable terms and features as the associated trust preferred securities (TPS). Payment of interest may be deferred for up to 20 consecutive quarters; however, stockholder dividends cannot be paid during any extended interest payment period or any time the debentures are in default. All have stated maturities of thirty years. None of the securities require the Company to maintain minimum financial covenants. The Company has guaranteed that amounts paid to the Trusts (discussed in Note 2) will be remitted to the holders of the associated TPS. This guarantee, when taken together with the obligations of the Company under the debentures, the Indentures pursuant to which the debentures were issued, and the related trust agreement (including obligations to pay related trust fees, expenses, debt and other obligations with respect to the TPS), provides a full and unconditional guarantee of amounts due the Trusts. The amount guaranteed is not expected to at any time exceed the obligations of the TPS, and no additional liability has been recorded related to the guarantee.

On September 13, 2007, the Company entered into a 5 year swap effective September 17, 2007 with a notional amount of \$3,000,000 and designated the swap as a hedge against changes in cash flows attributable to changes in the benchmark interest rate (LIBOR) associated with the subordinated debentures issued on June 21, 2007. Commencing December 17, 2007, under the terms of the swap, the Company will pay interest at the three-month LIBOR rate plus 3.4% and receive interest at the fixed rate of 8.34%.

On March 19, 2009, the Company entered into a forward swap effective September 17, 2012, which will also hedge against changes in cash flows following the termination of the 5 year swap agreement discussed previously. Commencing September 17, 2012, under the terms of the forward swap, the Company will pay interest at the three-month LIBOR rate plus 3.4% and receive interest at the fixed rate of 7.02%. This forward swap will effectively fix the interest rate on \$3,000,000 in debt until September of 2019.

NOTE 9 – NOTES PAYABLE AND LONG-TERM DEBT – CONTINUED

The swaps entered into in 2007 and 2009 have fair values of \$245,000 (liability) and \$185,000 (asset), respectively, for a net liability of \$60,000 at December 31, 2009 (\$316,000 at December 31, 2008) which is reported as a component of other liabilities on the consolidated balance sheets. A net valuation gain of \$256,000 is included in accumulated other comprehensive income related to the swap agreements for the current period. A net valuation loss of \$228,000 was included in accumulated other comprehensive income related to the swap in the prior year.

We use dollar offset at the hedge's inception and for each reporting period thereafter to assess whether the derivative used in a hedging transaction is expected to be, and has been, effective in offsetting changes in the fair value of the hedged item. Since inception no portion of the hedged item has been deemed ineffective. For all hedges, we discontinue hedge accounting if it is determined that a derivative is not expected to be, or has ceased to be, effective as a hedge.

The Company's interest rate swaps include provisions requiring the Company to post collateral when the derivative is in a net liability position. The Company has posted collateral of \$469,000. Please see Note 6 for additional information about the interest rate swaps.

In December of 2009, the Company obtained an unsecured line of credit for \$700,000, with an interest rate of 5%, to be made available for general corporate purposes. The line of credit matures December 25, 2010. No funds were drawn on this line at December 31, 2009.

NOTE 10 – POLICY AND CLAIM RESERVES

The Company regularly updates its reserve estimates as new information becomes available and events occur that may impact the resolution of unsettled claims. Changes in prior years' reserve estimates are reflected in the results of operations in the year such changes are determined. The following table is a reconciliation of beginning and ending property and casualty reserve balances for claims and claim adjustment expense for the years ended December 31:

| | (Dollars in thousands) | |
|---|------------------------|-----------|
| | 2009 | 2008 |
| Claims and claim adjustment expense | | |
| reserves at beginning of year | \$ 14,436 | \$ 11,973 |
| Less reinsurance recoverables on | | |
| unpaid losses | 2,421 | 555 |
| Net balances at beginning of year | 12,015 | 11,418 |
| Provision for claims and claim adjustment | | |
| expenses for claims arising in current year | 34,239 | 43,284 |
| Estimated claims and claim adjustment | | |
| expenses for claims arising in prior years | (2,626) | (2,374) |
| Total increases | 31,613 | 40,910 |
| Claims and claim adjustment expense | | |
| payments for claims arising in: | | |
| Current year | 25,941 | 35,516 |
| Prior years | 5,590 | 4,797 |
| Total payments | 31,531 | 40,313 |

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| | | |
|-------------------------------------|-----------|-----------|
| Net balance at end of year | 12,097 | 12,015 |
| Plus reinsurance recoverables on | | |
| unpaid losses | 549 | 2,421 |
| Claims and claim adjustment expense | | |
| reserves at end of year | \$ 12,646 | \$ 14,436 |

The 2009 decline in the provision for claims and claim adjustment expenses arising from claims in the current year and the ending reinsurance recoverable on unpaid losses are attributable to the absence of hurricane losses during the year. The decrease in provision for claims and claim adjustment expenses for prior years (net of reinsurance recoveries) for 2008 is primarily due to reductions in incurred but not reported loss reserves on dwelling property lines of business.

NOTE 10 – POLICY AND CLAIM RESERVES – CONTINUED

The Company has a geographic exposure to catastrophe losses in certain areas of the country. Catastrophes can be caused by various events including hurricanes, windstorms, earthquakes, hail, severe winter weather, explosions and fires, and the incidence and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Most catastrophe losses are restricted to small geographic areas; however, hurricanes and earthquakes may produce significant damage in large, heavily populated areas. The Company generally seeks to reduce its exposure to catastrophes through individual risk selection and the purchase of catastrophe reinsurance. At December 31, 2009, the Company's estimate of unpaid losses and adjustment expenses for hurricane related claims incurred in prior years totaled \$787,000 before reinsurance (\$758,000 in 2008). Because the Company has exhausted its catastrophe coverage limits available for Hurricane Katrina any additional development will not be covered by reinsurance. The Company maintains case reserves of \$519,000 for losses in excess of catastrophe reinsurance (\$594,000 in 2008).

NOTE 11 – REINSURANCE

The Company's insurance operations participate in reinsurance in order to limit losses, minimize exposure to large risks, provide additional capacity for future growth and effect business-sharing arrangements. Life reinsurance is accomplished through yearly renewable term. Property and casualty reinsurance is placed on both a quota-share and excess of loss basis. Reinsurance ceded arrangements do not discharge the insurance subsidiaries as the primary insurer, except for cases involving a novation. Failure of reinsurers to honor their obligations could result in losses to the insurance subsidiaries. The insurance subsidiaries evaluate the financial conditions of their reinsurers and monitor concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize their exposure to significant losses from reinsurance insolvencies.

At December 31, 2009, the largest reinsurance recoverable of a single reinsurer was \$95,000 (\$607,000 in 2008). The amounts of recoveries pertaining to reinsurance contracts that were deducted from losses incurred during 2009 and 2008 were approximately \$-0- and \$12,582,000, respectively. The Company incurred no losses from covered events occurring in 2009. Amounts reported as ceded incurred losses in 2009 were related to development of losses from prior year catastrophes.

The effect of reinsurance on premiums written and earned was as follows:

| (Dollars in Thousands) | | | | | |
|------------------------|----|---------|----------|---------------------|-----------|
| 2009 | | | | | |
| | | Life | | Property & Casualty | |
| | | Written | Earned | Written | Earned |
| Direct | \$ | 7,251 | \$ 7,247 | \$ 58,185 | \$ 59,213 |
| Assumed | | - | - | - | - |
| Ceded | | (48) | (48) | (6,660) | (6,818) |
| Net | \$ | 7,203 | \$ 7,199 | \$ 51,525 | \$ 52,395 |

| 2008 | | | | | |
|---------|----|---------|----------|---------------------|-----------|
| | | Life | | Property & Casualty | |
| | | Written | Earned | Written | Earned |
| Direct | \$ | 7,049 | \$ 7,003 | \$ 61,197 | \$ 55,866 |
| Assumed | | - | - | - | - |
| Ceded | | (47) | (47) | (6,487) | (6,558) |
| Net | \$ | 7,002 | \$ 6,956 | \$ 54,710 | \$ 49,308 |

NOTE 12 – EMPLOYEE BENEFIT PLANS

In 1989, the Company and its subsidiaries established a retirement savings plan (401K Plan) and transferred the assets from the defined contribution profit sharing plan into the new plan. All full-time employees who have completed six months of service at the beginning of any calendar quarter are eligible to participate and all employee contributions are fully vested for employees who have completed 1,000 hours of service in the year of contribution. Company matching contributions for 2009 and 2008 amounted to \$219,000 and \$255,000, respectively. The Company contributes dollar-for-dollar matching contributions up to 5% of compensation subject to government limitations.

In 1987, the Company established a non-qualified deferred compensation plan for its Board of Directors. The Board members had an option of deferring their fees to a cash account or to a stock account and all share deferrals are recorded at the fair market value on the date of the award. The directors' non-qualified deferred compensation plan was frozen on December 31, 2004, and deferrals are no longer allowed. A new non-qualified plan became effective January 1, 2006 under which directors are allowed to defer all or a portion of directors' fees into various investment options. The supplemental executive retirement plan (SERP) became effective March 1, 2008 and covers named executive officers with the Company contributing 15% of executive compensation to the plan. Contributions to the plan are fully vested upon the earlier of death, disability, change in control, or ten years of participation in the plan. Costs for amounts credited of the non-qualified deferred compensation plans for 2009 and 2008 amounted to approximately 388,000 and (\$349,000), respectively.

NOTE 13 – REGULATORY REQUIREMENTS AND DIVIDEND RESTRICTIONS

The amount of dividends paid from NSIC to the Company in any year may not exceed, without prior approval of regulatory authorities, the greater of 10% of statutory surplus as of the end of the preceding year, or the statutory net gain from operations for the preceding year. At December 31, 2009, NSIC's retained earnings unrestricted for the payment of dividends in 2010 amounted to \$1,250,000.

NSFC is similarly restricted in the amount of dividends payable to the Company; dividends may not exceed the greater of 10% of statutory surplus as of the end of the preceding year, or net income for the preceding year. At December 31, 2009, NSFC's retained earnings unrestricted for the payment of dividends in 2010 amounted to \$4,179,000.

NOTE 13 – REGULATORY REQUIREMENTS AND DIVIDEND RESTRICTIONS – CONTINUED

At December 31, 2009, securities with market values of \$3,530,000 (\$3,812,000 at December 31, 2008) were deposited with various states pursuant to statutory requirements.

Under applicable Alabama insurance laws and regulations, NSFC is required to maintain a minimum total surplus (to include both paid-in and contributed and unassigned surplus) of \$100,000.

Under applicable Alabama insurance laws and regulations, NSIC is required to maintain a minimum total surplus (to include both paid-in and contributed and unassigned surplus) of \$200,000.

Under applicable Alabama insurance laws and regulations, Omega is required to maintain a minimum total surplus (to include both paid-in and contributed and unassigned surplus) of \$500,000.

NOTE 14 – SHAREHOLDERS' EQUITY

Preferred Stock

The Preferred Stock may be issued in one or more series as shall from time to time be determined and authorized by the Board of Directors. The directors may make specific provisions regarding (a) the voting rights, if any (b) whether such dividends are to be cumulative or noncumulative (c) the redemption provisions, if any (d) participating rights, if any (e) any sinking fund or other retirement provisions (f) dividend rates (g) the number of shares of such series and (h) liquidation preference.

Common Stock

The holders of the Class A Common Stock will have one-twentieth of one vote per share, and the holders of the common stock will have one vote per share.

In the event of any liquidation, dissolution or distribution of the assets of the Company remaining after the payments to the holders of the Preferred Stock of the full preferential amounts to which they may be entitled as provided in the resolution or resolutions creating any series thereof, the remaining assets of the Company shall be divided and distributed among the holders of both classes of common stock, except as may otherwise be provided in any such resolution or resolutions.

An amendment changing the number of authorized shares of common stock from 10,000,000 to 3,000,000 was approved by the shareholders at the 2009 Annual Meeting on May 14, 2009.

NOTE 15 – INDUSTRY SEGMENTS

The Company and its subsidiaries operate primarily in the insurance industry. Selected balance sheet information by industry segment for the years ended December 31, 2009 and 2008 is summarized below:

(Dollars in thousands)

| | Total | P&C Insurance Operations | Life Insurance Operations | Non-Insurance Operations |
|--------------------------------------|------------|--------------------------------|---------------------------------|-----------------------------|
| December 31, 2009 | | | | |
| Selected Assets | | | | |
| Investments | \$ 101,720 | \$ 60,768 | \$ 40,079 | \$ 873 |
| Reinsurance recoverable | \$ 784 | \$ 784 | \$ - | \$ - |
| Deferred policy acquisition costs | \$ 10,210 | \$ 3,915 | \$ 6,295 | \$ - |
| Total Assets | \$ 131,396 | \$ 79,321 | \$ 49,872 | \$ 2,203 |
| Total Liabilities | \$ 90,228 | \$ 43,099 | \$ 34,348 | \$ 12,781 |

(Dollars in thousands)

| | Total | P&C Insurance Operations | Life Insurance Operations | Non-Insurance Operations |
|--------------------------------------|-----------|--------------------------------|---------------------------------|-----------------------------|
| December 31, 2008 | | | | |
| Selected Assets | | | | |
| Investments | \$ 90,132 | \$ 56,422 | \$ 33,200 | \$ 510 |
| Reinsurance recoverable | \$ 4,146 | \$ 4,146 | \$ - | \$ - |
| Deferred policy acquisition costs | \$ 9,825 | \$ 4,037 | \$ 5,788 | \$ - |

| | | | | | | | | |
|-------------------|----|---------|----|--------|----|--------|----|--------|
| Total Assets | \$ | 124,890 | \$ | 78,802 | \$ | 43,653 | \$ | 2,435 |
| Total Liabilities | \$ | 90,242 | \$ | 45,476 | \$ | 31,627 | \$ | 13,139 |

NOTE 15 – INDUSTRY SEGMENTS – CONTINUED

Premium revenues and operating income by industry segment for the years ended December 31, 2009 and 2008 are summarized below:

| (Dollars in thousands) | Total | P&C Insurance Operations | Life Insurance Operations | Non-Insurance Operations |
|---|-----------|--------------------------------|---------------------------------|-----------------------------|
| Year ended December 31, 2009 | | | | |
| REVENUE | | | | |
| Net premiums earned | \$ 59,594 | \$ 52,395 | \$ 7,199 | \$ - |
| Net investment income | 5,289 | 3,125 | 2,114 | 50 |
| Net realized investment gains | 357 | 120 | 234 | 3 |
| Other income | 764 | 761 | 3 | - |
| | 66,004 | 56,401 | 9,550 | 53 |
| BENEFITS AND EXPENSES | | | | |
| Policyholder benefits paid or provided | 35,839 | 30,908 | 4,931 | - |
| Amortization of deferred policy acquisition costs | 3,673 | 3,397 | 276 | - |
| Commissions | 7,863 | 7,317 | 546 | - |
| General and administrative expenses | 10,396 | 6,775 | 2,543 | 1,078 |
| Insurance taxes, licenses and fees | 1,631 | 1,387 | 244 | - |
| Interest expense | 1,126 | - | 49 | 1,077 |
| | 60,528 | 49,784 | 8,589 | 2,155 |
| Income (Loss) Before Income Taxes | 5,476 | 6,617 | 961 | (2,102) |
| INCOME TAX EXPENSE (BENEFIT) | | | | |
| Current | 1,136 | 1,369 | 105 | (338) |

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| | | | | |
|-------------------|----------|----------|--------|-------------|
| Deferred | 116 | 97 | 392 | (373) |
| | 1,252 | 1,466 | 497 | (711) |
| NET INCOME | | | | |
| (LOSS) | \$ 4,224 | \$ 5,151 | \$ 464 | \$ (1,391) |

NOTE 15 – INDUSTRY SEGMENTS – CONTINUED

(Dollars in thousands)

| | Total | P&C Insurance Operations | Life Insurance Operations | Non-Insurance Operations |
|---|-----------|--------------------------------|---------------------------------|-----------------------------|
| Year ended December 31, 2008 | | | | |
| REVENUE | | | | |
| Net premiums earned | \$ 56,264 | \$ 49,308 | \$ 6,956 | \$ - |
| Net investment income | 4,368 | 2,309 | 1,940 | 119 |
| Net realized investment (losses) gains | (1,049) | 372 | (1,423) | 2 |
| Other income | 1,107 | 1,047 | 60 | - |
| | 60,690 | 53,036 | 7,533 | 121 |
| BENEFITS AND EXPENSES | | | | |
| Policyholder benefits paid or provided | 44,746 | 39,719 | 5,027 | - |
| Amortization of deferred policy acquisition costs | 4,344 | 3,312 | 1,032 | - |
| Commissions | 8,262 | 7,772 | 490 | - |
| General and administrative expenses | 8,558 | 6,722 | 1,614 | 222 |
| Insurance taxes, licenses and fees | 1,447 | 1,159 | 288 | - |
| Interest expense | 1,147 | 1 | 61 | 1,085 |
| | 68,504 | 58,685 | 8,512 | 1,307 |
| Loss Before Income Taxes | (7,814) | (5,649) | (979) | (1,186) |
| INCOME TAX EXPENSE (BENEFIT) | | | | |
| Current | (3,495) | (2,919) | (281) | (295) |
| Deferred | 885 | 867 | 161 | (143) |
| | (2,610) | (2,052) | (120) | (438) |

| | | | | | | | | |
|----------|----|----------|----|----------|----|--------|----|--------|
| NET LOSS | \$ | (5,204) | \$ | (3,597) | \$ | (859) | \$ | (748) |
|----------|----|----------|----|----------|----|--------|----|--------|

NOTE 16 – CONTINGENCIES

Litigation

The Company and its subsidiaries continue to be named as parties to litigation related to the conduct of their insurance operations. These suits involve alleged breaches of contracts, torts, including bad faith and fraud claims based on alleged wrongful or fraudulent acts of agents of the Company's subsidiaries, and miscellaneous other causes of action. Most of these lawsuits include claims for punitive damages in addition to other specified relief.

The Company's property & casualty subsidiaries are defending a number of matters filed in the aftermath of Hurricanes Katrina and Rita in Mississippi, Louisiana and Alabama. These actions include individual lawsuits and purported statewide class action lawsuits, although to date no class has been certified in any action. These actions make a number of allegations of underpayment of hurricane-related claims, including allegations that the flood exclusion found in the Company's subsidiaries' policies, and in certain actions other insurance companies' policies, is either ambiguous, unenforceable as unconscionable or contrary to public policy, or inapplicable to the damage sustained. The various suits seek a variety of remedies, including actual and/or punitive damages in unspecified amounts and/or declaratory relief. All of these matters are in various stages of development and the Company's subsidiaries intend to vigorously defend them. The outcome of these disputes is currently uncertain.

In 2007, the Company sold substantially all of its interest in a consolidated subsidiary, Mobile Attic, Inc. On July 9, 2009, the Company moved to intervene in a complaint filed by the purchaser of Mobile Attic against the founder and former president/CEO of Mobile Attic and others, regarding the plaintiff's purchase of shares of Mobile Attic. The Company filed a proposed complaint in intervention requesting the Court to find that the Company is not liable for indemnity under the Stock Purchase Agreement, or in the alternative, to award damages to the Company for any loss suffered as a result of the fraudulent actions of the former president/CEO of Mobile Attic and as a result of the negligence of Mobile Attic and its auditors in the preparation of Mobile Attic's financial statements. The Court has subsequently granted the Company's motion to intervene and the action is in the initial stages of discovery. No amount has been accrued in these financial statements since the outcome of this matter is uncertain and the amount of liability, if any, cannot be determined.

NOTE 16 – CONTINGENCIES – CONTINUED

The Company establishes and maintains reserves on contingent liabilities. In many instances, however, it is not feasible to predict the ultimate outcome with any degree of accuracy.

NOTE 17 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during 2009 was \$1,077,000 (\$1,085,000 in 2008). Cash received from income taxes in 2009 was \$796,000 compared to cash paid for income taxes in 2008 was \$500,000.

NOTE 18 – SUBSEQUENT EVENTS

There were no subsequent events to the filing of the Company's original Form 10-K for the year ended December 31, 2009 other than updates related to the litigation involving the 2007 sale of its investment in a 50% subsidiary, Mobile Attic, Inc. referenced in Note 16 above. Under the terms of the Stock Purchase Agreement, the Purchaser paid the Company \$2,700,000 for 45% of the total outstanding stock of Mobile Attic and paid the other Sellers \$960,000 for an additional 16% of the total outstanding stock in Mobile Attic, thus obtaining a controlling interest of 61% of the outstanding stock. The Stock Purchase Agreement also required the Purchaser as a condition to the transaction to cause the Company to be released from its guaranty of a bank loan to Mobile Attic having an outstanding principal balance of approximately \$9,400,000. The bank loan was secured by portable storage containers of Mobile Attic. The Sellers made certain warranties to the Purchaser in the Stock Purchase Agreement regarding the financial condition of Mobile Attic and agreed to jointly and severally indemnify the Purchaser for any damages resulting from a breach of any of the warranties.

On January 9, 2009, Mobile Attic, MA Manufacturing Company, Inc., and Purchaser initiated an action against Peter Cash, Cash Brothers Leasing, Inc., Bridgeville Trailers, Inc., and Barfield, Murphy, Shank & Smith, P.C. in United States District Court for the Middle District of Alabama. In the complaint, Plaintiffs asserted, among other claims, a claim for damages resulting from a breach of certain of the warranties regarding the financial statements of Mobile Attic and other financial information provided by Mobile Attic. Purchaser then notified the Company of its claim for breach of warranty under the Stock Purchase Agreement and requested indemnity from the Company.

The Purchaser has asserted that the Company is jointly and severally liable with the other Sellers (whom the Company believes have limited resources) for all losses suffered by Purchaser as a result of Sellers' misrepresentations. Purchaser claims that the misrepresentations caused Purchaser to purchase the stock of Mobile Attic, Inc. with the result that Sellers should be liable for all of Purchaser's losses resulting from the transaction, which include the value paid for the stock of Mobile Attic, Inc., the losses suffered on the assumption of the bank loan, the operating losses funded by Purchaser after the transaction, and attorneys' fees incurred by Purchaser to enforce its claim for indemnity.

On July 9, 2009, the Company filed a complaint in intervention requesting the Court to find that the Company is not liable for indemnity under the Stock Purchase Agreement, or in the alternative, to award damages to the Company for any loss suffered as a result of the fraudulent actions of Peter Cash and as a result of the negligence of Mobile Attic and its auditors in the preparation of Mobile Attic's financial statements. [Mobile Attic, Inc., MA Manufacturing Company, Inc. and Bagley Family Revocable Trust, plaintiffs, v. Peter L. Cash, Cash Brothers Leasing, Inc., Bridgeville Trailers, Inc., and Barfield, Murphy, Shank & Smith, P.C, defendants, v. The National Security Group, Inc., intervenor plaintiff, v. Peter L. Cash, Barfield, Murphy, Shank & Smith, P.C. and Bagley Family Revocable Trust, intervenor defendants, U.S. District Court, Middle District of Alabama, Eastern Division, Civil Action No. 09-cv-00024.]

On August 13, 2009, the Court granted the Company's motion to intervene. The parties have conducted initial discovery in this action, and at the request of the Court, each party filed an amended complaint on or before August 23, 2010. The Purchaser has asserted counterclaims against the Company for losses incurred as a result of failure to disclose material facts or alleged innocent, negligent or reckless false representations made to induce Purchaser to enter into the Stock Purchase Agreement, breach of the Stock Purchase Agreement and indemnification of Purchaser's losses and damages as a result of the breach of representations and warranties in the Stock Purchase Agreement. .

The Company has denied the allegations supporting Purchaser's claims. The financial records of Mobile Attic have been in the possession of Purchaser since Purchaser acquired the stock of Mobile Attic in early 2007 and are only available to the Company through discovery in the litigation. The Company is actively conducting discovery in defense of Purchaser's claims and has requested Purchaser to provide the financial information supporting the allegations made in its complaint. Discovery has not been completed at this time. The Company believes that the Purchaser's claim for damages is unreasonable and excessive even if the Purchaser is able to prove the alleged misrepresentations in Mobile Attic's financial statements. Given the difficulty in obtaining access to the Mobile Attic financial records and the fact that discovery is ongoing, the Company is unable to predict the amount of the ultimate liability that the Company may have if the Purchaser is successful in this litigation.

The Company establishes and maintains reserves on contingent liabilities. In many instances, however, it is not feasible to predict the ultimate outcome with any degree of accuracy.

THE NATIONAL SECURITY GROUP, INC.
 SCHEDULE I. SUMMARY OF INVESTMENTS (CONSOLIDATED)
 (Dollars in Thousands)

| | December 31, 2009 | | | December 31, 2008 | | |
|---|-------------------|--------------|------------------------------|-------------------|---------------|------------------------------|
| | Cost | Fair Value | Amount per the Balance Sheet | Cost | Fair Value | Amount per the Balance Sheet |
| Securities | | | | | | |
| Held-to-Maturity: | | | | | | |
| United States government | | | | | | |
| ... | \$ 441 | \$ 455 | \$ 441 | \$ 4,387 | \$ 4,435 | \$ 4,387 |
| States, municipalities and political subdivisions | | | | | | |
| ... | 2,139 | 2,182 | 2,139 | 2,141 | 2,161 | 2,141 |
| Mortgage backed securities | | | | | | |
| ... | 3,175 | 3,251 | 3,175 | 4,087 | 4,066 | 4,087 |
| Private label mortgage backed securities | | | | | | |
| ... | 187 | 192 | 187 | 249 | 248 | 249 |
| Industrial and Miscellaneous | | | | | | |
| ... | - | - | - | 88 | 85 | 88 |
| Total Securities Held-to-Maturity | | | | | | |
| .... | 5,942 | 6,080 | 5,942 | 10,952 | 10,995 | 10,952 |
| Securities Available-for-Sale: | | | | | | |
| Equity Securities: | | | | | | |
| Banks and insurance companies | | | | | | |
| ... | 1,489 | 989 | 989 | 1,256 | 1,699 | 1,699 |
| Industrial and all other | | | | | | |
| ... | 4,362 | 8,046 | 8,046 | 4,211 | 5,870 | 5,870 |
| Total equity securities | | | | | | |
| .... | 5,851 | 9,035 | 9,035 | 5,467 | 7,569 | 7,569 |

| | | | | | | |
|---|--------|--------|-----------|--------|--------|--------|
| | | | | | | |
| Debt Securities: | | | | | | |
| United States government | | | | | | |
| ... | 9,532 | 9,713 | 9,713 | 9,551 | 9,983 | 9,983 |
| States, municipalities and political subdivisions | | | | | | |
| ... | 15,641 | 15,516 | 15,516 | 13,401 | 12,607 | 12,607 |
| Mortgage backed securities | | | | | | |
| .. | 8,203 | 8,320 | 8,320 | 11,101 | 11,334 | 11,334 |
| Private label mortgage backed securities | | | | | | |
| ..... | 9,634 | 8,896 | 8,896 | 6,590 | 5,223 | 5,223 |
| Public Utilities | | | | | | |
| ..... | - | - | - | 549 | 554 | 554 |
| Industrial and Miscellaneous | | | | | | |
| ... | 26,786 | 27,824 | 27,824 | 20,604 | 18,406 | 18,406 |
| Total Debt Securities | 69,796 | 70,269 | 70,269 | 61,796 | 58,107 | 58,107 |
| Total Available-for-Sale | 75,647 | 79,304 | 79,304 | 67,263 | 65,676 | 65,676 |
| Total Securities | 81,589 | 85,384 | \$ 85,246 | 78,215 | 76,671 | 76,628 |
| Trading securities | | | | | | |
| ... | 314 | 374 | 374 | 354 | 253 | 253 |
| Receivable for securities | | | | | | |
| ... | 96 | 96 | 96 | 513 | 513 | 513 |
| Mortgage loans on real estate | | | | | | |
| ..... | 1,041 | 1,041 | 1,041 | 502 | 502 | 502 |
| Investment real estate | | | | | | |
| .. | 4,815 | 4,815 | 4,815 | 4,754 | 4,754 | 4,754 |
| Policy loans | | | | | | |
| ... | 1,018 | 1,018 | 1,018 | 968 | 968 | 968 |
| Company owned life insurance | | | | | | |
| ..... | 5,000 | 5,197 | 5,197 | 2,500 | 1,957 | 1,957 |
| Other invested assets | 3,933 | 3,933 | 3,933 | 4,557 | 4,557 | 4,557 |
| | | | | | | |

| | | | | | | |
|-------------------------|-----------|------------|------------|-----------|-----------|-----------|
| Total investments . . . | \$ 97,806 | \$ 101,858 | \$ 101,720 | \$ 92,363 | \$ 90,175 | \$ 90,132 |
|-------------------------|-----------|------------|------------|-----------|-----------|-----------|

THE NATIONAL SECURITY GROUP, INC.
(PARENT COMPANY)

SCHEDULE II - CONDENSED FINANCIAL
INFORMATION OF REGISTRANT

BALANCE SHEETS

(Amounts in thousands)

| | December 31, | |
|--|------------------|------------------|
| | 2009 | 2008 |
| Assets | | |
| Cash | \$ 382 | \$ 454 |
| Investment in subsidiaries (equity method) eliminated upon consolidation | 51,658 | 45,380 |
| Other assets | 2,866 | 2,269 |
| Total Assets | \$ 54,906 | \$ 48,103 |
| Liabilities and Shareholders' Equity | | |
| Accrued general expenses | \$ 1,366 | \$ 1,083 |
| Notes payable | 12,372 | 12,372 |
| Total Liabilities | 13,738 | 13,455 |
| Total Shareholders' Equity | 41,168 | 34,648 |
| Total Liabilities and Shareholders' Equity | \$ 54,906 | \$ 48,103 |

| THE NATIONAL SECURITY GROUP, INC. (PARENT COMPANY) | | |
|---|-----------------|-------------------|
| SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF REGISTRANT | | |
| STATEMENTS OF INCOME (LOSS) | | |
| (Amounts in thousands) | | |
| | Years Ended | |
| | December 31, | |
| | 2009 | 2008 |
| Income | | |
| Dividends (eliminated upon consolidation) | \$ 2,800 | \$ - |
| Other income | 52 | 119 |
| | 2,852 | 119 |
| Expenses | | |
| State taxes | 1 | 1 |
| Other expenses | 2,154 | 1,300 |
| | 2,155 | 1,301 |
| Income before income taxes and equity in undistributed earnings (loss) of subsidiaries | | |
| Income tax (benefit) expense | (711) | (437) |
| Income (loss) before equity in undistributed earnings (loss) of subsidiaries | | |
| Equity in undistributed (losses) earnings of subsidiaries | 1,408 | (745) |
| | 2,816 | (4,459) |
| Net (loss) income | \$ 4,224 | \$ (5,204) |

THE NATIONAL SECURITY GROUP, INC. (PARENT
COMPANY)

SCHEDULE II - CONDENSED FINANCIAL INFORMATION
OF REGISTRANT

STATEMENTS OF CASH FLOWS

(Amounts in thousands)

| | Years Ended | |
|--|--------------|------------|
| | December 31, | |
| | 2009 | 2008 |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ 4,224 | \$ (5,204) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Equity in undistributed loss (income) of subsidiaries | (2,816) | 4,459 |
| Change in other assets | (539) | 3,246 |
| Change in accrued general expenses | 539 | (659) |
| Net cash provided by operating activities | 1,408 | 1,842 |
| Cash flows from investing activities: | | |
| Net cash provided by investing activities | - | - |
| Net cash provided by investing activities | - | - |
| Cash flows from financing activities: | | |
| Cash dividends | (1,480) | (2,220) |
| Net cash used in financing activities | (1,480) | (2,220) |
| Net (decrease) increase in cash and cash equivalents | (72) | (378) |
| Cash at beginning of year | 454 | 832 |

| | | |
|---------------------|--------|--------|
| Cash at end of year | \$ 382 | \$ 454 |
|---------------------|--------|--------|

THE NATIONAL SECURITY GROUP, INC. (PARENT COMPANY)

Notes to Condensed Financial Information of Registrant

Note 1-Basis of Presentation

Pursuant to the rules and regulations of the Securities and Exchange Commission, the Condensed Financial

Information of the Registrant does not include all of the information and notes normally included with financial

statements prepared in accordance with generally accepted accounting principles. It is, therefore, suggested

that this Condensed Financial Information be read in conjunction with the Consolidated Financial Statements

and Notes thereto included in the Registrant's Annual Report as referenced in Form 10-K, Part II, Item 8, page 44.

Note 2-Cash Dividends from Subsidiaries

In 2009, dividends of \$2.8 million were paid to the Registrant by its subsidiaries. No dividends were received from subsidiaries

during 2008.

THE NATIONAL SECURITY GROUP, INC.
SCHEDULE III SUPPLEMENTARY INSURANCE INFORMATION (CONSOLIDATED)
(Amounts in thousands)

| | Deferred Acquisition Costs | Future Policy Benefits | Unearned Premiums |
|--|----------------------------------|------------------------------|----------------------|
| At December 31, 2009: | | | |
| Life and accident and health insurance | \$ 6,295 | \$ 30,726 | \$ 16 |
| Property and casualty insurance | 3,915 | - | 27,365 |
| Total | \$ 10,210 | \$ 30,726 | \$ 27,381 |

| | | | |
|--|----------|-----------|-----------|
| At December 31, 2008: | | | |
| Life and accident and health insurance | \$ 5,788 | \$ 29,770 | \$ 44 |
| Property and casualty insurance | 4,037 | - | 27,720 |
| Total | \$ 9,825 | \$ 29,770 | \$ 27,764 |

| | Premium Revenue | Net Investment Income | Other Income | Benefits, Claims, Losses and Settlement Expenses | Commissions, Amortization of Deferred Policy Acquisition Costs | General Expenses, Taxes, Licenses and Fees |
|---|--------------------|-----------------------------|-----------------|--|--|--|
| For the year ended December 31, 2009: | | | | | | |
| Life and accident and health insurance | \$ 7,199 | \$ 2,114 | \$ 3 | \$ 4,931 | \$ 822 | \$ 2,787 |
| Property and casualty insurance | 52,395 | 3,125 | 761 | 30,908 | 10,714 | 8,162 |
| Other | - | 50 | - | - | - | 1,078 |
| Total | \$ 59,594 | \$ 5,289 | \$ 764 | \$ 35,839 | \$ 11,536 | \$ 12,027 |

| | | | | | | |
|---|----------|----------|-------|----------|----------|----------|
| For the year ended December 31, 2008: | | | | | | |
| Life and accident and health | \$ 6,956 | \$ 1,940 | \$ 60 | \$ 5,027 | \$ 1,522 | \$ 1,614 |

insurance

Property and
casualty

| | | | | | | |
|---------------------|-----------|----------|----------|-----------|-----------|-----------|
| insurance | 49,308 | 2,309 | 1,047 | 39,719 | 11,084 | 6,722 |
| Other | - | 119 | - | - | - | 222 |
| Total | \$ 56,264 | \$ 4,368 | \$ 1,107 | \$ 44,746 | \$ 12,606 | \$ 10,005 |

Note: Investment income and other operating expenses are reported separately by segment and not allocated.

THE NATIONAL SECURITY GROUP, INC.
 SCHEDULE IV. REINSURANCE (CONSOLIDATED)
 (Amounts in thousands)

| | Gross Amount | Ceded to Other Companies | Assumed from Other Companies | Net Amount | Percentage of Assumed to Net Amount |
|-----------------------|-----------------|--------------------------------|---------------------------------------|---------------|---|
| For the year ended | | | | | |
| December 31, 2009 | | | | | |
| Life insurance in | | | | | |
| force | | | | | |
| ..... | \$ 215,028 | \$ 12,034 | \$ - | \$ 202,994 | 0.00 % |
| Premiums: | | | | | |
| Life insurance and | | | | | |
| accident and health | | | | | |
| insurance | | | | | |
| ... | 7,247 | 48 | - | 7,199 | 0.00 % |
| Property and casualty | | | | | |
| insurance | | | | | |
| ..... | 59,213 | 6,818 | - | 52,395 | 0.00 % |
| Total premiums .. | | | | | |
| ..... | \$ 66,460 | \$ 6,866 | \$ - | \$ 59,594 | 0.00 % |
| For the year ended | | | | | |
| December 31, 2008: | | | | | |
| Life insurance in | | | | | |
| force | | | | | |
| ..... | \$ 214,160 | \$ 10,115 | \$ - | \$ 204,045 | 0.00 % |
| Premiums: | | | | | |
| Life insurance and | | | | | |
| accident and health | | | | | |
| insurance | | | | | |
| ... | 7,003 | 47 | - | 6,956 | 0.00 % |
| Property and casualty | | | | | |
| insurance | | | | | |
| ..... | 55,866 | 6,558 | - | 49,308 | 0.00 % |

| | | | | | | |
|--------------------|-----------|----------|------|-----------|------|---|
| Total premiums . . | | | | | | |
| | | | | | | |
| | | | | | | |
| . | \$ 62,869 | \$ 6,605 | \$ - | \$ 56,264 | 0.00 | % |

The National Security Group, Inc

Schedule V. Valuation and Qualifying Accounts
Years ended December 31, 2009 and 2008

| | 2009 | 2008 |
|----------------------|------------------------|--------|
| | (Dollars in thousands) | |
| Balance, January 1 | \$ 59 | \$ 110 |
| Additions | 0 | 0 |
| Deletions | 59 | 51 |
| Balance, December 31 | \$ 0 | \$ 59 |

Financial Statement Schedules

(a) The following documents are filed as part of this report:

1. Consolidated financial statements, notes thereto and related information of The National Security Group, Inc. (the "Company") are included in Item 8 of Part II of this report:

Report of Independent Registered Public Accounting Firm (2009)

Consolidated Statements of Operation – Years ended December 31, 2009 and 2008

Consolidated Balance Sheets – December 31, 2009 and 2008

Consolidated Statements of Shareholders' Equity – Years ended December 31, 2009 and 2008

Consolidated Statements of Cash Flows – Years ended December 31, 2009 and 2008

Consolidated Notes to the Financial Statements (2009 and 2008)

2. Additional financial statement schedules and report of independent registered accounting firm are furnished herewith pursuant to the requirements of Form 10-K:

The National Security Group, Inc.

| | |
|--------------|--|
| Schedule I | Summary of Investments Other Than Investments in Related Parties |
| Schedule II | Condensed Financial Information of Registrant |
| Schedule III | Supplementary Insurance Information (Consolidated) |
| Schedule IV | Reinsurance (Consolidated) |
| Schedule V | Valuation and Qualifying Accounts |

3. Exhibits filed as part of this Form 10-K:

31.1 Certification of Chief Executive Officer Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Chief Financial Officer Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32. Certification Chief Executive Officer and Chief Financial Officer Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

THE NATIONAL SECURITY GROUP, INC.

/s/ Brian R. McLeod

Brian R. McLeod
Chief Financial
Officer and
Treasurer

Date: May 4, 2011

/s/ William L.
Brunson, Jr.
William L. Brunson,
Jr.
President, Chief
Executive
Officer and Director

