

FIRST ACCEPTANCE CORP /DE/

Form 10-Q

November 06, 2012

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended September 30, 2012

Commission File Number: 001-12117

**FIRST ACCEPTANCE CORPORATION**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction)

75-1328153  
(I.R.S. Employer)

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of incorporation or organization)

Identification No.)

3813 Green Hills Village Drive

Nashville, Tennessee  
(Address of principal executive offices)

37215  
(Zip Code)

(615) 844-2800

(Registrant's telephone number, including area code)

Not applicable

(Former name, former address and former fiscal year, if changed since last report)

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 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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions 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 ☐ (Do not check if a smaller reporting company) 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 ☒

At November 6, 2012, there were 40,942,957 shares outstanding of the registrant's common stock, par value \$0.01 per share.

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FOR THE QUARTER ENDED SEPTEMBER 30, 2012

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(in thousands, except per share data)

|  | September 30,<br>2012<br>(Unaudited) | December 31,<br>2011 |
|--|--------------------------------------|----------------------|
| <b>ASSETS</b>  |                                      |                      |
| Investments, available-for-sale at fair value (amortized cost of \$117,215 and \$162,575, respectively)                | \$ 126,539                           | \$ 172,825           |
| Cash and cash equivalents  | 37,013                               | 23,751               |
| Premiums and fees receivable, net of allowance of \$478 and \$364  | 48,006                               | 41,313               |
| Receivable for securities  | 29,613                               |                      |
| Other assets   | 7,210                                | 8,005                |
| Property and equipment, net  | 5,017                                | 3,315                |
| Deferred acquisition costs   | 3,588                                | 3,243                |
| Identifiable intangible assets   | 4,800                                | 4,800                |
| <b>TOTAL ASSETS</b>  | <b>\$ 261,786</b>                    | <b>\$ 257,252</b>    |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                      |                      |
| Loss and loss adjustment expense reserves  | \$ 76,784                            | \$ 69,436            |
| Unearned premiums and fees   | 58,478                               | 50,464               |
| Debentures payable   | 41,240                               | 41,240               |
| Other liabilities  | 12,089                               | 13,383               |
| <b>Total liabilities</b>   | <b>188,591</b>                       | <b>174,523</b>       |
| <b>Stockholders' equity:</b>   |                                      |                      |
| Preferred stock, \$.01 par value, 10,000 shares authorized   |                                      |                      |
| Common stock, \$.01 par value, 75,000 shares authorized; 40,943 and 40,928 shares issued and outstanding, respectively | 409                                  | 409                  |
| Additional paid-in capital   | 456,584                              | 456,056              |
| Accumulated other comprehensive income   | 9,324                                | 10,250               |
| Accumulated deficit  | (393,122)                            | (383,986)            |
| <b>Total stockholders' equity</b>  | <b>73,195</b>                        | <b>82,729</b>        |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>  | <b>\$ 261,786</b>                    | <b>\$ 257,252</b>    |

See notes to consolidated financial statements.

**Table of Contents****FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)**

(in thousands, except per share data)

|   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |             |
|---|-------------------------------------|------------|------------------------------------|-------------|
|   | 2012                                | 2011       | 2012                               | 2011        |
| <b>Revenues:</b>  |                                     |            |                                    |             |
| Premiums earned   | \$ 46,444                           | \$ 40,505  | \$ 139,564                         | \$ 127,092  |
| Commission and fee income   | 8,287                               | 7,500      | 25,040                             | 22,642      |
| Investment income   | 1,624                               | 2,021      | 5,156                              | 6,155       |
| Net realized gains (losses) on investments, available-for-sale            | 3,213                               | (57)       | 3,220                              | 14          |
|   | 59,568                              | 49,969     | 172,980                            | 155,903     |
| <b>Costs and expenses:</b>  |                                     |            |                                    |             |
| Losses and loss adjustment expenses                                       | 35,828                              | 33,248     | 114,418                            | 97,020      |
| Insurance operating expenses  | 18,851                              | 18,625     | 62,411                             | 59,546      |
| Other operating expenses  | 192                                 | 244        | 682                                | 935         |
| Litigation settlement   |                                     |            |                                    | (4)         |
| Stock-based compensation  | 97                                  | 91         | 507                                | 724         |
| Depreciation and amortization   | 604                                 | 344        | 1,606                              | 1,008       |
| Interest expense  | 618                                 | 990        | 2,576                              | 2,938       |
| Goodwill and intangible assets impairment                                 |                                     |            |                                    | 52,434      |
|   | 56,190                              | 53,542     | 182,200                            | 214,601     |
| Income (loss) before income taxes   | 3,378                               | (3,573)    | (9,220)                            | (58,698)    |
| Provision (benefit) for income taxes                                      | 99                                  | 115        | (84)                               | 72          |
| Net income (loss)   | \$ 3,279                            | \$ (3,688) | \$ (9,136)                         | \$ (58,770) |
| Net income (loss) per share:  |                                     |            |                                    |             |
| Basic and diluted   | \$ 0.08                             | \$ (0.08)  | \$ (0.22)                          | \$ (1.22)   |
| Number of shares used to calculate net income (loss) per share:           |                                     |            |                                    |             |
| Basic   | 40,873                              | 48,232     | 40,856                             | 48,248      |
| Diluted   | 40,943                              | 48,232     | 40,856                             | 48,248      |
| Reconciliation of net income (loss) to comprehensive income (loss):       |                                     |            |                                    |             |
| Net income (loss)   | \$ 3,279                            | \$ (3,688) | \$ (9,136)                         | \$ (58,770) |
| Net unrealized change in investments                                      | (1,942)                             | 825        | (926)                              | 1,415       |
| Comprehensive income (loss)   | \$ 1,337                            | \$ (2,863) | \$ (10,062)                        | \$ (57,355) |
| Detail of net realized gains (losses) on investments, available-for-sale: |                                     |            |                                    |             |
| Net realized gains (losses) on sales and redemptions                      | \$ 3,220                            | \$ (26)    | \$ 3,243                           | \$ 122      |

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|  |          |         |          |       |
|--|----------|---------|----------|-------|
| Other-than-temporary impairment ( OTTI ) charges               |          |         |          |       |
| Non-credit portion included in comprehensive loss              |          |         |          |       |
| OTTI charges reclassified from other comprehensive loss        | (7)      | (31)    | (23)     | (108) |
| OTTI charges recognized in loss                                | (7)      | (31)    | (23)     | (108) |
| Net realized gains (losses) on investments, available-for-sale | \$ 3,213 | \$ (57) | \$ 3,220 | \$ 14 |

See notes to consolidated financial statements.

**Table of Contents****FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)****(in thousands)**

|   | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|--|-------------|
|   | <b>2012</b>                                | <b>2011</b> |
| Cash flows from operating activities:                                   |  |             |
| Net loss  | \$ (9,136)                                 | \$ (58,770) |
| Adjustments to reconcile net loss to cash used in operating activities: |  |             |
| Depreciation and amortization   | 1,606                                      | 1,008       |
| Stock-based compensation  | 507  | 724         |
| Deferred income taxes   | 1  | (98)        |
| Goodwill and intangible assets impairment                               |  | 52,434      |
| Other-than-temporary impairment on investment securities                | 23   | 108         |
| Net realized gains on sales and redemptions of investments              | (3,243)                                    | (122)       |
| Other   | 340  | 287         |
| Change in:  |  |             |
| Premiums and fees receivable  | (6,807)                                    | (3,414)     |
| Loss and loss adjustment expense reserves                               | 7,348                                      | (1,361)     |
| Unearned premiums and fees  | 8,014                                      | 2,847       |
| Other   | (808)                                      | (2,013)     |
| Net cash used in operating activities                                   | (2,155)                                    | (8,370)     |
| Cash flows from investing activities:                                   |  |             |
| Purchases of investments, available-for-sale                            | (3,836)                                    | (11,412)    |
| Maturities and redemptions of investments, available-for-sale           | 25,864                                     | 20,531      |
| Sales of investments, available-for-sale                                | 26,343                                     |             |
| Net change in receivable for securities                                 | (29,613)                                   |             |
| Capital expenditures  | (3,330)                                    | (997)       |
| Other   |  | (3)         |
| Net cash provided by investing activities                               | 15,428                                     | 8,119       |
| Cash flows from financing activities:                                   |  |             |
| Payments on borrowings  | (38)                                       | (60)        |
| Purchase of treasury stock  |  | (736)       |
| Net proceeds from issuance of common stock                              | 27   | 24          |
| Net cash used in financing activities                                   | (11)                                       | (772)       |
| Net change in cash and cash equivalents                                 | 13,262                                     | (1,023)     |
| Cash and cash equivalents, beginning of period                          | 23,751                                     | 29,078      |
| Cash and cash equivalents, end of period                                | \$ 37,013                                  | \$ 28,055   |

See notes to consolidated financial statements.

**Table of Contents****FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****1. General**

The consolidated financial statements of First Acceptance Corporation (the Company) included herein have been prepared without audit pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, certain information and disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been omitted. In the opinion of management, the consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) necessary for a fair statement of the interim periods. Certain reclassifications have been made to the prior year's consolidated financial statements to conform with the current year presentation.

The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full year. These consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements included in its Transition Report on Form 10-K for the transition period from July 1, 2011 to December 31, 2011.

**2. Fair Value**

Fair value is the price that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements are generally based upon observable and unobservable inputs. Observable inputs are based on market data from independent sources, while unobservable inputs reflect the Company's view of market assumptions in the absence of observable market information. All assets and liabilities that are carried at fair value are classified and disclosed in one of the following categories:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Quoted market prices for similar assets or liabilities in active markets; quoted prices by independent pricing services for identical or similar assets or liabilities in markets that are not active; and valuations, using models or other valuation techniques, that use observable market data. All significant inputs are observable, or derived from observable information in the marketplace, or are supported by observable levels at which transactions are executed in the market place.

Level 3 - Instruments that use non-binding broker quotes or model driven valuations that do not have observable market data. The Company categorizes valuation methods used in its identifiable intangible assets impairment tests as Level 3. To determine the fair value of acquired trademarks and trade names, the Company uses the relief-from-royalty method, which requires the Company to estimate the future revenue for the related brands, the appropriate royalty rate and the weighted average cost of capital.

***Fair Value of Financial Instruments***

The carrying values and fair values of certain of the Company's financial instruments were as follows (in thousands).

|                                 | September 30, 2012 |            | December 31, 2011 |            |
|---------------------------------|--------------------|------------|-------------------|------------|
|                                 | Carrying Value     | Fair Value | Carrying Value    | Fair Value |
| <b>Assets:</b>                  |                    |            |                   |            |
| Investments, available-for-sale | \$ 126,539         | \$ 126,539 | \$ 172,825        | \$ 172,825 |
| <b>Liabilities:</b>             |                    |            |                   |            |



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|                    |        |        |        |        |
|--------------------|--------|--------|--------|--------|
| Debentures payable | 41,240 | 11,758 | 41,240 | 14,868 |
|--------------------|--------|--------|--------|--------|

**Table of Contents****FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****(Unaudited)**

The fair values as presented above represent the Company's best estimates and may not be substantiated by comparisons to independent markets. The fair value of the debentures payable was based on current market rates offered for debt with similar risks and maturities and takes into account the Company's own credit risk (valuation classified as Level 3). Carrying values of certain financial instruments, such as cash and cash equivalents and premiums and fees receivable, approximate fair value due to the short-term nature of the instruments and are not required to be disclosed. Therefore, the aggregate of the fair values presented in the preceding table do not purport to represent the Company's underlying value.

The Company holds available-for-sale investments, which are carried at fair value. The following tables present the fair-value measurements for each major category of assets that are measured on a recurring basis (in thousands).

|   |              | Fair Value Measurements Using |             |              |
|---|--------------|-------------------------------|-------------|--------------|
|   |              | Quoted Prices                 |             |              |
|   |              | in Active                     | Significant | Significant  |
|   |              | Markets                       | Other       | Unobservable |
|   |              | for                           | Observable  | Inputs       |
|   |              | Identical Assets              | Inputs      | Inputs       |
|   |              | (Level 1)                     | (Level 2)   | (Level 3)    |
| <b>September 30, 2012</b>                     | <b>Total</b> |                               |             |              |
| Fixed maturities, available-for-sale:         |              |                               |             |              |
| U.S. government and agencies                  | \$ 18,202    | \$ 18,202                     | \$          | \$           |
| State   | 4,157        |                               | 4,157       |              |
| Political subdivisions                        | 795          |                               | 795         |              |
| Revenue and assessment                        | 21,238       |                               | 21,238      |              |
| Corporate bonds                               | 48,177       |                               | 48,177      |              |
| Collateralized mortgage obligations:          |              |                               |             |              |
| Agency backed                                 | 13,176       |                               | 13,176      |              |
| Non-agency backed residential                 | 5,555        |                               | 5,555       |              |
| Non-agency backed commercial                  | 5,309        |                               | 5,309       |              |
| Redeemable preferred stock                    | 1,746        | 1,746                         |             |              |
| Total fixed maturities, available-for-sale    | 118,355      | 19,948                        | 98,407      |              |
| Investment in mutual fund, available-for-sale | 8,184        | 8,184                         |             |              |
| Total investments, available-for-sale         | 126,539      | 28,132                        | 98,407      |              |
| Cash and cash equivalents                     | 37,013       | 37,013                        |             |              |
| Total   | \$ 163,552   | \$ 65,145                     | \$ 98,407   | \$           |

**Table of Contents****FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****(Unaudited)**

|  |                | Fair Value Measurements Using   |   |  |
|--|----------------|---|---|--|
|  |                | Quoted Prices<br>in Active<br>Markets<br>for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <b>December 31, 2011</b>                       | <b>Total</b>   |   |   |  |
| Fixed maturities, available-for-sale:          |                |   |   |  |
| U.S. government and agencies                   | \$ 25,528      | \$ 25,528   | \$  | \$   |
| State  | 6,387          |   | 6,387   |  |
| Political subdivisions                         | 781            |   | 781   |  |
| Revenue and assessment                         | 25,432         |   | 25,432  |  |
| Corporate bonds                                | 77,297         |   | 77,297  |  |
| Collateralized mortgage obligations:           |                |   |   |  |
| Agency backed                                  | 18,133         |   | 18,133  |  |
| Non-agency backed residential                  | 5,429          |   | 5,429   |  |
| Non-agency backed commercial                   | 6,125          |   | 6,125   |  |
| Redeemable preferred stock                     | 169            | 169   |   |  |
| <br>Total fixed maturities, available-for-sale | <br>165,281    | <br>25,697  | <br>139,584   |  |
| Investment in mutual fund, available-for-sale  | 7,544          | 7,544   |   |  |
| <br>Total investments, available-for-sale      | <br>172,825    | <br>33,241  | <br>139,584   |  |
| Cash and cash equivalents                      | 23,751         | 23,751  |   |  |
| <br>Total                                      | <br>\$ 196,576 | <br>\$ 56,992   | <br>\$ 139,584  | <br>\$   |

The fair values of the Company's investments are determined by management after taking into consideration available sources of data. All of the portfolio valuations classified as Level 1 or Level 2 in the above tables are priced exclusively by utilizing the services of independent pricing sources using observable market data. The Level 2 classified security valuations are obtained from a single independent pricing service. There were no transfers between Level 1 and Level 2 for the three and nine months ended September 30, 2012 and 2011. The Company's policy is to recognize transfers between levels at the end of the reporting period. The Company has not made any adjustments to the prices obtained from the independent pricing sources.

The Company has reviewed the pricing techniques and methodologies of the independent pricing service for Level 2 investments and believes that its policies adequately consider market activity, either based on specific transactions for the security valued or based on modeling of securities with similar credit quality, duration, yield and structure that were recently traded. The Company monitored security-specific valuation trends and has made inquiries with the pricing service about material changes or the absence of expected changes to understand the underlying factors and inputs and to validate the reasonableness of the pricing.

Based on the above categorization, there were no Level 3 classified security valuations at September 30, 2012 and 2011 and December 31, 2011 and 2010, nor any transfers into or out of Level 3 during these periods.

**Table of Contents****FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****(Unaudited)****3. Investments*****Investments, Available-for-Sale***

The following tables summarize the Company's investment securities (in thousands).

| <b>September 30, 2012</b>                     | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> |
|---|---------------------------|---------------------------------------|--|-----------------------|
| U.S. government and agencies                  | \$ 17,202                 | \$ 1,000                              | \$                                     | \$ 18,202             |
| State   | 3,997                     | 160                                   |  | 4,157                 |
| Political subdivisions                        | 753                       | 42                                    |  | 795                   |
| Revenue and assessment                        | 19,652                    | 1,593                                 | (7)                                    | 21,238                |
| Corporate bonds                               | 44,232                    | 3,945                                 |  | 48,177                |
| Collateralized mortgage obligations:          |                           |                                       |  |                       |
| Agency backed                                 | 12,242                    | 934                                   |  | 13,176                |
| Non-agency backed residential                 | 5,232                     | 438                                   | (115)                                  | 5,555                 |
| Non-agency backed commercial                  | 4,904                     | 405                                   |  | 5,309                 |
| Redeemable preferred stock                    | 1,500                     | 246                                   |  | 1,746                 |
| Total fixed maturities, available-for-sale    | 109,714                   | 8,763                                 | (122)                                  | 118,355               |
| Investment in mutual fund, available-for-sale | 7,501                     | 683                                   |  | 8,184                 |
|   | \$ 117,215                | \$ 9,446                              | \$ (122)                               | \$ 126,539            |

| <b>December 31, 2011</b>                      | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> |
|---|---------------------------|---------------------------------------|--|-----------------------|
| U.S. government and agencies                  | \$ 24,178                 | \$ 1,350                              | \$                                     | \$ 25,528             |
| State   | 6,099                     | 288                                   |  | 6,387                 |
| Political subdivisions                        | 754                       | 27                                    |  | 781                   |
| Revenue and assessment                        | 24,130                    | 1,302                                 |  | 25,432                |
| Corporate bonds                               | 71,392                    | 6,113                                 | (208)                                  | 77,297                |
| Collateralized mortgage obligations:          |                           |                                       |  |                       |
| Agency backed                                 | 16,953                    | 1,180                                 |  | 18,133                |
| Non-agency backed residential                 | 5,530                     | 66                                    | (167)                                  | 5,429                 |
| Non-agency backed commercial                  | 5,862                     | 275                                   | (12)                                   | 6,125                 |
| Redeemable preferred stock                    | 176                       |                                       | (7)                                    | 169                   |
| Total fixed maturities, available-for-sale    | 155,074                   | 10,601                                | (394)                                  | 165,281               |
| Investment in mutual fund, available-for-sale | 7,501                     | 43                                    |  | 7,544                 |
|   | \$ 162,575                | \$ 10,644                             | \$ (394)                               | \$ 172,825            |



**Table of Contents****FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****(Unaudited)**

The following tables set forth the scheduled maturities of the Company's fixed maturity securities based on their fair values (in thousands). Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

|                              | Securities<br>with<br>Unrealized<br>Gains | Securities<br>with<br>Unrealized<br>Losses | Securities<br>with No<br>Unrealized<br>Gains or<br>Losses | All<br>Fixed<br>Maturity<br>Securities |
|------------------------------|---|--|---|--|
| <b>September 30, 2012</b>    |   |  |   |  |
| One year or less             | \$ 21,862                                 | \$   | \$  | \$ 21,862                              |
| After one through five years | 35,154                                    | 702  |   | 35,856                                 |
| After five through ten years | 24,151                                    |  |   | 24,151                                 |
| After ten years              | 10,700                                    |  |   | 10,700                                 |
| No single maturity date      | 25,461                                    | 325  |   | 25,786                                 |
|                              | \$ 117,328                                | \$ 1,027                                   | \$  | \$ 118,355                             |

|                              | Securities<br>with<br>Unrealized<br>Gains | Securities<br>with<br>Unrealized<br>Losses | Securities<br>with No<br>Unrealized<br>Gains or<br>Losses | All<br>Fixed<br>Maturity<br>Securities |
|------------------------------|---|--|---|--|
| <b>December 31, 2011</b>     |   |  |   |  |
| One year or less             | \$ 15,801                                 | \$ 2,506                                   | \$ 955  | \$ 19,262                              |
| After one through five years | 61,511                                    |  |   | 61,511                                 |
| After five through ten years | 42,997                                    | 689  |   | 43,686                                 |
| After ten years              | 7,860                                     | 3,106                                      |   | 10,966                                 |
| No single maturity date      | 26,623                                    | 2,168                                      | 1,065   | 29,856                                 |
|                              | \$ 154,792                                | \$ 8,469                                   | \$ 2,020  | \$ 165,281                             |

The following table reflects the number of fixed maturity securities with gross unrealized gains and losses. Gross unrealized losses are further segregated by the length of time that individual securities have been in a continuous unrealized loss position.

| At:                | Gross Unrealized Losses                     |                                 | Gross<br>Unrealized<br>Gains |
|--------------------|---|---------------------------------|------------------------------|
|                    | Less<br>than<br>or equal to<br>12<br>months | Greater<br>than<br>12<br>months |                              |
| September 30, 2012 | 2   | 1                               | 116                          |
| December 31, 2011  | 7   | 4                               | 139                          |

The following tables reflect the fair value and gross unrealized losses of those fixed maturity securities in a continuous unrealized loss position for greater than 12 months. Gross unrealized losses are further segregated by the percentage of amortized cost (in thousands, except number of securities).

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| Gross Unrealized Losses       | Number<br>of<br>Securities | Fair<br>Value | Gross<br>Unrealized<br>Losses |
|-------------------------------|----------------------------|---------------|-------------------------------|
| <b>at September 30, 2012:</b> |                            |               |                               |
| Less than or equal to 10%     |                            | \$            | \$                            |
| Greater than 10%              | 1                          | 200           | (94)                          |
|                               | 1                          | \$ 200        | \$ (94)                       |

| Gross Unrealized Losses      | Number<br>of<br>Securities | Fair<br>Value | Gross<br>Unrealized<br>Losses |
|------------------------------|----------------------------|---------------|-------------------------------|
| <b>at December 31, 2011:</b> |                            |               |                               |
| Less than or equal to 10%    | 3                          | \$ 2,760      | \$ (92)                       |
| Greater than 10%             | 1                          | 191           | (110)                         |
|                              | 4                          | \$ 2,951      | \$ (202)                      |

**Table of Contents****FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****(Unaudited)**

The following tables set forth the amount of gross unrealized losses by current severity (as compared to amortized cost) and length of time that individual securities have been in a continuous unrealized loss position (in thousands).

| Length of<br>Gross Unrealized Losses | Fair Value of<br>Securities with |                               | Severity of Gross Unrealized Losses |              |                        |
|--------------------------------------|----------------------------------|-------------------------------|-------------------------------------|--------------|------------------------|
|                                      | Gross<br>Unrealized<br>Losses    | Gross<br>Unrealized<br>Losses | Less<br>than 5%                     | 5% to<br>10% | Greater<br>than<br>10% |
| <b>at September 30, 2012:</b>        |                                  |                               |                                     |              |                        |
| Less than or equal to:               |                                  |                               |                                     |              |                        |
| Three months                         | \$ 125                           | \$ (21)                       | \$                                  | \$           | \$ (21)                |
| Six months                           |                                  |                               |                                     |              |                        |
| Nine months                          | 702                              | (7)                           | (7)                                 |              |                        |
| Twelve months                        |                                  |                               |                                     |              |                        |
| Greater than twelve months           | 200                              | (94)                          |                                     |              | (94)                   |
| Total                                | \$ 1,027                         | \$ (122)                      | \$ (7)                              | \$           | \$ (115)               |

| Length of<br>Gross Unrealized Losses | Fair Value<br>of<br>Securities<br>with |                               | Severity of Gross Unrealized Losses |              |                        |
|--------------------------------------|--|-------------------------------|-------------------------------------|--------------|------------------------|
|                                      | Gross<br>Unrealized<br>Losses          | Gross<br>Unrealized<br>Losses | Less<br>than<br>5%                  | 5% to<br>10% | Greater<br>than<br>10% |
| <b>at December 31, 2011:</b>         |  |                               |                                     |              |                        |
| Less than or equal to:               |  |                               |                                     |              |                        |
| Three months                         | \$ 2,506                               | \$                            | \$                                  | \$           | \$                     |
| Six months                           | 1,945                                  | (174)                         |                                     | (174)        |                        |
| Nine months                          | 898                                    | (11)                          | (11)                                |              |                        |
| Twelve months                        | 169                                    | (7)                           | (7)                                 |              |                        |
| Greater than twelve months           | 2,951                                  | (202)                         | (45)                                | (47)         | (110)                  |
| Total                                | \$ 8,469                               | \$ (394)                      | \$ (63)                             | \$ (221)     | \$ (110)               |

***Restrictions***

At September 30, 2012, fixed maturities and cash equivalents with a fair value and amortized cost of \$5.9 million were on deposit with various insurance departments as a requirement of doing business in those states. Fixed maturities and cash equivalents with a fair value and amortized cost of \$9.3 million were on deposit with another insurance company as collateral for an assumed reinsurance contract.

***Investment Income and Net Realized Gains and Losses***



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The major categories of investment income follow (in thousands).

|   | Three Months  |               | Nine Months Ended |               |
|---|---------------|---------------|-------------------|---------------|
|   | Ended         |               | September 30,     |               |
|   | September 30, | September 30, | September 30,     | September 30, |
|   | 2012          | 2011          | 2012              | 2011          |
| Fixed maturities, available-for-sale          | \$ 1,629      | \$ 2,002      | \$ 5,136          | \$ 6,097      |
| Investment in mutual fund, available-for-sale | 144           | 150           | 420               | 452           |
| Other   | 10            | 29            | 77                | 89            |
| Investment expenses                           | (159)         | (160)         | (477)             | (483)         |
|   | \$ 1,624      | \$ 2,021      | \$ 5,156          | \$ 6,155      |

**Table of Contents****FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****(Unaudited)**

The components of net realized gains (losses) on investments, available-for-sale at fair value follow (in thousands).

|                                 | <b>Three Months</b> |             | <b>Nine Months Ended</b> |             |
|---------------------------------|---------------------|-------------|--------------------------|-------------|
|                                 | <b>Ended</b>        |             | <b>September 30,</b>     |             |
|                                 | <b>2012</b>         | <b>2011</b> | <b>2012</b>              | <b>2011</b> |
| Gains                           | \$ 3,242            | \$ 7        | \$ 3,274                 | \$ 157      |
| Losses                          | (22)                | (33)        | (31)                     | (35)        |
| Other-than-temporary impairment | (7)                 | (31)        | (23)                     | (108)       |
|                                 | \$ 3,213            | \$ (57)     | \$ 3,220                 | \$ 14       |

Realized gains and losses on sales of securities are computed based on specific identification. The non-credit related portion of other-than-temporary impairment ( OTTI ) charges is included in other comprehensive income (loss). The amounts of non-credit OTTI for securities still owned was \$1.0 million for non-agency backed residential collateralized mortgage obligations ( CMOs ) and \$0.2 million for non-agency backed commercial CMOs at both September 30, 2012 and December 31, 2011.

***Other-Than-Temporary Impairment***

In accordance with Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) 320-10, the Company separates OTTI into the following two components: (i) the amount related to credit losses, which is recognized in the consolidated statement of operations and (ii) the amount related to all other factors, which is recorded in other comprehensive income (loss). The credit-related portion of an OTTI is measured by comparing a security's amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge.

The determination of whether unrealized losses are other-than-temporary requires judgment based on subjective as well as objective factors. The Company routinely monitors its investment portfolio for changes in fair value that might indicate potential impairments and performs detailed reviews on such securities. Changes in fair value are evaluated to determine the extent to which such changes are attributable to (i) fundamental factors specific to the issuer or (ii) market-related factors such as interest rates or sector declines.

Securities with declines attributable to issuer-specific fundamentals are reviewed to identify all available evidence to estimate the potential for impairment. Resources used include historical financial data included in filings with the SEC for corporate bonds and performance data regarding the underlying loans for CMOs. Securities with declines attributable solely to market or sector declines where 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 the full recovery of its amortized cost basis are not deemed to be other-than-temporarily impaired.

The issuer-specific factors considered in reaching the conclusion that securities with declines are not other-than-temporarily impaired include (i) the extent and duration of the decline in fair value, including the duration of any significant decline in value, (ii) whether the security is current as to payments of principal and interest, (iii) a valuation of any underlying collateral, (iv) current and future conditions and trends for both the business and its industry, (v) changes in cash flow assumptions for CMOs and (vi) rating agency actions. Based on these factors, the Company makes a determination as to the probability of recovering principal and interest on the security.

**Table of Contents****FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****(Unaudited)**

The number and amount of securities for which the Company has recognized OTTI charges in net income (loss) are presented in the following tables (in thousands, except for the number of securities).

|   | Three Months Ended September 30,<br>2012 |        | 2011                       |         |
|---|--|--------|----------------------------|---------|
|   | Number<br>of<br>Securities               | OTTI   | Number<br>of<br>Securities | OTTI    |
| Collateralized mortgage obligations:  |  |        |                            |         |
| Non-agency backed residential   | 1  | \$ (7) | 2                          | \$ (31) |
| Non-agency backed commercial  |  |        |                            |         |
|   | 1  | (7)    | 2                          | (31)    |
| Portion of loss recognized in accumulated other comprehensive income (loss) |  |        |                            |         |
| Net OTTI recognized in net income (loss)                                    |  | \$ (7) |                            | \$ (31) |

|   | Nine Months Ended September 30,<br>2012 |         | 2011                       |          |
|---|---|---------|----------------------------|----------|
|   | Number<br>of<br>Securities              | OTTI    | Number<br>of<br>Securities | OTTI     |
| Collateralized mortgage obligations:  |   |         |                            |          |
| Non-agency backed residential   | 2                                       | \$ (8)  | 2                          | \$ (108) |
| Non-agency backed commercial  | 1                                       | (15)    |                            |          |
|   | 3                                       | (23)    | 2                          | (108)    |
| Portion of loss recognized in accumulated other comprehensive income (loss) |   |         |                            |          |
| Net OTTI recognized in net income (loss)                                    |   | \$ (23) |                            | \$ (108) |

The following is a progression of the credit-related portion of OTTI on investments owned at September 30, 2012 and 2011 (in thousands).

|   | Three Months Ended<br>September 30,<br>2012 |            | 2011       |            |
|---|---|------------|------------|------------|
|   | 2012  | 2011       | 2012       | 2011       |
| Beginning balance                       | \$ (3,441)                                  | \$ (3,343) | \$ (3,425) | \$ (3,590) |
| Additional credit impairments on:       |   |            |            |            |
| Previously impaired securities          | (7)   | (31)       | (23)       | (108)      |
| Securities without previous impairments |   |            |            |            |
|   | (7)   | (31)       | (23)       | (108)      |

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Reductions for securities sold (realized)

45

369

|            |            |            |            |
|------------|------------|------------|------------|
| \$ (3,448) | \$ (3,329) | \$ (3,448) | \$ (3,329) |
|------------|------------|------------|------------|

On a quarterly basis, the Company reviews cash flow estimates for certain non-agency backed CMOs of lesser credit quality following the guidance of FASB ASC 325-40, *Investments Other Beneficial Interests in Securitized Financial Assets* ( FASB ASC 325-40 ). Accordingly, when changes in estimated cash flows occur due to actual or estimated prepayment or credit loss experience, and the present value of the revised cash flows is less than the present value previously estimated, OTTI is deemed to have occurred. For non-agency backed CMOs not subject to FASB ASC 325-40, the Company reviews quarterly projected cash flow analyses and recognizes OTTI when it determines that a loss is probable. The Company has recognized OTTI related to certain non-agency backed CMOs as the underlying cash flows have been adversely impacted due to a reduction in prepayments from mortgage refinancing and an increase in actual and projected delinquencies in the underlying mortgages.

**Table of Contents****FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****(Unaudited)**

The Company's review of non-agency backed CMOs included an analysis of available information such as collateral quality, anticipated cash flows, credit enhancements, default rates, loss severities, the securities' relative position in their respective capital structures, and credit ratings from statistical rating agencies. The Company reviews quarterly projected cash flow analyses for each security utilizing current assumptions regarding (i) actual and anticipated delinquencies, (ii) delinquency transition-to-default rates and (iii) loss severities. Based on its quarterly reviews, the Company determined that there had not been an adverse change in projected cash flows, except in the case of those securities for which OTTI charges have been recorded. The Company believes that the unrealized losses on the remaining non-agency backed securities for which OTTI charges have not been recorded are not necessarily predictive of the ultimate performance of the underlying collateral. The Company does not intend to sell these securities and it is more likely than not that the Company will not be required to sell these securities before the recovery of their amortized cost basis.

The Company believes that the remaining securities having unrealized losses at September 30, 2012 were not other-than-temporarily impaired. The Company also does not intend to sell any of these securities and it is more likely than not that the Company will not be required to sell any of these securities before the recovery of their amortized cost basis.

**4. Net Income (Loss) Per Share**

The following table sets forth the computation of basic and diluted net income (loss) per share (in thousands, except per share data).

|   | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2012</b>                                 | <b>2011</b> | <b>2012</b>                                | <b>2011</b> |
| Net income (loss)                             | \$ 3,279                                    | \$ (3,688)  | \$ (9,136)                                 | \$ (58,770) |
| Weighted average common basic shares          | 40,873                                      | 48,232      | 40,856                                     | 48,248      |
| Effect of dilutive securities                 | 70  |             |  |             |
| Weighted average common dilutive shares       | 40,943                                      | 48,232      | 40,856                                     | 48,248      |
| Basic and diluted net income (loss) per share | \$ 0.08                                     | \$ (0.08)   | \$ (0.22)                                  | \$ (1.22)   |

For the three months ended September 30, 2012, the computation of diluted net income per share included 70 thousand shares of unvested restricted common stock. For the three months ended September 30, 2011 and both the nine months ended September 30, 2012 and 2011, the computation of diluted net loss per share did not include 70 thousand shares of unvested restricted common stock as their inclusion would have been anti-dilutive. Options to purchase approximately 1.6 million and 4.5 million shares for both the three and nine months ended September 30, 2012 and 2011, respectively, were not included in the computation of diluted net income (loss) per share as their exercise prices were in excess of the average stock prices for the periods presented.

**5. Income Taxes**

The provision (benefit) for income taxes consisted of the following (in thousands).

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|          | Three Months Ended<br>September 30, |        | Nine Months<br>Ended<br>September 30, |       |
|----------|-------------------------------------|--------|---------------------------------------|-------|
|          | 2012                                | 2011   | 2012                                  | 2011  |
| Federal: |                                     |        |                                       |       |
| Current  | \$                                  | \$     | \$                                    | \$    |
| Deferred |                                     |        |                                       |       |
| State:   |                                     |        |                                       |       |
| Current  | 99                                  | 115    | (85)                                  | 170   |
| Deferred |                                     |        | 1                                     | (98)  |
|          | 99                                  | 115    | (84)                                  | 72    |
|          | \$ 99                               | \$ 115 | \$ (84)                               | \$ 72 |

**Table of Contents****FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****(Unaudited)**

The provision (benefit) for income taxes differs from the amounts computed by applying the statutory federal corporate tax rate of 35% to income (loss) before income taxes as a result of the following (in thousands).

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|  | <b>2012</b>               | <b>2011</b> | <b>2012</b>              | <b>2011</b> |
| Provision (benefit) for income taxes at statutory rate   | \$ 1,182                  | \$ (1,250)  | \$ (3,227)               | \$ (20,544) |
| Tax effect of:   |                           |             |                          |             |
| Tax-exempt investment income   | (10)                      | (1)         | (13)                     | (8)         |
| Change in the beginning of the period balance of the valuation allowance for deferred tax assets allocated to federal income taxes | (3,693)                   | 1,247       | 678                      | 5,578       |
| Net operating loss carryforward expirations  |                           |             |                          | 735         |
| Goodwill and identifiable intangible assets  |                           |             |                          | 14,084      |
| Stock-based compensation   | 2,516                     |             | 2,530                    | 167         |
| State income taxes, net of federal income tax benefit and valuation allowance  | 99                        | 115         | (84)                     | 72          |
| Other  | 5                         | 4           | 32                       | (12)        |
|  | \$ 99                     | \$ 115      | \$ (84)                  | \$ 72       |

The Company had a valuation allowance of \$28.2 million and \$27.2 million at September 30, 2012 and December 31, 2011, respectively, to reduce deferred tax assets to the amount that is more likely than not to be realized. The change in the total valuation allowance for the nine months ended September 30, 2012 was an increase of \$1.0 million. For the nine months ended September 30, 2012, the change in the valuation allowance included a reduction of \$0.3 million related to unrealized change in investments included in other comprehensive income (loss).

In assessing the realization of deferred tax assets, management considered whether it was more likely than not that some portion or all of the deferred tax assets will not be realized. The Company is required to assess whether a valuation allowance should be established against the Company's deferred tax assets based on the consideration of all available evidence using a more likely than not standard. In making such judgments, significant weight is given to evidence that can be objectively verified. In assessing the Company's ability to support the realizability of its deferred tax assets, management considered both positive and negative evidence. The Company placed greater weight on historical results than on the Company's outlook for future profitability and established a deferred tax valuation allowance at September 30, 2012 and December 31, 2011. The deferred tax valuation allowance may be adjusted in future periods if management determines that it is more likely than not that some portion or all of the deferred tax assets will be realized. In the event the deferred tax valuation allowance is adjusted, the Company would record an income tax benefit for the adjustment.

The Company's policy is to consider all known income sources, including other comprehensive income, in determining the amount of tax benefit allocated to continuing operations. The Company has not recognized any benefit in its consolidated statements of operations for the three and nine months ended September 30, 2012 given the current uncertainty related to whether the Company will have both a loss from continuing operations and income from other sources for the year ending December 31, 2012.

**6. Segment Information**

The Company operates in two business segments with its primary focus being the selling, servicing and underwriting of non-standard personal automobile insurance. The real estate and corporate segment consists of the activities related to the disposition of foreclosed real estate held for sale, interest expense associated with all debt and other general corporate overhead expenses.





**Table of Contents****FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****(Unaudited)**

The following table presents selected financial data by business segment (in thousands).

|                                    | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|------------------------------------|---|-------------|--|-------------|
|                                    | <b>2012</b>                                 | <b>2011</b> | <b>2012</b>                                | <b>2011</b> |
| Revenues:                          |   |             |  |             |
| Insurance                          | \$ 59,550                                   | \$ 49,939   | \$ 172,900                                 | \$ 155,817  |
| Real estate and corporate          | 18  | 30          | 80   | 86          |
| Consolidated total                 | \$ 59,568                                   | \$ 49,969   | \$ 172,980                                 | \$ 155,903  |
| Income (loss) before income taxes: |   |             |  |             |
| Insurance                          | \$ 4,266                                    | \$ (2,278)  | \$ (5,537)                                 | \$ (54,190) |
| Real estate and corporate          | (888)                                       | (1,295)     | (3,683)                                    | (4,508)     |
| Consolidated total                 | \$ 3,378                                    | \$ (3,573)  | \$ (9,220)                                 | \$ (58,698) |

|                           | <b>September 30,<br/>2012</b> | <b>December 31,<br/>2011</b> |
|---------------------------|-------------------------------|------------------------------|
| Total assets:             |                               |                              |
| Insurance                 | \$ 256,843                    | \$ 241,815                   |
| Real estate and corporate | 4,943                         | 15,437                       |
| Consolidated total        | \$ 261,786                    | \$ 257,252                   |

**7. Recent Accounting Pronouncements**

In October 2010, the FASB issued ASU No. 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force) (Topic 944)*, which clarifies what costs should be deferred by insurance companies when issuing or renewing insurance contracts. The guidance is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2011. The Company adopted this standard on a prospective basis on January 1, 2012 and, therefore, recognized additional expense of \$0.4 million over the first six months of 2012, consistent with the Company's insurance policy terms and estimated deferred acquisition costs amortization period.

In May 2011, the FASB issued ASU No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, which amends certain measurement and disclosure requirements related to fair value measurements to improve consistency with international reporting standards. The Company adopted the provisions of this guidance in the quarter ended March 31, 2012. The adoption of this guidance did not have an impact on the Company's financial position or results of operations.

In June 2011, the FASB issued ASU No. 2011-05, *Presentation of Comprehensive Income*, which requires a company to present components of net income and other comprehensive income in one continuous statement or in two separate, but consecutive statements. There are no changes to the components that are recognized in net income or other comprehensive income under current GAAP. The Company adopted the provisions of

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this guidance in the quarter ended March 31, 2012. The adoption of this guidance did not have an impact on the Company's financial position or results of operations.

In September 2011, the FASB issued ASU 2011-08, *Intangibles – Goodwill and Other (Topic 350)*, which allows companies to waive comparing the fair value of a reporting unit to its carrying amount in assessing the recoverability of goodwill if, based on qualitative factors, it is more likely than not that the fair value of a reporting unit is greater than its carrying amount. The Company adopted the provisions of this guidance in the quarter ended March 31, 2012. The adoption of this guidance did not have an impact on the Company's financial position or results of operations.

In July 2012, the FASB issued ASU 2012-02, *Intangibles – Goodwill and Other (Topic 350)*, which allows companies to waive comparing the fair value of indefinite-lived intangible assets to their carrying amounts in assessing the recoverability of these assets if, based on qualitative factors, it is more likely than not that the fair value of the indefinite-lived intangible assets is greater than their carrying amounts. The Company early adopted the provisions of this guidance in the quarter ended June 30, 2012. The adoption of this guidance did not have an impact on the Company's financial position or results of operations.

**Table of Contents****FIRST ACCEPTANCE CORPORATION 10-Q****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements which involve risks and uncertainties. Our actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such a difference include those discussed in Item 1A. Risk Factors in our Transition Report on Form 10-K for the transition period from July 1, 2011 to December 31, 2011. The following discussion should be read in conjunction with our consolidated financial statements included with this report and our consolidated financial statements and related Management's Discussion and Analysis of Financial Condition and Results of Operations for the six months ended December 31, 2011 included in our Transition Report on Form 10-K for the transition period from July 1, 2011 to December 31, 2011.*

**General**

We are principally a retailer, servicer and underwriter of non-standard personal automobile insurance. We also own two tracts of land in San Antonio, Texas that are held for sale. Non-standard personal automobile insurance is made available to individuals who are categorized as non-standard because of their inability or unwillingness to obtain standard insurance coverage due to various factors, including payment history, payment preference, failure in the past to maintain continuous insurance coverage, driving record and/or vehicle type.

At September 30, 2012, we leased and operated 369 retail locations (or stores) staffed by employee-agents who primarily sell non-standard personal automobile insurance products underwritten by us as well as certain commissionable ancillary products. In most states, our employee-agents also sell a tenant homeowner insurance product underwritten by us. At September 30, 2012, we wrote non-standard personal automobile insurance in 12 states and were licensed in 13 additional states. See the discussion in Item 1. Business - General in our Transition Report on Form 10-K for the transition period from July 1, 2011 to December 31, 2011 for additional information with respect to our business.

The following table shows the number of our retail locations. Retail location counts are based upon the date that a location commenced or ceased writing business.

|                  |                     | Three Months Ended |      | Nine Months   |      |
|------------------|---------------------|--------------------|------|---------------|------|
|                  |                     | September 30,      |      | Ended         |      |
|                  |                     | 2012               | 2011 | September 30, | 2011 |
| Retail locations | beginning of period | 369                | 385  | 382           | 393  |
| Opened           |                     |                    |      |               |      |
| Closed           |                     |                    | (2)  | (13)          | (10) |
| Retail locations | end of period       | 369                | 383  | 369           | 383  |

The following table shows the number of our retail locations by state.

|             | September 30, |      | June 30, |      | December 31, |      |
|-------------|---------------|------|----------|------|--------------|------|
|             | 2012          | 2011 | 2012     | 2011 | 2011         | 2010 |
| Alabama     | 24            | 24   | 24       | 24   | 24           | 25   |
| Florida     | 30            | 31   | 30       | 31   | 30           | 31   |
| Georgia     | 60            | 60   | 60       | 60   | 60           | 60   |
| Illinois    | 63            | 67   | 63       | 68   | 67           | 73   |
| Indiana     | 17            | 17   | 17       | 17   | 17           | 17   |
| Mississippi | 7             | 8    | 7        | 8    | 8            | 8    |
| Missouri    | 11            | 12   | 11       | 12   | 12           | 12   |
| Ohio        | 27            | 27   | 27       | 27   | 27           | 27   |

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|                |     |     |     |     |     |     |
|----------------|-----|-----|-----|-----|-----|-----|
| Pennsylvania   | 16  | 16  | 16  | 16  | 16  | 16  |
| South Carolina | 26  | 26  | 26  | 26  | 26  | 26  |
| Tennessee      | 19  | 20  | 19  | 20  | 20  | 20  |
| Texas          | 69  | 75  | 69  | 76  | 75  | 78  |
| Total          | 369 | 383 | 369 | 385 | 382 | 393 |

**Table of Contents****FIRST ACCEPTANCE CORPORATION 10-Q****Consolidated Results of Operations*****Overview***

Our primary focus is selling, servicing and underwriting non-standard personal automobile insurance. Our real estate and corporate segment consists of activities related to the disposition of real estate held for sale, interest expense associated with debt, and other general corporate overhead expenses. Our insurance operations generate revenues from selling, servicing and underwriting non-standard personal automobile insurance policies in 12 states. We conduct our underwriting operations through three insurance company subsidiaries: First Acceptance Insurance Company, Inc., First Acceptance Insurance Company of Georgia, Inc. and First Acceptance Insurance Company of Tennessee, Inc. Our insurance revenues are primarily generated from:

premiums earned, including policy and renewal fees, from sales of policies written and assumed by our insurance company subsidiaries;

commission and fee income, including installment billing fees on policies written, agency fees and commissions and fees for other ancillary products and services; and

investment income earned on the invested assets of the insurance company subsidiaries.

The following table presents gross premiums earned by state (in thousands). Driven by improvements in sales execution, a higher percentage of full coverage policies sold and rate increases taken in most states, net premiums earned for the three and nine months ended September 30, 2012 increased 14.7% and 9.8%, respectively, compared with the same periods in the prior year.

|                             | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |            |
|-----------------------------|-------------------------------------|-----------|------------------------------------|------------|
|                             | 2012                                | 2011      | 2012                               | 2011       |
| Gross premiums earned:      |                                     |           |                                    |            |
| Georgia                     | \$ 9,694                            | \$ 8,711  | \$ 29,127                          | \$ 27,430  |
| Florida                     | 6,863                               | 4,810     | 19,781                             | 14,705     |
| Texas                       | 5,520                               | 5,219     | 17,049                             | 16,863     |
| Illinois                    | 5,394                               | 5,268     | 16,518                             | 16,596     |
| Alabama                     | 4,275                               | 3,986     | 12,946                             | 12,339     |
| Ohio                        | 3,940                               | 3,367     | 11,741                             | 10,388     |
| South Carolina              | 3,172                               | 2,389     | 9,406                              | 7,339      |
| Tennessee                   | 2,960                               | 2,524     | 8,971                              | 7,853      |
| Pennsylvania                | 2,083                               | 2,020     | 6,230                              | 6,476      |
| Indiana                     | 1,161                               | 1,049     | 3,540                              | 3,328      |
| Missouri                    | 773                                 | 614       | 2,395                              | 2,014      |
| Mississippi                 | 657                                 | 593       | 2,004                              | 1,899      |
| Total gross premiums earned | 46,492                              | 40,550    | 139,708                            | 127,230    |
| Premiums ceded to reinsurer | (48)                                | (45)      | (144)                              | (138)      |
| Total net premiums earned   | \$ 46,444                           | \$ 40,505 | \$ 139,564                         | \$ 127,092 |

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The following table presents the change in the total number of policies in force ( PIF ) for the insurance operations. PIF increased on a year-over-year basis as a result of improved policy life and retention, as well as higher new business policy production driven by improved retail sales execution and the addition of sales through the call center and website. At September 30, 2012, PIF was 5.6% higher than at the same date in the prior year. The higher percentage decrease in PIF in the current quarter of 5.7%, compared with 2.4% during the same period in the prior year, resulted from higher new business policy production during the first and second quarters of 2012 and the timing of cancellations on those policies. The decline in the current quarter is attributed to new business as renewal business PIF is up 1.0% in the current quarter.

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|                                       | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---------------------------------------|---|-------------|--|-------------|
|                                       | <b>2012</b>                                 | <b>2011</b> | <b>2012</b>                                | <b>2011</b> |
| Policies in force beginning of period | 157,795                                     | 144,410     | 141,862                                    | 144,582     |
| Net change during period              | (8,996)                                     | (3,480)     | 6,937                                      | (3,652)     |
| Policies in force end of period       | 148,799                                     | 140,930     | 148,799                                    | 140,930     |

The following tables present total PIF for the insurance operations segregated by policies that were sold through our open and closed retail locations as well as our independent agents, call center and web. For our retail locations, PIF are further segregated by (i) new and renewal and (ii) liability-only or full coverage. New policies are defined as those policies issued to both first-time customers and customers who have reinstated a lapsed or cancelled policy. Renewal policies are those policies which renewed after completing their full uninterrupted policy term. Liability-only policies are defined as those policies including only bodily injury (or no-fault) and property damage coverages, which are the required coverages in most states. For comparative purposes, the PIF data with respect to closed retail locations for each of the periods presented below includes all retail locations closed at September 30, 2012. PIF from open retail locations increased 6.6% during the current quarter on a year-over-year basis. In addition, the percentage of PIF with full coverage at September 30, 2012 that were sold through our open retail locations increased to 41.7%, compared with 39.3% at the same date in the prior year.

|                          | <b>September 30,</b> |             |
|--------------------------|----------------------|-------------|
|                          | <b>2012</b>          | <b>2011</b> |
| Retail locations:        |                      |             |
| Open retail locations:   |                      |             |
| New                      | 65,978               | 59,932      |
| Renewal                  | 77,644               | 74,759      |
|                          | 143,622              | 134,691     |
| Closed retail locations: |                      |             |
| New                      | 135                  | 1,311       |
| Renewal                  | 1,847                | 3,111       |
|                          | 1,982                | 4,422       |
| Independent agents       | 1,895                | 1,783       |
| Call center and web      | 1,300                | 34          |
| Total policies in force  | 148,799              | 140,930     |

|                          | <b>September 30,</b> |             |
|--------------------------|----------------------|-------------|
|                          | <b>2012</b>          | <b>2011</b> |
| Retail locations:        |                      |             |
| Open retail locations:   |                      |             |
| Liability-only           | 83,740               | 81,806      |
| Full coverage            | 59,882               | 52,885      |
|                          | 143,622              | 134,691     |
| Closed retail locations: |                      |             |
| Liability-only           | 1,161                | 2,778       |
| Full coverage            | 821                  | 1,644       |

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|                         |         |         |
|-------------------------|---------|---------|
|                         | 1,982   | 4,422   |
| Independent agents      | 1,895   | 1,783   |
| Call center and web     | 1,300   | 34      |
| Total policies in force | 148,799 | 140,930 |

Insurance companies present a combined ratio as a measure of their overall underwriting profitability. The components of the combined ratio are as follows.



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*Loss Ratio* - Loss ratio is the ratio (expressed as a percentage) of losses and loss adjustment expenses incurred to premiums earned and is a basic element of underwriting profitability. We calculate this ratio based on all direct and assumed premiums earned, net of ceded reinsurance.

*Expense Ratio* - Expense ratio is the ratio (expressed as a percentage) of insurance operating expenses to net premiums earned. Insurance operating expenses are reduced by commission and fee income from insureds. This is a measurement that illustrates relative management efficiency in administering our operations.

*Combined Ratio* - Combined ratio is the sum of the loss ratio and the expense ratio. If the combined ratio is at or above 100%, an insurance company cannot be profitable without sufficient investment income.

The following table presents the loss, expense and combined ratios for our insurance operations.

|                                  | <b>Three Months Ended<br/>September 30,</b> |               | <b>Nine Months Ended<br/>September 30,</b> |               |
|----------------------------------|---|---------------|--|---------------|
|                                  | <b>2012</b>                                 | <b>2011</b>   | <b>2012</b>                                | <b>2011</b>   |
| Loss and loss adjustment expense | 77.1%                                       | 82.1%         | 82.0%                                      | 76.4%         |
| Expense                          | 22.8%                                       | 27.5%         | 26.8%                                      | 29.0%         |
| <b>Combined</b>                  | <b>99.9%</b>                                | <b>109.6%</b> | <b>108.8%</b>                              | <b>105.4%</b> |

Excluding the severance and related benefits charges incurred in connection with the separation of certain executive officers of \$1.3 million during March 2011, the expense and combined ratios for the nine months ended September 30, 2011 were 28.0% and 104.3%, respectively.

***Operational Initiatives***

During the past year, we renewed our focus on improving the customer experience and value through several initiatives. Through October 2012, our progress has included:

investment in our sales management organization that improved the quality and consistency of the customer experience in our retail stores,

development of a new brand logo and cohesive brand strategy,

investment in rebranding our store fronts and refurbishing our store interiors,

development of electronic signature capabilities, thereby enabling most customers to receive quotes and bind policies over the phone and through the internet,

development of a consumer-based website that reflects our branding strategy, improves the customer experience, and allows for full-service capabilities including quoting, binding and receiving payments,

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implementation of trial sales of third party carrier auto insurance in select locations where pricing is highly competitive, and

development of a web-specific sales strategy to drive quote traffic to our website.

Moving forward, we continue to believe that our retail stores are the foundation of our business, providing an opportunity for us to directly interact with our customers on a regular basis. We also recognize that customer preferences have changed and that we need to adapt to meet those needs. For that reason, we will continue to invest in our people, retail stores, web and call center initiatives, and our customer interaction efforts in order to improve the customer experience. Our current initiatives include:

expansion of our potential customer base through enhancements to our insurance products and expansion of ancillary product offerings, including life insurance,

continued investment and refinement of our web-specific sales strategy,

continued investment and development of our website's full-service capabilities,

continued trial sales of third party carrier auto insurance in select locations where pricing is highly competitive, and

investment in our call center processes and people in order to better support our phone and web sales efforts.

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We use the services of an independent investment manager to manage our investment portfolio. The investment manager conducts, in accordance with our investment policy, all of the investment purchases and sales for our insurance company subsidiaries. Our investment policy has been established by the Investment Committee of our Board of Directors and specifically addresses overall investment goals and objectives, authorized investments, prohibited securities, restrictions on sales by the investment manager and guidelines as to asset allocation, duration and credit quality. Management and the Investment Committee meet regularly with our investment manager to review the performance of the portfolio and compliance with our investment guidelines.

The invested assets of the insurance company subsidiaries consist substantially of marketable, investment grade U.S. government securities, municipal bonds, corporate bonds and collateralized mortgage obligations ( CMOs ). Investment income is comprised primarily of interest earned on these securities, net of related investment expenses. Realized gains and losses may occur from time to time as changes are made to our holdings based upon changes in interest rates, the credit quality of specific securities or other corporate objectives.

The value of our consolidated investment portfolio was \$126.5 million at September 30, 2012 and consisted of fixed maturity securities and an investment in a mutual fund, all carried at fair value with unrealized gains and losses reported as a separate component of stockholders' equity. At September 30, 2012, we had gross unrealized gains of \$9.4 million and gross unrealized losses of \$0.1 million in our consolidated investment portfolio.

At September 30, 2012, 84% of the fair value of our fixed maturity portfolio was rated investment grade (a credit rating of AAA to BBB-) by nationally recognized statistical rating organizations. The average credit rating of our fixed maturity portfolio was AA- at September 30, 2012. Investment grade securities generally bear lower yields and have lower degrees of risk than those that are unrated or non-investment grade. We believe that a high quality investment portfolio is more likely to generate a stable and predictable investment return.

Investments in CMOs had a fair value of \$24.0 million at September 30, 2012 and represented 20% of our fixed maturity portfolio. At September 30, 2012, 75% of our CMOs were considered investment grade by nationally recognized statistical rating agencies. In addition, 14% of our CMOs were rated AAA and 55% of our CMOs were backed by agencies of the United States government. Of the non-agency backed CMOs, 30% were rated AAA.

The following table summarizes our investment securities at September 30, 2012 (in thousands).

| <b>September 30, 2012</b>                         | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> |
|---|---------------------------|---------------------------------------|--|-----------------------|
| U.S. government and agencies                      | \$ 17,202                 | \$ 1,000                              | \$                                     | \$ 18,202             |
| State   | 3,997                     | 160                                   |  | 4,157                 |
| Political subdivisions                            | 753                       | 42                                    |  | 795                   |
| Revenue and assessment                            | 19,652                    | 1,593                                 | (7)                                    | 21,238                |
| Corporate bonds                                   | 44,232                    | 3,945                                 |  | 48,177                |
| Collateralized mortgage obligations:              |                           |                                       |  |                       |
| Agency backed                                     | 12,242                    | 934                                   |  | 13,176                |
| Non-agency backed residential                     | 5,232                     | 438                                   | (115)                                  | 5,555                 |
| Non-agency backed commercial                      | 4,904                     | 405                                   |  | 5,309                 |
| Redeemable preferred stock                        | 1,500                     | 246                                   |  | 1,746                 |
| <b>Total fixed maturities, available-for-sale</b> | <b>109,714</b>            | <b>8,763</b>                          | <b>(122)</b>                           | <b>118,355</b>        |
| Investment in mutual fund, available-for-sale     | 7,501                     | 683                                   |  | 8,184                 |
|   | <b>\$ 117,215</b>         | <b>\$ 9,446</b>                       | <b>\$ (122)</b>                        | <b>\$ 126,539</b>     |

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*Three and Nine Months Ended September 30, 2012 Compared with the Three and Nine Months Ended September 30, 2011*

### ***Consolidated Results***

Revenues for the three months ended September 30, 2012 increased 19% to \$59.6 million from \$50.0 million in the same period in the prior year. Income before income taxes for the three months ended September 30, 2012 was \$3.4 million, compared with loss before income taxes of \$3.6 million for the three months ended September 30, 2011. Income before income taxes for the three months ended September 30, 2012 included the recognition of a

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net realized gain on investments of \$3.2 million, or \$0.08 per share on a diluted basis. Net income for the three months ended September 30, 2012 was \$3.3 million, compared with net loss of \$3.7 million for the three months ended September 30, 2011. Basic and diluted net income per share were \$0.08 for the three months ended September 30, 2012, compared with basic and diluted net loss per share of \$0.08 for the same period in the prior year.

Revenues for the nine months ended September 30, 2012 increased 11% to \$173.0 million from \$155.9 million in the same period in the prior year. Loss before income taxes for the nine months ended September 30, 2012 was \$9.2 million, compared with loss before income taxes of \$58.7 million for the nine months ended September 30, 2011. The loss before income taxes for the nine months ended September 30, 2012 included the recognition of a net realized gain on investments of \$3.2 million, or \$0.08 per share on a diluted basis, while the loss before income taxes for the same period in the prior year included a goodwill and intangible assets impairment charge of \$52.4 million, or \$1.09 per share on a diluted basis. Net loss for the nine months ended September 30, 2012 was \$9.1 million, compared with net loss of \$58.8 million for the nine months ended September 30, 2011. Basic and diluted net loss per share were \$0.22 for the nine months ended September 30, 2012, compared with basic and diluted net loss per share of \$1.22 for the same period in the prior year.

#### ***Insurance Operations***

Revenues from insurance operations were \$59.6 million for the three months ended September 30, 2012, compared with \$49.9 million for the three months ended September 30, 2011. Revenues from insurance operations were \$172.9 million for the nine months ended September 30, 2012, compared with \$155.8 million for the nine months ended September 30, 2011.

Income before income taxes from insurance operations for the three months ended September 30, 2012 was \$4.3 million, compared with loss before income taxes from insurance operations of \$2.3 million for the three months ended September 30, 2011. Loss before income taxes from insurance operations for the nine months ended September 30, 2012 was \$5.5 million, compared with loss before income taxes from insurance operations of \$54.2 million for the nine months ended September 30, 2011. Income (loss) before income taxes from insurance operations for the three and nine months ended September 30, 2012 included the recognition of a net realized gain on investments of \$3.2 million, while the loss before income taxes from insurance operations for the nine months ended September 30, 2011 included a goodwill and intangible assets impairment charge of \$52.4 million.

#### ***Premiums Earned***

Premiums earned increased by \$5.9 million, or 15%, to \$46.4 million for the three months ended September 30, 2012, from \$40.5 million for the three months ended September 30, 2011. For the nine months ended September 30, 2012, premiums earned increased by \$12.5 million, or 10%, to \$139.6 million from \$127.1 million for the nine months ended September 30, 2011. This improvement was primarily due to an increase in the number of PIF from 140,930 at September 30, 2011 to 148,799 at September 30, 2012, which we attribute to the continued sales, marketing, customer interaction and product initiatives. In addition, we experienced increases in both new policies sold during the most recent quarter and nine-month period on a year-over-year basis and the number of PIF at September 30, 2012 compared to December 31, 2011. For those policies quoted, we continue to experience a higher close ratio for the quarter and nine-month period ended September 30, 2012 compared with the same periods in the prior year.

#### ***Commission and Fee Income***

Commission and fee income increased 11% to \$8.3 million for the three months ended September 30, 2012, from \$7.5 million for the three months ended September 30, 2011. For the nine months ended September 30, 2012, commission and fee income increased 11% to \$25.0 million from \$22.6 million for the nine months ended September 30, 2011. This increase in commission and fee income was a result of higher fee income related to commissionable ancillary products sold through our retail locations and the increase in PIF noted above.

#### ***Investment Income***

Investment income decreased to \$1.6 million during the three months ended September 30, 2012 from \$2.0 million during the three months ended September 30, 2011. For the nine months ended September 30, 2012, investment income decreased to \$5.2 million from \$6.2 million during the nine months ended September 30, 2011. This decrease in investment income was primarily a result of the decline in invested assets as a result of cash used in operations and the \$11.0 million used for repurchases of common stock during the prior calendar year. At September 30,

2012 and 2011, the tax-equivalent book yields for our fixed maturities portfolio were 3.4% and 4.6%, respectively, with effective durations of 2.20 and 3.30 years, respectively.

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*Net realized gains (losses) on investments, available-for-sale*

Net realized gains on investments, available-for-sale during the three and nine months ended September 30, 2012 primarily included \$3.2 million in net realized gain from the sales of \$29.6 million of corporate bonds which were sold in September 2012 in order to increase the statutory capital and surplus of the insurance company subsidiaries.

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#### *Loss and Loss Adjustment Expenses*

The loss and loss adjustment expense ratio was 77.1% for the three months ended September 30, 2012, compared with 82.1% for the three months ended September 30, 2011. The loss and loss adjustment expense ratio was 82.0% for the nine months ended September 30, 2012, compared with 76.4% for the nine months ended September 30, 2011. We experienced favorable development related to prior periods of \$0.1 million for the three months ended September 30, 2012, compared with unfavorable development of \$1.1 million for the three months ended September 30, 2011. For the nine months ended September 30, 2012, we experienced unfavorable development related to prior periods of \$4.4 million, compared with favorable development of \$1.7 million for the nine months ended September 30, 2011. The unfavorable development for the nine months ended September 30, 2012 was primarily due to adverse trends in bodily injury and Florida personal injury protection claims for recent accident years.

Excluding the development related to prior periods, the loss and loss adjustment expense ratios for the three months ended September 30, 2012 and 2011 were 77.4% and 79.5%, respectively. Excluding the development related to prior periods, the loss and loss adjustment expense ratios for the nine months ended September 30, 2012 and 2011 were 78.8% and 77.6%, respectively. The year-over-year increase in the loss and loss adjustment expense ratio during the nine months ended September 30, 2012 was primarily due to higher loss and loss adjustment expense driven by an increase in frequency experienced during the second quarter of 2012.

In December 2011, we completed the process of implementing new scored pricing programs. We believe these new scored pricing programs provide us with greater pricing segmentation and improve our pricing relative to the risk we are insuring. Currently, approximately 70% of our PIF have been underwritten using these new scored pricing programs.

We perform state-by-state reviews of all insurance pricing programs on a quarterly basis and alter rates as we believe necessary. In response to the increases in our loss ratio during recent quarters, we implemented rate increases on most of our non-scored pricing programs during the first quarter and for our scored pricing programs in most states during the second and third quarters. The full benefit of these rate actions will not be fully realized until all customers renew their policies under the new rates, typically six months from the date of rate change implementation.

#### *Operating Expenses*

Insurance operating expenses increased 1% to \$18.9 million for the three months ended September 30, 2012 from \$18.6 million for the three months ended September 30, 2011. The increase was primarily a result of additional costs associated with sales, marketing and customer service organizational initiatives, additional variable costs associated with higher PIF, and enhancements to our underwriting processes associated with the new scored pricing programs, offset by savings realized from the closure of underperforming stores and a reduction in advertising expenses from the same period in the prior year. For the nine months ended September 30, 2012, insurance operating expenses increased 5% to \$62.4 million from \$59.5 million for the nine months ended September 30, 2011. In addition to the factors noted above, the increase for the nine months ended September 30, 2012 was also greater considering the March 2011 severance and related benefits charges of \$1.3 million incurred in connection with the separation of certain executive officers.

The expense ratio was 22.8% for the three months ended September 30, 2012, compared with 27.5% for the three months ended September 30, 2011. The expense ratio was 26.8% for the nine months ended September 30, 2012, compared with 29.0% for the nine months ended September 30, 2011. Excluding the severance and related benefits charges noted above, the expense ratio for the nine months ended September 30, 2011 was 28.0%, compared to 26.8% for the nine months ended September 30, 2012.

Overall, the combined ratio decreased to 99.9% for the three months ended September 30, 2012 from 109.6% for the three months ended September 30, 2011. For the nine months ended September 30, 2012, the combined ratio increased to 108.8% from 105.4% for the nine months ended September 30, 2011. Excluding the severance and related benefits charges noted above, the combined ratio for the nine months ended September 30, 2011 was 104.3%.



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#### *Goodwill and Intangible Assets Impairment*

We recorded a non-cash, pre-tax goodwill and intangible assets impairment charge during the quarter ended June 30, 2011 of \$52.4 million. We are required to perform periodic impairment tests of our goodwill and intangible assets. As a result of trends in industry transaction and trading multiples, we recognized a non-cash, pre-tax goodwill impairment charge of \$50.9 million during the quarter ended June 30, 2011, which included a \$1.9 million addition to deferred tax liabilities.

Indefinite-lived intangible assets primarily consist of acquired trademarks and trade names. As a result of decisions made by management during the quarter ended June 30, 2011 regarding entity-wide branding initiatives, we recognized a non-cash, pre-tax impairment charge of \$1.6 million related to trade name intangible assets.

#### *Provision (Benefit) for Income Taxes*

The provision for income taxes was \$0.1 million for both the three months ended September 30, 2012 and 2011. For the nine months ended September 30, 2012, the benefit for income taxes was \$0.1 million, compared with the provision for income taxes of \$0.1 million for the nine months ended September 30, 2011. The provision (benefit) for income taxes related to current state income taxes for certain subsidiaries with taxable income. The provision (benefit) for income taxes for the nine months ended September 30, 2012 and 2011 included adjustments that reduced certain state income taxes. At September 30, 2012 and 2011, we established a valuation allowance to reduce deferred tax assets to the amount that is more likely than not to be realized. In assessing our ability to support the realizability of our deferred tax assets, we considered both positive and negative evidence. We placed greater weight on historical results than on our outlook for future profitability. The deferred tax valuation allowance may be adjusted in future periods if we determine that it is more likely than not that some portion or all of the deferred tax assets will be realized. In the event the deferred tax valuation allowance is adjusted, we would record an income tax benefit for the adjustment.

#### *Real Estate and Corporate*

Loss before income taxes from real estate and corporate operations for the three months ended September 30, 2012 was \$0.9 million, compared with a loss before income taxes from real estate and corporate operations of \$1.3 million for the three months ended September 30, 2011. Loss before income taxes from real estate and corporate operations for the nine months ended September 30, 2012 was \$3.7 million, compared with a loss before income taxes from real estate and corporate operations of \$4.5 million for the nine months ended September 30, 2011. Segment losses consist of other operating expenses not directly related to our insurance operations, interest expense and stock-based compensation offset by investment income on corporate invested assets. We incurred \$0.6 million and \$1.0 million, respectively, of interest expense during the three months ended September 30, 2012 and 2011 and \$2.6 million and \$2.9 million, respectively, of interest expense during the nine months ended September 30, 2012 and 2011 related to the debentures issued in June 2007. The decrease in interest expense was due the contractual interest rate related to the debentures decreasing effective August 2012. For additional information, see *Liquidity and Capital Resources* in Item 2 of this report.

#### *Liquidity and Capital Resources*

Our primary sources of funds are premiums, fees and investment income from our insurance company subsidiaries and commissions and fee income from our non-insurance company subsidiaries. Our primary uses of funds are the payment of claims and operating expenses. Net cash used in operating activities for the nine months ended September 30, 2012 was \$2.2 million, compared with net cash used in operating activities of \$8.4 million for the same period in the prior fiscal year. This improvement was primarily as a result of the increase in premiums written and the improvement in our loss ratio. Net cash provided by investing activities for the nine months ended September 30, 2012 was \$15.4 million, compared with net cash provided by investing activities of \$8.1 million for the same period in the prior fiscal year. During September 2012, we sold \$29.6 million of corporate bonds in order to increase the statutory capital and surplus of the insurance company subsidiaries. At September 30, 2012, the net proceeds from these sales are included within receivable for securities in the consolidated balance sheet. The nine months ended September 30, 2012 and 2011 included total net reductions in our investment portfolio of \$48.4 million and \$9.1 million, respectively. The remaining net reductions in our investment portfolio in both periods were primarily a result of maturities and redemptions. Investing activities during the nine months ended September 30, 2012 also included capital expenditures of \$3.3 million primarily related to the rebranding of our retail stores.



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Our holding company requires cash for general corporate overhead expenses and for debt service related to our debentures payable. The holding company's primary source of unrestricted cash to meet its obligations is the sale of ancillary products to our insureds and, if necessary and available subject to state law limitations, the holding company may receive dividends from our insurance company subsidiaries. The holding company also receives cash from operating activities as a result of investment income. Through an intercompany tax allocation arrangement, taxable losses of the holding company provide cash to the holding company to the extent that taxable income is generated by the insurance company subsidiaries. During September 2012, the holding company contributed \$13.0 million in cash to increase the statutory capital and surplus of the insurance company subsidiaries. At September 30, 2012, we had \$2.3 million remaining available in unrestricted cash and investments outside of the insurance company subsidiaries. These funds and the additional unrestricted cash from the sources noted above will be used to pay our future cash requirements outside of the insurance company subsidiaries.

The holding company has debt service requirements related to the debentures payable. The debentures are interest-only and mature in full in July 2037. The debentures paid a fixed rate of 9.277% until July 30, 2012, after which time the rate became variable (Three-Month LIBOR plus 375 basis points). Our interest rate related to the debentures was 4.197% for the period from August 2012 to October 2012 and is 4.063% for the period from November 2012 to January 2013, after which the quarterly variable interest rate will reset.

State insurance laws limit the amount of dividends that may be paid from our insurance company subsidiaries. At September 30, 2012, our insurance company subsidiaries could not pay ordinary dividends without prior regulatory approval due to a negative earned surplus position.

The National Association of Insurance Commissioners Model Act for risk-based capital provides formulas to determine each December 31 on an annual basis the amount of statutory capital and surplus that an insurance company needs to ensure that it has an acceptable expectation of not becoming financially impaired. There are also statutory guidelines that suggest that on an annual calendar year basis an insurance company should not exceed a ratio of net premiums written to statutory capital and surplus of 3-to-1. On a combined basis, the ratios for our insurance company subsidiaries of net premiums written for the last twelve months to statutory capital and surplus were 2.08-to-1 at September 30, 2012. Based on our current forecast on a combined basis, we anticipate that our risk-based capital levels will be adequate and that our ratio of net premiums written to statutory capital and surplus will not exceed the 3-to-1 statutory guideline for the reasonably foreseeable future. We therefore believe that our insurance company subsidiaries have sufficient statutory capital and surplus available to support their net premium writings in this time frame.

We believe that existing cash and investment balances, when combined with anticipated cash flows as noted above, will be adequate to meet our expected liquidity needs, for both the holding company and our insurance company subsidiaries, in both the short-term and the reasonably foreseeable future. Any future growth strategy may require external financing, and we may from time to time seek to obtain external financing. We cannot assure that additional sources of financing will be available to us on favorable terms, or at all, or that any such financing would not negatively impact our results of operations.

#### **Off-Balance Sheet Arrangements**

We have not entered into any new off-balance sheet arrangements since December 31, 2011. For information with respect to our off-balance sheet arrangements at December 31, 2011, see Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Off-Balance Sheet Arrangements included in our Transition Report on Form 10-K for the transition period from July 1, 2011 to December 31, 2011.

#### **Critical Accounting Estimates**

There have been no significant changes to our critical accounting estimates during the three months ended September 30, 2012 compared with those disclosed in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Estimates included in our Transition Report on Form 10-K for the transition period from July 1, 2011 to December 31, 2011.

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**Forward-Looking Statements**

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements made in this report, other than statements of historical fact, are forward-looking statements. You can identify these statements from our use of the words may, should, could, potential, continue, plan, estimate, project, believe, intent, anticipate, expect, target, is likely, will, or the negative of these terms and similar expressions. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements may include, among other things statements and assumptions relating to:

our future growth, income, income per share and other financial performance measures;

the anticipated effects on our results of operations or financial condition from recent and expected developments or events;

the financial condition of, and other issues relating to the strength of and liquidity available to, issuers of securities held in our investment portfolio;

the accuracy and adequacy of our loss reserving methodologies; and

our business and growth strategies.

We believe that our expectations are based on reasonable assumptions. However, these forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause our actual results, performance or achievements, or industry results to differ materially from our expectations of future results, performance or achievements expressed or implied by these forward-looking statements. In addition, our past results of operations do not necessarily indicate our future results. We discuss these and other uncertainties in Item 1A. Risk Factors of our Transition Report on Form 10-K for the transition period from July 1, 2011 to December 31, 2011.

You should not place undue reliance on any forward-looking statements. These statements speak only as of the date of this report. Except as otherwise required by applicable laws, we undertake no obligation to publicly update or revise any forward-looking statements or the risk factors described in this report, whether as a result of new information, future events, changed circumstances or any other reason after the date of this report.

**Table of Contents****FIRST ACCEPTANCE CORPORATION 10-Q****Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Market risk represents the potential economic loss arising from adverse changes in the fair value of financial instruments. Our exposures to market risk relate primarily to our investment portfolio, which is exposed primarily to interest rate risk and credit risk. The fair value of our investment portfolio is directly impacted by changes in market interest rates; generally, the fair value of fixed-income investments moves inversely with movements in market interest rates. Our fixed maturity portfolio is comprised of substantially all fixed rate investments with primarily short-term and intermediate-term maturities. Likewise, the underlying investments of our current mutual fund investment are also fixed-income investments. This portfolio composition allows flexibility in reacting to fluctuations of interest rates. The portfolios of our insurance company subsidiaries are managed to achieve an adequate risk-adjusted return while maintaining sufficient liquidity to meet policyholder obligations.

**Interest Rate Risk**

The fair values of our fixed maturity investments fluctuate in response to changes in market interest rates. Increases and decreases in prevailing interest rates generally translate into decreases and increases, respectively, in the fair values of those instruments. Additionally, the fair values of interest rate sensitive instruments may be affected by the creditworthiness of the issuer, prepayment options, relative values of alternative investments, the liquidity of the instrument and other general market conditions.

The following table summarizes the estimated effects of hypothetical increases and decreases in interest rates resulting from parallel shifts in market yield curves on our fixed maturity portfolio (in thousands). It is assumed that the effects are realized immediately upon the change in interest rates. The hypothetical changes in market interest rates do not reflect what could be deemed best or worst case scenarios. Variations in market interest rates could produce significant changes in the timing of repayments due to prepayment options available. For these and other reasons, actual results might differ from those reflected in the table.

|  | Sensitivity to Instantaneous Interest Rate Changes (basis points) |            |            |            |            |            |
|--|---|------------|------------|------------|------------|------------|
|  | (100)   | (50)       | 0          | 50         | 100        | 200        |
| Fair value of fixed maturity portfolio | \$ 122,246  | \$ 120,301 | \$ 118,355 | \$ 116,439 | \$ 114,573 | \$ 111,017 |

The following table provides information about our fixed maturity investments at September 30, 2012 which are sensitive to interest rate risk. The table shows expected principal cash flows (at par value, which differs from amortized cost as a result of premiums or discounts at the time of purchase and OTTI) by expected maturity date for each of the next five fiscal years and collectively for all fiscal years thereafter (in thousands). Callable bonds and notes are included based on call date or maturity date depending upon which date produces the most conservative yield. CMOs and sinking fund issues are included based on maturity year adjusted for expected payment patterns. Actual cash flows may differ from those expected.

| Year Ending December 31, | Securities with Unrealized Gains | Securities with Unrealized Losses | Securities with No Unrealized Gains or Losses | All Fixed Maturity Securities |
|--------------------------|----------------------------------|-----------------------------------|---|-------------------------------|
| 2012                     | \$ 13,210                        | \$                                | \$  | \$ 13,210                     |
| 2013                     | 10,410                           |                                   |   | 10,410                        |
| 2014                     | 19,132                           |                                   |   | 19,132                        |
| 2015                     | 8,331                            | 700                               |   | 9,031                         |
| 2016                     | 7,541                            |                                   |   | 7,541                         |
| Thereafter               | 47,667                           | 346                               |   | 48,013                        |
| Total                    | \$ 106,291                       | \$ 1,046                          | \$  | \$ 107,337                    |

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|            |            |          |    |            |
|------------|------------|----------|----|------------|
| Fair value | \$ 117,328 | \$ 1,027 | \$ | \$ 118,355 |
|------------|------------|----------|----|------------|

On June 15, 2007, our trust entity, First Acceptance Statutory Trust I, used the proceeds from its sale of trust preferred securities to purchase \$41.2 million of junior subordinated debentures. The debentures paid a fixed rate of

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9.277% until July 30, 2012, after which the rate became variable (Three-Month LIBOR plus 375 basis points). Our interest rate related to the debentures was 4.197% for the period from August 2012 to October 2012 and is 4.063% for the period from November 2012 to January 2013, after which the quarterly variable interest rate will reset.

**Credit Risk**

Credit risk is managed by diversifying our investment portfolio to avoid concentrations in any single industry group or issuer and by limiting investments in securities with lower credit ratings. Our largest investment in any one investment, excluding U.S. government and agency securities, is our investment in a single mutual fund with a fair value of \$8.1 million, or 6% of our investment portfolio. Our five largest investments make up 21% of our investment portfolio. The average credit quality rating for our fixed maturity portfolio was AA- at September 30, 2012.

The following table presents the underlying ratings of our fixed maturity portfolio by nationally recognized statistical rating organizations at September 30, 2012 (in thousands).

| Comparable Rating          | Amortized Cost | % of Amortized Cost | Fair Value | % of Fair Value |
|----------------------------|----------------|---------------------|------------|-----------------|
| AAA                        | \$ 20,847      | 18%                 | \$ 21,997  | 17%             |
| AA+, AA, AA-               | 36,985         | 32%                 | 40,008     | 32%             |
| A+, A, A-                  | 33,030         | 28%                 | 35,965     | 28%             |
| BBB+, BBB, BBB-            | 8,452          | 7%                  | 9,068      | 7%              |
| Total investment grade     | 99,314         | 85%                 | 107,038    | 84%             |
| Not rated                  | 13,217         | 11%                 | 14,486     | 12%             |
| B+, B, B-                  | 1,772          | 2%                  | 1,931      | 2%              |
| CCC+, CCC, CCC-            | 2,831          | 2%                  | 2,950      | 2%              |
| CC+, CC, CC-               | 81             | 0%                  | 112        | 0%              |
| C+, C, C-                  |                | 0%                  | 22         | 0%              |
| D                          |                | 0%                  |            | 0%              |
| Total non-investment grade | 4,684          | 4%                  | 5,015      | 4%              |
| Total                      | \$ 117,215     | 100%                | \$ 126,539 | 100%            |

The mortgage industry has experienced a significant number of delinquencies and foreclosures, particularly among lower quality exposures ( sub-prime and Alt-A ). As a result of these delinquencies and foreclosures, many CMOs with underlying sub-prime and Alt-A mortgages as collateral experienced significant declines in fair value. At September 30, 2012, our fixed maturity portfolio included three CMOs having sub-prime exposure with both an amortized cost and a fair value of \$0.7 million, and no exposure to Alt-A investments.

Our investment portfolio included \$26.2 million of municipal bonds, of which \$15.7 million are insured. Of the insured bonds, 74% are insured with MBIA, 12% with AMBAC and 14% with XL Capital. These securities are paying their principal and periodic interest timely.

The following table presents the underlying ratings at September 30, 2012, represented by the lower of either Standard and Poor's, Fitch's, or Moody's ratings, of the municipal bond portfolio (in thousands).

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|                 | Insured       |                       | Uninsured     |                       | Total         |                       |
|-----------------|---------------|-----------------------|---------------|-----------------------|---------------|-----------------------|
|                 | Fair<br>Value | % of<br>Fair<br>Value | Fair<br>Value | % of<br>Fair<br>Value | Fair<br>Value | % of<br>Fair<br>Value |
| AAA             | \$            | 0%                    | \$ 1,789      | 17%                   | \$ 1,789      | 7%                    |
| AA+, AA, AA-    | 7,404         | 47%                   | 4,559         | 43%                   | 11,963        | 46%                   |
| A+, A, A-       | 6,562         | 42%                   | 4,186         | 40%                   | 10,748        | 41%                   |
| BBB+, BBB, BBB- | 1,686         | 11%                   |               | 0%                    | 1,686         | 6%                    |
| Not Rated       | 5             | 0%                    |               | 0%                    | 5             | 0%                    |
| Total           | \$ 15,657     | 100%                  | \$ 10,534     | 100%                  | \$ 26,191     | 100%                  |



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**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management team, including our Principal Executive Officer and Principal Financial Officer, we conducted an evaluation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended, or the Exchange Act ) as of September 30, 2012. Based on that evaluation, our Chief Executive Officer (principal executive officer) and Senior Vice President of Finance (principal financial officer) concluded that our disclosure controls and procedures were effective as of September 30, 2012 to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

**Changes in Internal Control Over Financial Reporting**

During the period covered by this report, there has been no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

We and our subsidiaries are named from time to time as defendants in various legal actions that are incidental to our business, including those which arise out of or are related to the handling of claims made in connection with our insurance policies and claims handling. The plaintiffs in some of these lawsuits have alleged bad faith or extra-contractual damages, and some have sought punitive damages or class action status. We believe that the resolution of these legal actions will not have a material adverse effect on our financial condition or results of operations. However, the ultimate outcome of these matters is uncertain.

As discussed in Part I, Item 3. Legal Proceedings of our Transition Report on Form 10-K for the transition period from July 1, 2011 to December 31, 2011, in the interest of judicial economy, in March 2012, we settled a lawsuit against our insured in which the plaintiffs sought extra-contractual damages against one of our insurance company subsidiaries. We have not accrued any amount at September 30, 2012 for possible recoveries that may offset the costs and expenses relating to this litigation settlement. Any such recoveries will be recorded in our operating results during the periods in which the recoveries are probable.

**Item 4. Mine Safety Disclosures**

None.

**Item 6. Exhibits**

The following exhibits are attached to this report:

- 31.1 Certification of Principal Executive Officer pursuant to Rule 13a-14(a).
- 31.2 Certification of Principal Financial Officer pursuant to Rule 13a-14(a).
- 32.1 Principal Executive Officer's Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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|      |   |
|------|---|
| 32.2 | Principal Financial Officer's Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101  | XBRL  |

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**SIGNATURES**

Pursuant to the requirements 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.

FIRST ACCEPTANCE CORPORATION

Date: November 6, 2012

By: /s/ John R. Barnett

John R. Barnett

Senior Vice President of Finance

(Principal Financial Officer and Principal Accounting Officer)