

CITIZENS INC  
Form 10-Q  
November 06, 2012

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q

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Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2012

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-16509

CITIZENS, INC.

(Exact name of registrant as specified in its charter)

Colorado

84-0755371

(State of other jurisdiction of incorporation or  
organization)

(I.R.S. Employer Identification No.)

400 East Anderson Lane, Austin, TX

78752

(Address of principal executive offices)

(Zip Code)

(512) 837-7100

(Registrant's telephone number, including area code)

N/A

(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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a small reporting company. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of November 5, 2012, the Registrant had 49,080,114 shares of Class A common stock, no par value, outstanding and 1,001,714 shares of Class B common stock outstanding.

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## PART I. FINANCIAL INFORMATION

## Item 1. FINANCIAL STATEMENTS

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Financial Position

(In thousands)

|   | September 30, 2012<br>(Unaudited) | December 31, 2011<br>(As adjusted) |
|---|-----------------------------------|------------------------------------|
| Assets  |                                   |                                    |
| Investments:  |                                   |                                    |
| Fixed maturities available-for-sale, at fair value (cost: \$549,205 and \$484,809 in 2012 and 2011, respectively)         | \$ 594,620                        | 514,253                            |
| Fixed maturities held-to-maturity, at amortized cost (fair value: \$209,580 and \$230,093 in 2012 and 2011, respectively) | 203,237                           | 227,500                            |
| Equity securities available-for-sale, at fair value (cost: \$42,812 and \$45,599 in 2012 and 2011, respectively)          | 44,091                            | 46,137                             |
| Mortgage loans on real estate   | 1,521                             | 1,557                              |
| Policy loans  | 42,784                            | 39,090                             |
| Real estate held for investment (less \$1,252 and \$1,149 accumulated depreciation in 2012 and 2011, respectively)        | 8,530                             | 8,539                              |
| Other long-term investments   | 178                               | 105                                |
| Short-term investments  | 2,356                             | 2,048                              |
| Total investments   | 897,317                           | 839,229                            |
| Cash and cash equivalents   | 39,830                            | 33,255                             |
| Accrued investment income   | 10,178                            | 7,787                              |
| Reinsurance recoverable   | 9,228                             | 9,562                              |
| Deferred policy acquisition costs   | 132,206                           | 124,542                            |
| Cost of customer relationships acquired   | 25,764                            | 27,945                             |
| Goodwill  | 17,160                            | 17,160                             |
| Other intangible assets   | 886                               | 906                                |
| Federal income tax receivable   | —                                 | 901                                |
| Property and equipment, net   | 7,450                             | 7,860                              |
| Due premiums, net (less \$1,275 and \$1,698 allowance for doubtful accounts in 2012 and 2011, respectively)               | 9,693                             | 9,169                              |
| Prepaid expenses  | 1,175                             | 396                                |
| Other assets  | 832                               | 800                                |
| Total assets  | \$1,151,719                       | 1,079,512                          |

(Continued)

See accompanying notes to consolidated financial statements.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Financial Position

(In thousands, except share amounts)

|   | September 30, 2012<br>(Unaudited) | December 31, 2011<br>(As adjusted) |
|---|-----------------------------------|------------------------------------|
| Liabilities and Stockholders' Equity  |                                   |                                    |
| Liabilities:  |                                   |                                    |
| Policy liabilities:   |                                   |                                    |
| Future policy benefit reserves:   |                                   |                                    |
| Life insurance  | \$743,845                         | 697,502                            |
| Annuities   | 50,125                            | 47,060                             |
| Accident and health   | 5,496                             | 5,612                              |
| Dividend accumulations  | 11,717                            | 10,601                             |
| Premiums paid in advance  | 27,003                            | 25,291                             |
| Policy claims payable   | 9,514                             | 10,020                             |
| Other policyholders' funds  | 9,463                             | 8,760                              |
| Total policy liabilities  | 857,163                           | 804,846                            |
| Commissions payable   | 1,920                             | 2,851                              |
| Federal income tax payable  | 1,188                             | —                                  |
| Deferred federal income tax   | 17,545                            | 13,940                             |
| Payable for securities in process of settlement   | 1,231                             | —                                  |
| Warrants outstanding  | 137                               | 451                                |
| Other liabilities   | 8,490                             | 9,382                              |
| Total liabilities   | 887,674                           | 831,470                            |
| Commitments and contingencies (Note 7)  |                                   |                                    |
| Stockholders' equity:   |                                   |                                    |
| Class A, no par value, 100,000,000 shares authorized, 52,203,365 shares issued in 2012 and 52,089,189 shares issued in 2011, including shares in treasury of 3,135,738 in 2012 and 2011 | 259,371                           | 258,548                            |
| Class B, no par value, 2,000,000 shares authorized, 1,001,714 shares issued and outstanding in 2012 and 2011  | 3,184                             | 3,184                              |
| Accumulated deficit   | (17,025                           | ) (21,851                          |
| Accumulated other comprehensive income:   |                                   |                                    |
| Unrealized gains on securities, net of tax  | 29,526                            | 19,172                             |
| Treasury stock, at cost   | (11,011                           | ) (11,011                          |
| Total stockholders' equity  | 264,045                           | 248,042                            |
| Total liabilities and stockholders' equity  | \$1,151,719                       | 1,079,512                          |

See accompanying notes to consolidated financial statements.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Comprehensive Income

Three Months Ended September 30,

(In thousands, except per share amounts)

(Unaudited)

|   | 2012     |   | 2011          |
|---|----------|---|---------------|
| Revenues:   |          |   | (As adjusted) |
| Premiums:   |          |   |               |
| Life insurance  | \$41,257 |   | 38,639        |
| Accident and health insurance   | 414      |   | 383           |
| Property insurance  | 1,281    |   | 1,277         |
| Net investment income   | 8,114    |   | 7,478         |
| Realized investment gains, net  | 763      |   | 35            |
| Decrease in fair value of warrants                                      | 241      |   | 239           |
| Other income  | 112      |   | 282           |
| Total revenues  | 52,182   |   | 48,333        |
| Benefits and expenses:  |          |   |               |
| Insurance benefits paid or provided:                                    |          |   |               |
| Claims and surrenders   | 15,627   |   | 14,803        |
| Increase in future policy benefit reserves                              | 16,901   |   | 14,365        |
| Policyholders' dividends  | 2,600    |   | 2,169         |
| Total insurance benefits paid or provided                               | 35,128   |   | 31,337        |
| Commissions   | 9,769    |   | 9,224         |
| Other general expenses  | 6,055    |   | 6,642         |
| Capitalization of deferred policy acquisition costs                     | (7,547   | ) | (6,531        |
| Amortization of deferred policy acquisition costs                       | 4,134    |   | 4,171         |
| Amortization of cost of customer relationships acquired                 | 598      |   | 708           |
| Total benefits and expenses   | 48,137   |   | 45,551        |
| Income before federal income tax  | 4,045    |   | 2,782         |
| Federal income tax expense  | 1,134    |   | 729           |
| Net income  | 2,911    |   | 2,053         |
| Per Share Amounts:  |          |   |               |
| Basic earnings per share of Class A common stock                        | \$0.06   |   | 0.04          |
| Basic earnings per share of Class B common stock                        | 0.03     |   | 0.02          |
| Diluted earnings per share of Class A common stock                      | 0.06     |   | 0.04          |
| Diluted earnings per share of Class B common stock                      | 0.03     |   | 0.02          |
| Other comprehensive income:   |          |   |               |
| Unrealized gains on available-for-sale securities:                      |          |   |               |
| Unrealized holding gains arising during period                          | 8,542    |   | 15,431        |
| Reclassification adjustment for gains included in net income            | (708     | ) | —             |
| Unrealized gains on available-for-sale securities, net                  | 7,834    |   | 15,431        |
| Income tax expense on unrealized gains on available-for-sale securities | 2,878    |   | 5,460         |
| Other comprehensive income  | 4,956    |   | 9,971         |
| Comprehensive income  | \$7,867  |   | 12,024        |

See accompanying notes to consolidated financial statements.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Comprehensive Income

Nine Months Ended September 30,

(In thousands, except per share amounts)

(Unaudited)

|   | 2012       |   | 2011          |
|---|------------|---|---------------|
| Revenues:   |            |   | (As adjusted) |
| Premiums:   |            |   |               |
| Life insurance  | \$ 118,608 |   | 112,481       |
| Accident and health insurance   | 1,244      |   | 1,151         |
| Property insurance  | 3,792      |   | 3,781         |
| Net investment income   | 23,303     |   | 22,281        |
| Realized investment gains, net  | 1,107      |   | 41            |
| Decrease in fair value of warrants                                      | 314        |   | 1,454         |
| Other income  | 321        |   | 509           |
| Total revenues  | 148,689    |   | 141,698       |
| Benefits and expenses:  |            |   |               |
| Insurance benefits paid or provided:                                    |            |   |               |
| Claims and surrenders   | 46,490     |   | 44,587        |
| Increase in future policy benefit reserves                              | 47,793     |   | 39,683        |
| Policyholders' dividends  | 6,755      |   | 5,751         |
| Total insurance benefits paid or provided                               | 101,038    |   | 90,021        |
| Commissions   | 28,164     |   | 28,226        |
| Other general expenses  | 19,013     |   | 19,743        |
| Capitalization of deferred policy acquisition costs                     | (20,530)   | ) | (20,536)      |
| Amortization of deferred policy acquisition costs                       | 12,693     |   | 12,480        |
| Amortization of cost of customer relationships acquired                 | 1,834      |   | 2,113         |
| Total benefits and expenses   | 142,212    |   | 132,047       |
| Income before federal income tax  | 6,477      |   | 9,651         |
| Federal income tax expense  | 1,651      |   | 2,967         |
| Net income  | 4,826      |   | 6,684         |
| Per Share Amounts:  |            |   |               |
| Basic earnings per share of Class A common stock                        | \$0.10     |   | 0.13          |
| Basic earnings per share of Class B common stock                        | 0.05       |   | 0.07          |
| Diluted earnings per share of Class A common stock                      | 0.10       |   | 0.13          |
| Diluted earnings per share of Class B common stock                      | 0.05       |   | 0.07          |
| Other comprehensive income:   |            |   |               |
| Unrealized gains on available-for-sale securities:                      |            |   |               |
| Unrealized holding gains arising during period                          | 17,106     |   | 27,546        |
| Reclassification adjustment for gains included in net income            | (915)      | ) | —             |
| Unrealized gains on available-for-sale securities, net                  | 16,191     |   | 27,546        |
| Income tax expense on unrealized gains on available-for-sale securities | 5,837      |   | 9,700         |
| Other comprehensive income  | 10,354     |   | 17,846        |
| Comprehensive income  | \$ 15,180  |   | 24,530        |

See accompanying notes to consolidated financial statements.





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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Cash Flows

Nine Months Ended September 30,

(In thousands)

(Unaudited)

|   | 2012      | 2011          |   |
|---|-----------|---------------|---|
| Cash flows from operating activities:   |           | (As adjusted) |   |
| Net income  | \$4,826   | 6,684         |   |
| Adjustments to reconcile net income to net cash provided by operating activities: |           |               |   |
| Realized gains on sale of investments and other assets                            | (1,107)   | ) (41         | ) |
| Net deferred policy acquisition costs   | (7,837)   | ) (8,056      | ) |
| Amortization of cost of customer relationships acquired                           | 1,834     | 2,113         |   |
| Decrease in fair value of warrants  | (314)     | ) (1,454      | ) |
| Depreciation  | 915       | 753           |   |
| Amortization of premiums and discounts on investments                             | 4,115     | 3,208         |   |
| Deferred federal income tax benefit   | (2,232)   | ) (870        | ) |
| Change in:  |           |               |   |
| Accrued investment income   | (2,391)   | ) (1,032      | ) |
| Reinsurance recoverable   | 334       | (161          | ) |
| Due premiums  | (524)     | ) 730         |   |
| Future policy benefit reserves  | 47,530    | 39,308        |   |
| Other policyholders' liabilities  | 3,025     | 1,747         |   |
| Federal income tax receivable   | 2,089     | 1,570         |   |
| Commissions payable and other liabilities   | (1,823)   | ) (269        | ) |
| Other, net  | (846)     | ) (668        | ) |
| Net cash provided by operating activities   | 47,594    | 43,562        |   |
| Cash flows from investing activities:   |           |               |   |
| Sale of fixed maturities, available-for-sale                                      | 503       | —             |   |
| Maturities and calls of fixed maturities, available-for-sale                      | 125,622   | 127,342       |   |
| Maturities and calls of fixed maturities, held-to-maturity                        | 154,630   | 52,900        |   |
| Purchase of fixed maturities, available-for-sale                                  | (184,728) | ) (82,184     | ) |
| Purchase of fixed maturities, held-to-maturity                                    | (138,756) | ) (104,466    | ) |
| Sales of equity securities, available-for-sale                                    | 2,856     | —             |   |
| Calls of equity securities, available-for-sale                                    | 820       | 682           |   |
| Purchase of equity securities, available-for-sale                                 | —         | (25,000       | ) |
| Principal payments on mortgage loans  | 36        | 36            |   |
| Increase in policy loans, net   | (3,694)   | ) (2,464      | ) |
| Sale of other long-term investments   | 4         | 5             |   |
| Purchase of other long-term investments   | (116)     | ) (25         | ) |
| Sale of property and equipment  | —         | 2             |   |
| Purchase of property and equipment  | (402)     | ) (1,662      | ) |
| Maturity of short-term investments  | 2,000     | —             |   |
| Purchase of short-term investments  | (2,378)   | ) (2,066      | ) |
| Proceeds from assumption reinsurance agreement                                    | —         | 4,550         |   |
| Net cash used in investing activities   | (43,603)  | ) (32,350     | ) |



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Cash Flows, Continued

Nine Months Ended September 30,

(In thousands)

(Unaudited)

|   | 2012     | 2011<br>(As adjusted) |
|---|----------|-----------------------|
| Cash flows from financing activities:             |          |                       |
| Warrants exercised                                | \$822    | 1,791                 |
| Annuity deposits                                  | 4,769    | 4,818                 |
| Annuity withdrawals                               | (3,007   | ) (3,119              |
| Net cash provided by financing activities         | 2,584    | 3,490                 |
| Net increase in cash and cash equivalents         | 6,575    | 14,702                |
| Cash and cash equivalents at beginning of year    | 33,255   | 49,723                |
| Cash and cash equivalents at end of period        | \$39,830 | 64,425                |
| Supplemental disclosures of operating activities: |          |                       |
| Cash paid during the period for income taxes, net | \$1,794  | 2,267                 |

## Supplemental Disclosures of Non-Cash Investing Activities:

None.

See accompanying notes to consolidated financial statements.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES  
Notes to Consolidated Financial Statements  
September 30, 2012  
(Unaudited)

(1) Financial Statements

Basis of Presentation and Consolidation

The accompanying consolidated financial statements of Citizens, Inc. and its wholly-owned subsidiaries have been prepared in conformity with U.S. generally accepted accounting principles ("U.S. GAAP").

The consolidated financial statements include the accounts and operations of Citizens, Inc. ("Citizens"), a Colorado corporation, and its wholly-owned subsidiaries, CICA Life Insurance Company of America ("CICA"), Security Plan Life Insurance Company ("SPLIC"), Security Plan Fire Insurance Company ("SPFIC"), Citizens National Life Insurance Company ("CNLIC"), Computing Technology, Inc. ("CTI") and Insurance Investors, Inc. ("III"). Citizens and its wholly-owned subsidiaries are collectively referred to as "the Company," "we," "us" or "our."

The consolidated statements of financial position for September 30, 2012, the consolidated statements of comprehensive income for the three and nine-month periods ended September 30, 2012 and 2011, and the consolidated statements of cash flows for the nine-month period then ended have been prepared by the Company without audit. In the opinion of management, all adjustments to present fairly the financial position, results of operations, and changes in cash flows at September 30, 2012 and for comparative periods have been made. The consolidated financial statements have been prepared in accordance with U.S. GAAP accounting principles for interim financial information and with the instructions to Form 10-Q adopted by the Securities and Exchange Commission ("SEC"). Accordingly, the financial statements do not include all of the information and footnotes required for complete financial statements and should be read in conjunction with the Company's consolidated financial statements, and notes thereto, for the year ended December 31, 2011. Operating results for the interim periods disclosed herein are not necessarily indicative of the results that may be expected for a full year or any future period.

We provide primarily life insurance and a small amount of health insurance policies through our insurance subsidiaries: CICA, SPLIC, and CNLIC. CICA and CNLIC issue ordinary whole-life policies, credit life and disability, burial insurance, pre-need policies, and accident and health related policies, throughout the Midwest and southern United States. CICA also issues ordinary whole-life policies to non-U.S. residents. SPLIC offers final expense and home service life insurance in Louisiana, Arkansas and Mississippi and SPFIC, a wholly-owned subsidiary of SPLIC, writes a limited amount of property insurance in Louisiana.

CTI provides data processing systems and services, as well as furniture and equipment, to the Company. III provides aviation transportation to the Company.

Deferred Policy Acquisition Costs ("DAC")

The Company has recognized adjustments in the nine month period ending September 30, 2012 that relate to prior reporting periods in the amount of \$0.5 million, net of tax, reducing DAC and increasing DAC amortization. These adjustments relate to actuarial modifications for a plan set up issue in the Life segment that was discovered during a routine process review and an adjustment related to ungrouping certain prior issue year reserve models in the Home Service segment as experience showed differing characteristics.

Benefit Reserves

The Company recorded adjustments to decrease reserves in the amount of \$0.3 million, net of tax, for the nine months in 2012 that related to prior periods. These adjustments resulted from the ungrouping of certain prior issue year reserve models as noted above in the DAC discussion of adjustments as well as adjustments identified by operational controls that resulted in corrections to Life segment policy values.

#### Commissions Payable

The current period includes a reduction of approximately \$0.4 million in commission expense for the three and nine months ended September 30, 2012 due to balances that were held pending validation that are no longer considered payable.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

Use of Estimates

The preparation of financial statements, in conformity with U.S. GAAP, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The most significant estimates include those used in the evaluation of other-than-temporary impairments on debt and equity securities and valuation allowances on investments, actuarially determined assets and liabilities and assumptions, goodwill impairment, valuation allowance on deferred tax assets, and contingencies relating to litigation and regulatory matters. Certain of these estimates are particularly sensitive to market conditions, and deterioration and/or volatility in the worldwide debt or equity markets could have a material impact on the Consolidated Financial Statements.

Reclassification

Reclassifications have been made in the current year related to certain prior year reported amounts to provide consistent presentation.

Significant Accounting Policies

For a description of significant accounting policies, see Note 1 of the Notes to Consolidated Financial Statements included in our 2011 Form 10-K Annual Report, which should be read in conjunction with these accompanying Consolidated Financial Statements.

(2) Accounting Pronouncements

Accounting Standards Recently Adopted

Effective January 1, 2012, the Company retrospectively adopted the Financial Accounting Standards Board's ("FASB") guidance modifying the definition of the types of costs incurred by insurance entities that can be capitalized in the acquisition of new and renewal contracts. The guidance specified that the costs must be based on successful efforts. The guidance also specifies that advertising costs should be included as deferred acquisition costs only when the direct-response advertising accounting criteria are met. The retrospective effect of the change in our deferred acquisition costs decreased the December 31, 2011 DAC asset by \$11.8 million, deferred taxes by \$4.1 million and stockholders' equity balance by \$7.6 million.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

The following table provides the balance sheet and income statement accounts that were impacted by the change in accounting principle.

|   | As Previously<br>Reported | Impact of<br>Change in<br>Accounting<br>Principle | As<br>Adjusted |
|---|---------------------------|---|----------------|
| (In thousands, except per share data)               |                           |   |                |
| Balance Sheet Accounts:                             |                           |   |                |
| As of December 31, 2011:                            |                           |   |                |
| Deferred acquisition costs                          | \$136,300                 | (11,758 )   | 124,542        |
| Deferred federal income taxes                       | 18,055                    | (4,115 )  | 13,940         |
| Accumulated deficit                                 | (14,208 )                 | (7,643 )  | (21,851 )      |
| Statement of Operations:                            |                           |   |                |
| Three months ended September 30, 2011:              |                           |   |                |
| Capitalization of deferred policy acquisition costs | \$(7,121 )                | 590   | (6,531 )       |
| Amortization of deferred policy acquisition costs   | 4,500                     | (329 )  | 4,171          |
| Federal income tax expense                          | 820                       | (91 )   | 729            |
| Net income  | 2,223                     | (170 )  | 2,053          |
| Per share of Class A common stock:                  |                           |   |                |
| Basic earnings per share                            | 0.05                      | (0.01 )   | 0.04           |
| Diluted earnings per share                          | 0.05                      | (0.01 )   | 0.04           |
| Nine months ended September 30, 2011:               |                           |   |                |
| Capitalization of deferred policy acquisition costs | \$(22,170 )               | 1,634   | (20,536 )      |
| Amortization of deferred policy acquisition costs   | 13,249                    | (769 )  | 12,480         |
| Federal income tax expense                          | 3,270                     | (303 )  | 2,967          |
| Net income  | 7,246                     | (562 )  | 6,684          |
| Per share of Class A common stock:                  |                           |   |                |
| Basic earnings per share                            | 0.15                      | (0.02 )   | 0.13           |
| Diluted earnings per share                          | 0.15                      | (0.02 )   | 0.13           |

In June 2011, the FASB amended its guidance on the presentation of comprehensive income in financial statements to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items that are recorded in other comprehensive income. The new accounting guidance requires entities to report components of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. The provisions of this new guidance are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The adoption of this guidance did not have any impact on our financial statements other than providing a continuous statement of comprehensive income.

Accounting Standards Update ("ASU") 2011-04, "Fair Value Measurement ("Topic 820") – Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs." ASU 2011-04 amends Topic 820, "Fair Value Measurements and Disclosures," to converge the fair value measurement guidance in U.S. GAAP and International Financial Reporting Standards ("IFRS"). ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 is effective for annual periods beginning after December 15, 2011, and did not have any impact on the Company's financial statements.





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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

## (3) Segment Information

The Company has three reportable segments: Life Insurance, Home Service Insurance, and Other Non-Insurance Enterprises. The accounting policies of the segments are in accordance with U.S. GAAP and are the same as those used in the preparation of the consolidated financial statements. The Company evaluates profit and loss performance based on U.S. GAAP income before federal income taxes for its three reportable segments.

The Company has no reportable differences between segments and consolidated operations.

|  | Three Months Ended<br>September 30, 2012 |                              |                                       |              |
|--|--|------------------------------|---------------------------------------|--------------|
|  | Life<br>Insurance                        | Home<br>Service<br>Insurance | Other<br>Non-Insurance<br>Enterprises | Consolidated |
|  | (In thousands)                           |                              |                                       |              |
| Revenues:  |  |                              |                                       |              |
| Premiums   | \$31,876                                 | 11,076                       | —                                     | 42,952       |
| Net investment income                                      | 4,538                                    | 3,273                        | 303                                   | 8,114        |
| Realized investment gains, net                             | 720                                      | 43                           | —                                     | 763          |
| Decrease in fair value of warrants                         | —  | —                            | 241                                   | 241          |
| Other income   | 56                                       | 5                            | 51                                    | 112          |
| Total revenue  | 37,190                                   | 14,397                       | 595                                   | 52,182       |
| Benefits and expenses:                                     |  |                              |                                       |              |
| Insurance benefits paid or provided:                       |  |                              |                                       |              |
| Claims and surrenders                                      | 10,213                                   | 5,414                        | —                                     | 15,627       |
| Increase in future policy benefit reserves                 | 16,058                                   | 843                          | —                                     | 16,901       |
| Policyholders' dividends                                   | 2,395                                    | 205                          | —                                     | 2,600        |
| Total insurance benefits paid or provided                  | 28,666                                   | 6,462                        | —                                     | 35,128       |
| Commissions  | 6,115                                    | 3,654                        | —                                     | 9,769        |
| Other general expenses                                     | 2,622                                    | 2,962                        | 471                                   | 6,055        |
| Capitalization of deferred policy acquisition costs        | (6,090)                                  | (1,457)                      | —                                     | (7,547)      |
| Amortization of deferred policy acquisition costs          | 3,358                                    | 776                          | —                                     | 4,134        |
| Amortization of cost of customer relationships<br>acquired | 164                                      | 434                          | —                                     | 598          |
| Total benefits and expenses                                | 34,835                                   | 12,831                       | 471                                   | 48,137       |
| Income before income tax expense                           | \$2,355                                  | 1,566                        | 124                                   | 4,045        |

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

|  | Nine Months Ended<br>September 30, 2012 |                              |                                       | Consolidated |
|--|---|------------------------------|---------------------------------------|--------------|
|  | Life<br>Insurance                       | Home<br>Service<br>Insurance | Other<br>Non-Insurance<br>Enterprises |              |
|  | (In thousands)                          |                              |                                       |              |
| Revenues:  |   |                              |                                       |              |
| Premiums   | \$90,646                                | 32,998                       | —                                     | 123,644      |
| Net investment income                                      | 12,949                                  | 9,503                        | 851                                   | 23,303       |
| Realized investment gains, net                             | 909                                     | 170                          | 28                                    | 1,107        |
| Decrease in fair value of warrants                         | —                                       | —                            | 314                                   | 314          |
| Other income   | 188                                     | 17                           | 116                                   | 321          |
| Total revenue  | 104,692                                 | 42,688                       | 1,309                                 | 148,689      |
| Benefits and expenses:                                     |   |                              |                                       |              |
| Insurance benefits paid or provided:                       |   |                              |                                       |              |
| Claims and surrenders                                      | 30,912                                  | 15,578                       | —                                     | 46,490       |
| Increase in future policy benefit reserves                 | 45,477                                  | 2,316                        | —                                     | 47,793       |
| Policyholders' dividends                                   | 6,525                                   | 230                          | —                                     | 6,755        |
| Total insurance benefits paid or provided                  | 82,914                                  | 18,124                       | —                                     | 101,038      |
| Commissions  | 17,127                                  | 11,037                       | —                                     | 28,164       |
| Other general expenses                                     | 7,953                                   | 8,932                        | 2,128                                 | 19,013       |
| Capitalization of deferred policy acquisition costs        | (16,109)                                | (4,421)                      | —                                     | (20,530)     |
| Amortization of deferred policy acquisition costs          | 10,758                                  | 1,935                        | —                                     | 12,693       |
| Amortization of cost of customer relationships<br>acquired | 557                                     | 1,277                        | —                                     | 1,834        |
| Total benefits and expenses                                | 103,200                                 | 36,884                       | 2,128                                 | 142,212      |
| Income (loss) before income tax expense                    | \$1,492                                 | 5,804                        | (819)                                 | 6,477        |

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

|  | Three Months Ended<br>September 30, 2011 |                              |                                       | Consolidated |
|--|--|------------------------------|---------------------------------------|--------------|
|  | Life<br>Insurance                        | Home<br>Service<br>Insurance | Other<br>Non-Insurance<br>Enterprises |              |
|  | (In thousands)                           |                              |                                       |              |
| Revenues:  |  |                              |                                       |              |
| Premiums   | \$29,491                                 | 10,808                       | —                                     | 40,299       |
| Net investment income                                      | 4,094                                    | 3,178                        | 206                                   | 7,478        |
| Realized investment gains, net                             | 25                                       | 4                            | 6                                     | 35           |
| Decrease in fair value of warrants                         | —  | —                            | 239                                   | 239          |
| Other income   | 240                                      | 6                            | 36                                    | 282          |
| Total revenue  | 33,850                                   | 13,996                       | 487                                   | 48,333       |
| Benefits and expenses:                                     |  |                              |                                       |              |
| Insurance benefits paid or provided:                       |  |                              |                                       |              |
| Claims and surrenders                                      | 9,834                                    | 4,969                        | —                                     | 14,803       |
| Increase in future policy benefit reserves                 | 13,133                                   | 1,232                        | —                                     | 14,365       |
| Policyholders' dividends                                   | 2,152                                    | 17                           | —                                     | 2,169        |
| Total insurance benefits paid or provided                  | 25,119                                   | 6,218                        | —                                     | 31,337       |
| Commissions  | 5,516                                    | 3,708                        | —                                     | 9,224        |
| Other general expenses                                     | 2,875                                    | 3,126                        | 641                                   | 6,642        |
| Capitalization of deferred policy acquisition costs        | (5,026                                   | ) (1,505                     | ) —                                   | (6,531       |
| Amortization of deferred policy acquisition costs          | 3,431                                    | 740                          | —                                     | 4,171        |
| Amortization of cost of customer relationships<br>acquired | 206                                      | 502                          | —                                     | 708          |
| Total benefits and expenses                                | 32,121                                   | 12,789                       | 641                                   | 45,551       |
| Income (loss) before income tax expense                    | \$1,729                                  | 1,207                        | (154                                  | ) 2,782      |

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

|  | Nine Months Ended<br>September 30, 2011 |                              |                                       | Consolidated |
|--|---|------------------------------|---------------------------------------|--------------|
|  | Life<br>Insurance                       | Home<br>Service<br>Insurance | Other<br>Non-Insurance<br>Enterprises |              |
|  | (In thousands)                          |                              |                                       |              |
| Revenues:  |   |                              |                                       |              |
| Premiums   | \$85,027                                | 32,386                       | —                                     | 117,413      |
| Net investment income                                      | 12,019                                  | 9,690                        | 572                                   | 22,281       |
| Realized investment gains, net                             | 29                                      | 6                            | 6                                     | 41           |
| Decrease in fair value of warrants                         | —                                       | —                            | 1,454                                 | 1,454        |
| Other income   | 404                                     | 20                           | 85                                    | 509          |
| Total revenue  | 97,479                                  | 42,102                       | 2,117                                 | 141,698      |
| Benefits and expenses:                                     |   |                              |                                       |              |
| Insurance benefits paid or provided:                       |   |                              |                                       |              |
| Claims and surrenders                                      | 29,691                                  | 14,896                       | —                                     | 44,587       |
| Increase in future policy benefit reserves                 | 36,957                                  | 2,726                        | —                                     | 39,683       |
| Policyholders' dividends                                   | 5,696                                   | 55                           | —                                     | 5,751        |
| Total insurance benefits paid or provided                  | 72,344                                  | 17,677                       | —                                     | 90,021       |
| Commissions  | 16,916                                  | 11,310                       | —                                     | 28,226       |
| Other general expenses                                     | 8,614                                   | 9,167                        | 1,962                                 | 19,743       |
| Capitalization of deferred policy acquisition costs        | (15,763)                                | (4,773)                      | —                                     | (20,536)     |
| Amortization of deferred policy acquisition costs          | 10,743                                  | 1,737                        | —                                     | 12,480       |
| Amortization of cost of customer relationships<br>acquired | 705                                     | 1,408                        | —                                     | 2,113        |
| Total benefits and expenses                                | 93,559                                  | 36,526                       | 1,962                                 | 132,047      |
| Income before income tax expense                           | \$3,920                                 | 5,576                        | 155                                   | 9,651        |

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

## (4) Earnings Per Share

The following tables set forth the computation of basic and diluted earnings per share.

|  | Three Months Ended                          |                    |
|--|---|--------------------|
|  | September 30, 2012                          | September 30, 2011 |
|  | (In thousands,<br>except per share amounts) |                    |
| Basic and diluted earnings per share:                              |   |                    |
| Numerator:   |   |                    |
| Net income   | \$2,911                                     | 2,053              |
| Net income allocated to Class A common stock                       | \$2,881                                     | 2,032              |
| Net income allocated to Class B common stock                       | 30  | 21                 |
| Net income   | \$2,911                                     | 2,053              |
| Denominator:   |   |                    |
| Weighted average shares of Class A outstanding - basic             | 49,019                                      | 48,912             |
| Weighted average shares of Class A outstanding - diluted           | 49,030                                      | 48,912             |
| Weighted average shares of Class B outstanding - basic and diluted | 1,002                                       | 1,002              |
| Basic earnings per share of Class A common stock                   | \$0.06                                      | 0.04               |
| Basic earnings per share of Class B common stock                   | 0.03  | 0.02               |
| Diluted earnings per share of Class A common stock                 | 0.06  | 0.04               |
| Diluted earnings per share of Class B common stock                 | 0.03  | 0.02               |

|  | Nine Months Ended                           |                    |
|--|---|--------------------|
|  | September 30, 2012                          | September 30, 2011 |
|  | (In thousands,<br>except per share amounts) |                    |
| Basic and diluted earnings per share:                              |   |                    |
| Numerator:   |   |                    |
| Net income   | \$4,826                                     | 6,684              |
| Net income allocated to Class A common stock                       | \$4,777                                     | 6,616              |
| Net income allocated to Class B common stock                       | 49  | 68                 |
| Net income   | \$4,826                                     | 6,684              |
| Denominator:   |   |                    |
| Weighted average shares of Class A outstanding - basic             | 48,962                                      | 48,762             |
| Weighted average shares of Class A outstanding - diluted           | 48,972                                      | 48,764             |
| Weighted average shares of Class B outstanding - basic and diluted | 1,002                                       | 1,002              |
| Basic earnings per share of Class A common stock                   | \$0.10                                      | 0.13               |
| Basic earnings per share of Class B common stock                   | 0.05  | 0.07               |
| Diluted earnings per share of Class A common stock                 | 0.10  | 0.13               |
| Diluted earnings per share of Class B common stock                 | 0.05  | 0.07               |

The diluted earnings per share calculation has assumptions regarding the exercise of warrants issued to certain investors as discussed below in Note 8 - Convertible Preferred Stock: Warrants. Dilution was immaterial for the three and nine months ended September 30, 2012.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

## (5) Investments

The Company invests primarily in fixed maturity securities, which totaled 85.1% of total investments and cash and cash equivalents at September 30, 2012.

|  | September 30, 2012 |                           | December 31, 2011 |                           |  |
|--|--------------------|---------------------------|-------------------|---------------------------|--|
|  | Carrying Value     | % of Total Carrying Value | Carrying Value    | % of Total Carrying Value |  |
|  | (In thousands)     |                           | (In thousands)    |                           |  |
| Fixed maturity securities                    | \$797,857          | 85.1 %                    | \$741,753         | 85.0 %                    |  |
| Equity securities                            | 44,091             | 4.7 %                     | 46,137            | 5.3 %                     |  |
| Mortgage loans                               | 1,521              | 0.2 %                     | 1,557             | 0.2 %                     |  |
| Policy loans                                 | 42,784             | 4.6 %                     | 39,090            | 4.5 %                     |  |
| Real estate and other long-term investments  | 8,708              | 0.9 %                     | 8,644             | 1.0 %                     |  |
| Short-term investments                       | 2,356              | 0.3 %                     | 2,048             | 0.2 %                     |  |
| Cash and cash equivalents                    | 39,830             | 4.2 %                     | 33,255            | 3.8 %                     |  |
| Total cash, cash equivalents and investments | \$937,147          | 100.0 %                   | \$872,484         | 100.0 %                   |  |



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

The following tables represent the cost, gross unrealized gains and losses and fair value for fixed maturities and equity securities as of the periods indicated.

|  | September 30, 2012                             |                              |                               |               |
|--|--|------------------------------|-------------------------------|---------------|
|  | Cost or<br>Amortized<br>Cost<br>(In thousands) | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| Fixed maturities:  |  |                              |                               |               |
| Available-for-sale:  |  |                              |                               |               |
| U.S. Treasury securities   | \$ 10,184                                      | 3,931                        | —                             | 14,115        |
| U.S. Government-sponsored enterprises<br>States and political subdivisions | 89,397   | 4,255                        | 32                            | 93,620        |
| Foreign governments  | 233,712  | 16,678                       | 748                           | 249,642       |
| Corporate  | 105  | 38                           | —                             | 143           |
| Commercial mortgage-backed   | 209,153  | 21,397                       | 669                           | 229,881       |
| Residential mortgage-backed  | 547  | 19                           | 1                             | 565           |
| Total available-for-sale securities  | 6,107  | 549                          | 2                             | 6,654         |
| Held-to-maturity securities:   | 549,205  | 46,867                       | 1,452                         | 594,620       |
| U.S. Government-sponsored enterprises<br>States and political subdivisions | 51,136   | 622                          | 4                             | 51,754        |
| Corporate  | 119,206  | 4,975                        | 287                           | 123,894       |
| Total held-to-maturity securities  | 32,895   | 1,054                        | 17                            | 33,932        |
| Total fixed maturities   | 203,237  | 6,651                        | 308                           | 209,580       |
| Equity securities:   | \$ 752,442                                     | 53,518                       | 1,760                         | 804,200       |
| Stock mutual funds   | \$ 10,463                                      | 263                          | 24                            | 10,702        |
| Bond mutual funds  | 31,503   | 649                          | 19                            | 32,133        |
| Common stock   | 17   | —                            | 3                             | 14            |
| Preferred stock  | 829  | 413                          | —                             | 1,242         |
| Total equity securities  | \$ 42,812                                      | 1,325                        | 46                            | 44,091        |

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

|                                       | December 31, 2011 |            |            |         |
|---------------------------------------|-------------------|------------|------------|---------|
|                                       | Cost or           | Gross      | Gross      | Fair    |
|                                       | Amortized         | Unrealized | Unrealized | Value   |
|                                       | Cost              | Gains      | Losses     |         |
|                                       | (In thousands)    |            |            |         |
| Fixed maturities:                     |                   |            |            |         |
| Available-for-sale securities:        |                   |            |            |         |
| U.S. Treasury securities              | \$ 10,228         | 3,730      | —          | 13,958  |
| U.S. Government-sponsored enterprises | 143,684           | 3,198      | 65         | 146,817 |
| States and political subdivisions     | 151,058           | 10,275     | 1,391      | 159,942 |
| Foreign governments                   | 105               | 37         | —          | 142     |
| Corporate                             | 171,462           | 14,576     | 1,493      | 184,545 |
| Commercial mortgage-backed            | 736               | 23         | —          | 759     |
| Residential mortgage-backed           | 7,536             | 562        | 8          | 8,090   |
| Total available-for-sale securities   | 484,809           | 32,401     | 2,957      | 514,253 |
| Held-to-maturity securities:          |                   |            |            |         |
| U.S. Government-sponsored enterprises | 160,411           | 742        | 12         | 161,141 |
| States and political subdivisions     | 56,260            | 1,941      | 84         | 58,117  |
| Corporate                             | 10,829            | 49         | 43         | 10,835  |
| Total held-to-maturity securities     | 227,500           | 2,732      | 139        | 230,093 |
| Total fixed maturity securities       | \$ 712,309        | 35,133     | 3,096      | 744,346 |
| Equity securities:                    |                   |            |            |         |
| Stock mutual funds                    | \$ 12,686         | 415        | 376        | 12,725  |
| Bond mutual funds                     | 31,504            | 27         | 117        | 31,414  |
| Common stock                          | 17                | 7          | —          | 24      |
| Preferred stock                       | 1,392             | 582        | —          | 1,974   |
| Total equity securities               | \$ 45,599         | 1,031      | 493        | 46,137  |

At September 30, 2012, the Company had \$6.7 million of mortgage-backed security holdings based on amortized cost, of which \$6.1 million, or 91.0%, were residential U.S. Government-sponsored issues. Mortgage-backed securities are also referred to as securities not due at a single maturity date throughout this report. The majority of the Company's equity securities are diversified stock and bond mutual funds.

## Valuation of Investments in Fixed Maturity and Equity Securities

Held-to-maturity securities are reported in the financial statements at amortized cost and available-for-sale securities are reported at fair value.

The Company monitors all debt and equity securities on an on-going basis relative to changes in credit ratings, market prices, earnings trends and financial performance, in addition to specific region or industry reviews. The assessment of whether impairments have occurred is based on a case-by-case evaluation of underlying reasons for the decline in fair value. The Company determines other-than-temporary impairment by reviewing relevant evidence related to the specific security issuer as well as the Company's intent to sell the security, or if it is more likely than not that the Company would be required to sell a security before recovery of its amortized cost.

When an other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis. If the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis, the other-than-temporary impairment is recognized in earnings equal to the

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

entire difference between the investment's cost and its fair value at the balance sheet date. If the Company does not intend to sell the security and it is more likely than not that the Company will not be required to sell the security before recovery of its amortized cost basis, the other-than-temporary impairment is separated into the following: (a) the amount representing the credit loss; and (b) the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to other factors is recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the other-than-temporary impairment recognized in earnings becomes the new amortized cost basis of the investment. The new amortized cost basis is not adjusted for subsequent recoveries in fair value.

The Company evaluates whether a credit impairment exists for debt securities by considering primarily the following factors: (a) changes in the financial condition of the security's underlying collateral; (b) whether the issuer is current on contractually obligated interest and principal payments; (c) changes in the financial condition, credit rating and near-term prospects of the issuer; (d) the length of time to which the fair value has been less than the amortized cost of the security; and (e) the payment structure of the security. The Company's best estimate of expected future cash flows used to determine the credit loss amount is a quantitative and qualitative process. Quantitative review includes information received from third party sources such as financial statements, pricing and rating changes, liquidity and other statistical information. Qualitative factors include judgments related to business strategies, economic impacts on the issuer and overall judgment related to estimates and industry factors. The Company's best estimate of future cash flows involves assumptions including, but not limited to, various performance indicators, such as historical and projected default and recovery rates, credit ratings, and current delinquency rates. These assumptions require the use of significant management judgment and include the probability of issuer default and estimates regarding timing and amount of expected recoveries, which may include estimating the underlying collateral value. In addition, projections of expected future debt security cash flows may change based upon new information regarding the performance of the issuer.

The primary factors considered in evaluating whether an impairment exists for an equity security include, but are not limited to: (a) the length of time and the extent to which the fair value has been less than the cost of the security; (b) changes in the financial condition, credit rating and near-term prospects of the issuer; (c) whether the issuer is current on contractually obligated payments; and (d) the intent and ability of the Company to retain the investment for a period of time sufficient to allow for recovery.

The Company did not recognize any other-than-temporary impairments ("OTTI") during the nine months ended September 30, 2012 and 2011.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

The following tables present the fair values and gross unrealized losses of fixed maturities and equity securities that have remained in a continuous unrealized loss position for the periods indicated.

|  | September 30, 2012  |                   |                 |                        |                   |                 |            |                   |                 |
|--|---------------------|-------------------|-----------------|------------------------|-------------------|-----------------|------------|-------------------|-----------------|
|  | Less than 12 months |                   |                 | Greater than 12 months |                   |                 | Total      |                   |                 |
|  | Fair Value          | Unrealized Losses | # of Securities | Fair Value             | Unrealized Losses | # of Securities | Fair Value | Unrealized Losses | # of Securities |
| (In thousands, except for # of securities) |                     |                   |                 |                        |                   |                 |            |                   |                 |
| Fixed maturities:                          |                     |                   |                 |                        |                   |                 |            |                   |                 |
| Available-for-sale securities:             |                     |                   |                 |                        |                   |                 |            |                   |                 |
| U.S.                                       |                     |                   |                 |                        |                   |                 |            |                   |                 |
| Government-sponsored enterprises           | \$9,993             | 32                | 8               | —                      | —                 | —               | 9,993      | 32                | 8               |
| States and political subdivisions          | 44,391              | 408               | 40              | 5,095                  | 340               | 2               | 49,486     | 748               | 42              |
| Corporate                                  | 14,820              | 315               | 10              | 4,623                  | 354               | 4               | 19,443     | 669               | 14              |
| Commercial mortgage-backed                 | 143                 | 1                 | 1               | —                      | —                 | —               | 143        | 1                 | 1               |
| Residential mortgage-backed                | —                   | —                 | —               | 55                     | 2                 | 1               | 55         | 2                 | 1               |
| Total available-for-sale securities        | 69,347              | 756               | 59              | 9,773                  | 696               | 7               | 79,120     | 1,452             | 66              |
| Held-to-maturity securities:               |                     |                   |                 |                        |                   |                 |            |                   |                 |
| U.S.                                       |                     |                   |                 |                        |                   |                 |            |                   |                 |
| Government-sponsored enterprises           | 1,751               | 2                 | 3               | 1,105                  | 2                 | 1               | 2,856      | 4                 | 4               |
| States and political subdivisions          | 37,322              | 287               | 32              | —                      | —                 | —               | 37,322     | 287               | 32              |
| Corporate                                  | 4,255               | 17                | 3               | —                      | —                 | —               | 4,255      | 17                | 3               |
| Total held-to-maturity securities          | 43,328              | 306               | 38              | 1,105                  | 2                 | 1               | 44,433     | 308               | 39              |
| Total fixed maturities                     | \$112,675           | 1,062             | 97              | 10,878                 | 698               | 8               | 123,553    | 1,760             | 105             |
| Equity securities:                         |                     |                   |                 |                        |                   |                 |            |                   |                 |
| Stock mutual funds                         | \$—                 | —                 | —               | 976                    | 24                | 1               | 976        | 24                | 1               |
| Bond mutual funds                          | —                   | —                 | —               | 2,981                  | 19                | 2               | 2,981      | 19                | 2               |
| Common stocks                              | 14                  | 3                 | 1               | —                      | —                 | —               | 14         | 3                 | 1               |
| Total equities                             | \$14                | 3                 | 1               | 3,957                  | 43                | 3               | 3,971      | 46                | 4               |

As of September 30, 2012, the Company had 7 available-for-sale securities and 1 held-to-maturity security that were in an unrealized loss position for greater than 12 months. These securities consisted of U.S. Government-sponsored enterprises, municipals, corporate and mortgage-backed securities.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

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(Unaudited)

|                                     | December 31, 2011                          |                   |                 |                        |                   |                 |            |                   |                 |
|-------------------------------------|--|-------------------|-----------------|------------------------|-------------------|-----------------|------------|-------------------|-----------------|
|                                     | Less than 12 months                        |                   |                 | Greater than 12 months |                   |                 | Total      |                   |                 |
|                                     | Fair Value                                 | Unrealized Losses | # of Securities | Fair Value             | Unrealized Losses | # of Securities | Fair Value | Unrealized Losses | # of Securities |
|                                     | (In thousands, except for # of securities) |                   |                 |                        |                   |                 |            |                   |                 |
| Fixed maturities:                   |  |                   |                 |                        |                   |                 |            |                   |                 |
| Available-for-sale securities:      |  |                   |                 |                        |                   |                 |            |                   |                 |
| U.S.                                |  |                   |                 |                        |                   |                 |            |                   |                 |
| Government-sponsored enterprises    | \$—  | —                 | —               | 3,718                  | 65                | 2               | 3,718      | 65                | 2               |
| States and political subdivisions   | 1,965                                      | 29                | 4               | 11,777                 | 1,362             | 9               | 13,742     | 1,391             | 13              |
| Corporate                           | 27,239                                     | 976               | 30              | 8,886                  | 517               | 6               | 36,125     | 1,493             | 36              |
| Residential mortgage-backed         | 536  | 4                 | 1               | 67                     | 4                 | 2               | 603        | 8                 | 3               |
| Total available-for-sale securities | 29,740                                     | 1,009             | 35              | 24,448                 | 1,948             | 19              | 54,188     | 2,957             | 54              |
| Held-to-maturity securities:        |  |                   |                 |                        |                   |                 |            |                   |                 |
| U.S.                                |  |                   |                 |                        |                   |                 |            |                   |                 |
| Government-sponsored enterprises    | 6,997                                      | 2                 | 4               | 1,121                  | 10                | 1               | 8,118      | 12                | 5               |
| States and political subdivisions   | 8,345                                      | 84                | 7               | —                      | —                 | —               | 8,345      | 84                | 7               |
| Corporate                           | 6,706                                      | 43                | 4               | —                      | —                 | —               | 6,706      | 43                | 4               |
| Total held-to-maturity securities   | 22,048                                     | 129               | 15              | 1,121                  | 10                | 1               | 23,169     | 139               | 16              |
| Total fixed maturities              | \$51,788                                   | 1,138             | 50              | 25,569                 | 1,958             | 20              | 77,357     | 3,096             | 70              |
| Equity securities:                  |  |                   |                 |                        |                   |                 |            |                   |                 |
| Stock mutual funds                  | \$7,158                                    | 376               | 2               | —                      | —                 | —               | 7,158      | 376               | 2               |
| Bond mutual funds                   | 25,387                                     | 117               | 10              | —                      | —                 | —               | 25,387     | 117               | 10              |
| Total equities                      | \$32,545                                   | 493               | 12              | —                      | —                 | —               | 32,545     | 493               | 12              |

We have reviewed these securities for the periods ended September 30, 2012 and December 31, 2011 and determined that no other-than-temporary impairment exists based on our evaluation of the credit worthiness of the issuers and the fact that we do not intend to sell the investments nor is it likely that we will be required to sell the securities before recovery of their amortized cost bases which may be maturity. We continue to monitor all securities on an on-going basis, and future information may become available which could result in impairments being recorded.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

The amortized cost and fair value of fixed maturity securities at September 30, 2012 by contractual maturity are shown in the table below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|  | September 30, 2012 |            |
|--|--------------------|------------|
|  | Amortized Cost     | Fair Value |
|  | (In thousands)     |            |
| Available-for-sale securities:               |                    |            |
| Due in one year or less                      | \$ 15,102          | 15,309     |
| Due after one year through five years        | 74,476             | 79,431     |
| Due after five years through ten years       | 111,759            | 119,654    |
| Due after ten years                          | 341,214            | 373,007    |
| Securities not due at a single maturity date | 6,654              | 7,219      |
| Total available-for-sale securities          | 549,205            | 594,620    |
| Held-to-maturity securities:                 |                    |            |
| Due in one year or less                      | 10,013             | 10,044     |
| Due after one year through five years        | 35,564             | 35,841     |
| Due after five years through ten years       | 47,212             | 50,192     |
| Due after ten years                          | 110,448            | 113,503    |
| Total held-to-maturity securities            | 203,237            | 209,580    |
| Total fixed maturities                       | \$ 752,442         | 804,200    |

The securities not due at a single maturity date are primarily mortgage-backed obligations of U.S. Government-sponsored enterprises and corporate securities.

The Company uses the specific identification method of the individual security to determine the cost basis used in the calculation of realized gains and losses related to security sales. Proceeds and gross realized gains from sales of securities for the three and nine months ended September 30, 2012 and 2011 are summarized as follows.

|                       | Fixed Maturities Available-for-Sale |      |                   |      | Equity Securities  |      |                   |      |
|-----------------------|-------------------------------------|------|-------------------|------|--------------------|------|-------------------|------|
|                       | Three Months Ended                  |      | Nine Months Ended |      | Three Months Ended |      | Nine Months Ended |      |
|                       | September 30,                       |      | September 30,     |      | September 30,      |      | September 30,     |      |
|                       | 2012                                | 2011 | 2012              | 2011 | 2012               | 2011 | 2012              | 2011 |
|                       | (In thousands)                      |      |                   |      |                    |      |                   |      |
| Proceeds              | \$—                                 | —    | 503               | —    | 2,856              | —    | 2,856             | —    |
| Gross realized gains  | \$—                                 | —    | 4                 | —    | 632                | —    | 632               | —    |
| Gross realized losses | \$—                                 | —    | 3                 | —    | —                  | —    | —                 | —    |

During the nine months ended September 30, 2012, one equity mutual fund security was sold which resulted in a realized gain of approximately \$0.6 million. There were no securities sold at a loss during the three month period ended September 30, 2012 and one sold at a loss for the nine months ended September 30, 2012. There were no securities sold from the held-to-maturity portfolio for the nine months ended September 30, 2012 and 2011.





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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

(6) Fair Value Measurements

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. We hold available-for-sale fixed maturity securities and equity securities, which are carried at fair value.

Fair value measurements are generally based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our view of market assumptions in the absence of observable market information. We utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. All assets and liabilities carried at fair value are required to be classified and disclosed in one of the following three categories:

Level 1 - Quoted prices for identical instruments in active markets.

Level 2 - Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs or whose significant value drivers are observable.

Level 3 - Instruments whose significant value drivers are unobservable.

Level 1 primarily consists of financial instruments whose value is based on quoted market prices such as U.S. Treasury securities and actively traded mutual fund and stock investments.

Level 2 includes those financial instruments that are valued by independent pricing services or broker quotes. These models are primarily industry-standard models that consider various inputs, such as interest rates, credit spreads and foreign exchange rates for the underlying financial instruments. 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 marketplace. Financial instruments in this category primarily include corporate securities, U.S.

Government-sponsored enterprise securities, municipal securities and certain mortgage and asset-backed securities.

Level 3 is comprised of financial instruments whose fair value is estimated based on non-binding broker prices utilizing significant inputs not based on or corroborated by readily available market information. This category consists of two private placement mortgage-backed securities.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

The following tables set forth our assets and liabilities that are measured at fair value on a recurring basis as of the dates indicated.

| Available-for-sale investments                          | September 30, 2012 |         |         | Total<br>Fair Value |
|---|--------------------|---------|---------|---------------------|
|   | Level 1            | Level 2 | Level 3 |                     |
|   | (In thousands)     |         |         |                     |
| Financial assets:                                       |                    |         |         |                     |
| Fixed maturities:                                       |                    |         |         |                     |
| U.S. Treasury and U.S. Government-sponsored enterprises | \$ 14,115          | 93,620  | —       | 107,735             |
| States and political subdivisions                       | —                  | 249,642 | —       | 249,642             |
| Corporate   | —                  | 229,881 | —       | 229,881             |
| Commercial mortgage-backed                              | —                  | 158     | 407     | 565                 |
| Residential mortgage-backed                             | —                  | 6,654   | —       | 6,654               |
| Foreign governments                                     | —                  | 143     | —       | 143                 |
| Total fixed maturities                                  | 14,115             | 580,098 | 407     | 594,620             |
| Equity securities:                                      |                    |         |         |                     |
| Stock mutual funds                                      | 10,702             | —       | —       | 10,702              |
| Bond mutual funds                                       | 32,133             | —       | —       | 32,133              |
| Common stock  | 14                 | —       | —       | 14                  |
| Preferred stock   | 1,242              | —       | —       | 1,242               |
| Total equity securities                                 | 44,091             | —       | —       | 44,091              |
| Total financial assets                                  | \$ 58,206          | 580,098 | 407     | 638,711             |
| Financial liabilities:                                  |                    |         |         |                     |
| Warrants outstanding                                    | \$—                | 137     | —       | 137                 |

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

| Available-for-sale investments                          | December 31, 2011 |         |         | Total<br>Fair Value |
|---|-------------------|---------|---------|---------------------|
|   | Level 1           | Level 2 | Level 3 |                     |
|   | (In thousands)    |         |         |                     |
| Financial assets:                                       |                   |         |         |                     |
| Fixed maturities:                                       |                   |         |         |                     |
| U.S. Treasury and U.S. Government-sponsored enterprises | \$ 13,958         | 146,817 | —       | 160,775             |
| States and political subdivisions                       | —                 | 159,942 | —       | 159,942             |
| Corporate   | —                 | 184,545 | —       | 184,545             |
| Commercial mortgage-backed                              | —                 | 300     | 459     | 759                 |
| Residential mortgage-backed                             | —                 | 8,090   | —       | 8,090               |
| Foreign governments                                     | —                 | 142     | —       | 142                 |
| Total fixed maturities                                  | 13,958            | 499,836 | 459     | 514,253             |
| Equity securities:                                      |                   |         |         |                     |
| Stock mutual funds                                      | 12,725            | —       | —       | 12,725              |
| Bond mutual funds                                       | 31,414            | —       | —       | 31,414              |
| Common stock  | 24                | —       | —       | 24                  |
| Preferred stock   | 1,974             | —       | —       | 1,974               |
| Total equity securities                                 | 46,137            | —       | —       | 46,137              |
| Total financial assets                                  | \$ 60,095         | 499,836 | 459     | 560,390             |
| Financial liabilities:                                  |                   |         |         |                     |
| Warrants outstanding                                    | \$—               | 451     | —       | 451                 |

## Financial Instruments Valuation

Fixed maturity securities, available-for-sale. At September 30, 2012, our fixed maturity securities, valued using a third-party pricing source, totaled \$580.1 million for Level 2 assets and comprised 90.8% of total reported fair value of our financial assets. The Level 1 and Level 2 valuations are reviewed and updated quarterly through random testing by comparisons to separate pricing models, other third-party pricing services, and back tested to recent trades. In addition, we obtain information relative to the third-party pricing models and review model parameters for reasonableness. Fair values for Level 3 assets are based upon unadjusted broker quotes that are non-binding, and consist of two private placement mortgage-backed securities with a total value of \$0.4 million. Our Level 3 assets are current relative to principal and interest payments and are considered immaterial to our financial statements. For the nine months ended September 30, 2012, there were no material changes to the valuation methods or assumptions used to determine fair values, and no broker or third party prices were changed from the values received.

Equity securities, available-for-sale. Our available-for-sale equity securities are classified as Level 1 assets as their fair values are based upon quoted market prices.

Warrants outstanding. Our outstanding warrants are classified as Level 2 liabilities as their fair values are based upon industry standard models that consider various observable inputs.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

The following table presents additional information about fixed maturity securities measured at fair value on a recurring basis that are classified as Level 3 assets and for which we have utilized significant unobservable inputs to determine fair value.

|  | September 30,<br>2012 | December 31,<br>2011 |
|--|-----------------------|----------------------|
|  | (In thousands)        |                      |
| Balance at beginning of period               | \$459                 | 519                  |
| Total realized and unrealized gains (losses) |                       |                      |
| Included in net income                       | —                     | —                    |
| Included in other comprehensive income       | (3                    | ) 6                  |
| Principal paydowns                           | (49                   | ) (66                |
| Transfer in and (out) of Level 3             | —                     | —                    |
| Balance at end of period                     | \$407                 | 459                  |

We review the fair value hierarchy classifications each reporting period. Changes in the observability of the valuation attributes may result in a reclassification of certain financial assets. Such reclassifications are reported as transfers in and out of Level 3 at the beginning fair value for the reporting period in which the changes occur. There were no transfers in or out of Level 1 or 2.

## Financial Instruments not Carried at Fair Value

Estimates of fair values are made at a specific point in time, based on relevant market prices and information about the financial instruments. The estimated fair values of financial instruments presented below are not necessarily indicative of the amounts the Company might realize in actual market transactions.

The carrying amount and fair value for the financial assets and liabilities on the consolidated balance sheets not otherwise disclosed for the periods indicated are as follows:

|                                    | September 30, 2012 |            | December 31, 2011 |            |
|------------------------------------|--------------------|------------|-------------------|------------|
|                                    | Carrying Value     | Fair Value | Carrying Value    | Fair Value |
|                                    | (In thousands)     |            |                   |            |
| Financial assets:                  |                    |            |                   |            |
| Fixed maturities, held-to-maturity | \$203,237          | 209,580    | 227,500           | 230,093    |
| Mortgage loans                     | 1,521              | 1,333      | 1,557             | 1,428      |
| Policy loans                       | 42,784             | 42,784     | 39,090            | 39,090     |
| Short-term investments             | 2,356              | 2,356      | 2,048             | 2,048      |
| Cash and cash equivalents          | 39,830             | 39,830     | 33,255            | 33,255     |
| Financial liabilities:             |                    |            |                   |            |
| Annuity benefit reserves           | 50,125             | 52,118     | 47,060            | 43,402     |

Fair values for fixed income securities, which are characterized as Level 2 assets in the fair value hierarchy, are based on quoted market prices for the same or similar securities. In cases where quoted market prices are not available, fair values are based on estimates using present value or other assumptions, including a discount rate and estimates of future cash flows.

Mortgage loans are secured principally by residential and commercial properties. Weighted average interest rates for these loans were approximately 6.6% as of September 30, 2012 and December 31, 2011, with maturities ranging from 1 to 30 years. Management estimated the fair value using an annual interest rate of 6.25% at September 30, 2012. Our mortgage loans

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

are considered Level 3 assets in the fair value hierarchy.

Policy loans had a weighted average annual interest rate of 7.7% as of September 30, 2012 and December 31, 2011, and no specified maturity dates. The aggregate fair value of policy loans approximates the carrying value reflected on the consolidated balance sheets. These loans typically carry an interest rate that is tied to the crediting rate applied to the related policy and contract reserves. Policy loans are an integral part of the life insurance policies we have in force, cannot be valued separately and are not marketable. Therefore, the fair value of policy loans approximates the carrying value and policy loans are considered Level 3 assets in the fair value hierarchy.

The fair value of short-term investments approximate carrying value due to their short-term nature. Our short-term investments are considered Level 2 assets in the fair value hierarchy.

The fair value of cash and cash equivalents approximate carrying value and are characterized as Level 1 assets in the fair value hierarchy.

The fair value of the Company's liabilities under annuity contract policies, which are considered Level 3 assets, was estimated at September 30, 2012 using discounted cash flows based upon a swap rate curve with interest rates ranging from 0.67% to 3.81% based upon swap rates adjusted for various risk adjustments. The fair value of liabilities under all insurance contracts are taken into consideration in the overall management of interest rate risk, which seeks to minimize exposure to changing interest rates through the matching of investment maturities with amounts due under insurance contracts.

(7) Legal Proceedings

We are a defendant in a lawsuit filed on August 6, 1999, in the Texas District Court, Austin, Texas, now styled Delia Bolanos Andrade, et al., Plaintiffs, v. Citizens Insurance Company of America, et al., Defendants in which a class was originally certified by the trial court and reversed by the Texas Supreme Court in 2007 with an order to the trial court to conduct further proceedings consistent with its ruling. The underlying lawsuit alleged that certain life insurance policies CICA made available to non-U.S. residents, when combined with a policy feature that allowed certain cash benefits to be assigned to two non-U.S. trusts for the purpose of accumulating ownership of our Class A common stock, along with allowing the policyholders to make additional contributions to the trusts, were actually offers and sales of securities that occurred in Texas by unregistered dealers in violation of the Texas securities laws. The remedy sought was rescission and return of the insurance premium payments. On December 9, 2009, the trial court denied the recertification of the class after conducting additional proceedings in accordance with the Texas Supreme Court's ruling. The remaining plaintiffs must now proceed individually, and not as a class, if they intend to pursue their claims against us. Since the December 9, 2009 trial court ruling, no individual cases have been further pursued by the plaintiffs. The probability of the plaintiffs further pursuing their cases individually remains unknown. An estimate of any possible loss or range of losses cannot be made at this time in regard to individuals pursuing claims. However, should the plaintiffs further pursue their claims individually, we intend to vigorously defend any proceedings.

SPFIC is vigorously defending a lawsuit filed in the aftermath of Hurricane Katrina and currently pending in the United States District Court for the Eastern District of Louisiana. This matter was filed by the Louisiana Attorney General against SPFIC and every other homeowner insurer doing business in the State of Louisiana, on behalf of the State of Louisiana, as assignee, and on behalf of certain Road Home fund recipients. Although this lawsuit was originally filed as a class action, the Louisiana Attorney General moved to dismiss the class in 2011 and the motion



was granted. In this matter the State alleged that the insurers failed to pay all damages owed under their policies. The claims currently pending in this matter are for breach of contract and for declaratory relief on the alleged underpayment of claims by the insurers. All other claims, including extra-contractual claims, have been dismissed.

There are many potential individual claims at issue in this matter, each of which will require individual analysis and a number of which may be subject to individual defenses, including release, accord and satisfaction, prescription, waiver, and estoppel. There has been no discovery in connection with this matter. The court has ordered the State to provide specificity as to its claims in this matter. SPFIC believes its claims practices in connection with Katrina homeowners claims were sound and in accordance with industry standards and state law. In SPFIC's judgment, an estimate of possible loss or range of loss cannot be made at this time. SPFIC intends to vigorously defend all claims asserted in any remaining proceedings.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

SPFIC is vigorously defending a number of matters in various stages of development filed in the aftermath of Hurricane Katrina and Hurricane Rita in addition to the Road Home Litigation, including a number of individual lawsuits, which are immaterial to the Company's financial statements.

## (8) Convertible Preferred Stock: Warrants

In July 2004, the Company completed a private placement of Series A-1 Convertible Preferred Stock ("Series A-1 Preferred") to four unaffiliated institutional investors. The investors were also issued unit warrants to purchase Series A-2 Convertible Preferred Stock ("Series A-2 Preferred"). In 2005, three of the four investors exercised their right to purchase the Series A-2 Preferred. We also issued to the investors warrants to purchase shares of our Class A common stock at various exercise prices that range from \$6.72 to \$7.93, with most of them striking at \$6.95. The conversion, exercise and redemption prices, along with the number of shares and warrants, were adjusted for stock dividends paid on December 31, 2004 and 2005.

On July 13, 2009, the Company converted all of its outstanding Series A-1 Preferred and Series A-2 Preferred into Class A common shares in accordance with the mandatory redemption provision of the preferred shareholder agreement dated July 12, 2004. The total amount of Class A common shares issued as part of the conversion was 1,706,682, inclusive of pro rata dividends due through the conversion date.

As of September 30, 2012, there were outstanding warrants to purchase the Company's stock at \$7.86, which were issued to investors of the Series A-2 Preferred. These warrants were converted into 12,487 Class A shares through a cashless exercise provision on their October 6, 2012 expiration date.

As of 9/30/2012

| Warrants Outstanding | Expiration Date | Exercise Price | Fair Value<br>(In thousands) |
|----------------------|-----------------|----------------|------------------------------|
| 52,121               | 10/6/2012       | \$7.86         | \$137                        |

The fair value of the warrants is calculated using the Black-Scholes option pricing model and is classified as a liability on the balance sheet in the amount of approximately \$137 thousand and \$451 thousand at September 30, 2012 and December 31, 2011, respectively. The change in fair value of warrants is reported as a component of revenue in the statement of comprehensive income.

## (9) Income Taxes

The effective tax rate was 28.0% and 26.2% for the third quarter of 2012 and 2011, respectively and 25.5% and 30.7% for the nine months ended September 30, 2012 and 2011, respectively. In periods where our effective tax rate is lower than the statutory tax rate of 35%, the difference is primarily due to tax exempt state and local bonds, and in some years, to gains arising from the change in fair value of outstanding warrants to purchase Class A common stock. The effective tax rate is lower in the current year compared to 2011 primarily because the Company began purchasing tax-exempt state and local bonds in the second half of 2011 and continued to do so in 2012 in the non-insurance companies where the full tax benefit can be realized.



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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

September 30, 2012

(Unaudited)

(10) Related Party Transactions

The Company has various routine related party transactions in conjunction with our holding company structure, such as a management service agreement related to costs incurred, a tax sharing agreement between entities, and inter-company dividends and capital contributions. There were no changes related to these relationships during the nine months ended September 30, 2012 except as identified below. See our Annual Report on Form 10-K as of December 31, 2011 for a comprehensive discussion of these transactions.

During the quarter ended September 30, 2012, CICA paid a cash dividend to its parent Citizens in the amount of \$5.4 million and SPLIC paid a cash dividend to CICA totaling \$2.3 million. These payments do not impact the consolidated results of the Company.

On October 2, 2012, a reinsurance agreement was executed between CICA and CNLIC where CICA assumes insurance risk relative to claims over \$35,000 and up to a maximum of \$100,000. This agreement is effective for business written beginning January 1, 2012. This reinsurance agreement has no impact on the consolidated financial statements of the Company.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

September 30, 2012

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

Certain statements contained in this Quarterly Report on Form 10-Q are not statements of historical fact and constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act (the "Act"), including, without limitation, statements specifically identified as forward-looking statements within this document. Many of these statements contain risk factors as well. In addition, certain statements in future filings by the Company with the Securities and Exchange Commission, in press releases, and in oral and written statements made by us or with the approval of the Company, which are not statements of historical fact, constitute forward-looking statements within the meaning of the Act. Examples of forward-looking statements include, but are not limited to: (i) projections of revenues, income or loss, earnings or loss per share, the payment or non-payment of dividends, capital structure, and other financial items, (ii) statements of our plans and objectives by our management or Board of Directors, including those relating to products or services, (iii) statements of future economic performance and (iv) statements of assumptions underlying such statements. Words such as "believes," "anticipates," "assumes," "estimates," "plans," "projects," "could," "expects," "intends," "targeted," "may," "will" and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements.

Forward-looking statements are subject to known and unknown risks, uncertainties and other factors that may cause actual results to differ materially from those contemplated by the forward-looking statements. Factors that could cause the Company's future results to differ materially from expected results include, but are not limited to:

- Changes in foreign and U.S. general economic, market, and political conditions, including the performance of financial markets and interest rates;
- Changes in consumer behavior, which may affect the Company's ability to sell its products and retain business;
- The timely development of and acceptance of new products of the Company and perceived overall value of these products and services by existing and potential customers;
- Fluctuations in experience regarding current mortality, morbidity, persistency and interest rates relative to expected amounts used in pricing and actuarial valuation of the Company's products;
- The performance of our investment portfolio, which may be adversely affected by changes in interest rates, adverse developments and ratings of issuers whose debt securities we may hold, and other adverse macroeconomic events;
- Results of litigation we may be involved in;
- Changes in assumptions related to deferred acquisition costs and the value of any businesses we may acquire;
- Regulatory, accounting or tax changes that may affect the cost of, or the demand for, the Company's products or services;
- Our concentration of business from persons residing in Latin America and the Pacific Rim;
- Changes in tax laws;
- Effects of acquisitions and restructuring, including possible difficulties in integrating and realizing the projected results of acquisitions;
- Changes in statutory or U.S. GAAP accounting principles, policies or practices; and
- Our success at managing risks involved in the foregoing;
- The risk factors discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 under the heading "Part II. - Item 1A - Risk Factors."

Such forward-looking statements speak only as of the date on which such statements are made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made.

We make available, free of charge, through our Internet website (<http://www.citizensinc.com>), our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, Section 16 Reports filed by officers and directors, news

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

September 30, 2012

releases, and, if applicable, amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as soon as reasonably practicable after we electronically file such reports with, or furnish such reports to, the Securities and Exchange Commission. We are not including any of the information contained on our website as part of, or incorporating it by reference into, this Quarterly Report on Form 10-Q.

Overview

Citizens is an insurance holding company serving the life insurance needs of individuals in the United States since 1969 and internationally since 1975. Through our insurance subsidiaries, we pursue a strategy of offering traditional insurance products in niche markets where we believe we are able to achieve competitive advantages. As of September 30, 2012, we had approximately \$1.2 billion of total assets and approximately \$5.3 billion of insurance in force. Our core insurance operations include issuing and servicing:

U.S. Dollar-denominated ordinary whole life insurance and endowment policies predominantly to high net worth, high income foreign residents, principally in Latin America and the Pacific Rim through independent marketing consultants;  
ordinary whole life insurance policies to middle income households concentrated in the Midwest and southern United States through independent marketing consultants; and  
final expense and limited liability property policies to middle and lower income households in Louisiana, Arkansas and Mississippi through employee and independent agents in our home service distribution channel.

We were formed in 1969 by our Chairman, Harold E. Riley. Prior to our formation, Mr. Riley had many years of experience in the international and domestic life insurance business. Our Company has experienced significant growth through acquisitions in the domestic market and through market expansion in the international market. We seek to capitalize on the experience of our management team in marketing and operations as we strive to generate bottom line return using knowledge of our niche markets and our well-established distribution channels. We believe our underwriting processes, policy terms, pricing practices and proprietary administrative systems enable us to be competitive in our current markets, while protecting our shareholders and servicing our policyholders.

Current Financial Highlights

Financial highlights for the three and nine-month periods ended September 30, 2012 compared to the same period in 2011 were:

Insurance premiums rose 6.6% and 5.3% for the three and nine month period to \$43.0 million and \$123.6 million in 2012 from \$40.3 million and \$117.4 million in 2011, primarily from renewal premiums in our life insurance segment. Net investment income increased 8.5% and 4.6%, respectively. The average yield on the consolidated portfolio remained relatively steady for the third consecutive quarter at an annualized rate of 3.74% down from 3.92% for full year 2011. For the nine month period, the increase in the invested assets due to premium revenue growth offset the decrease in yield.

Gains of \$0.6 million were realized on the sale of previously impaired equity mutual funds during the third quarter of 2012 in the life segment.

Claims and surrenders expense increased 5.6% and 4.3% for the three and nine months ended 2012 as the home service segment was impacted by Hurricane Isaac which hit the Louisiana coast on August 29, 2012 and caused increased property claims. In addition, we experienced higher death claims expense in the current year compared to 2011 due to the release of incurred but unreported death claims liability in 2011 of \$0.7 million. Excluding this prior

year liability release, death claims were flat.

Changes in reserves resulted in liability increases due to the increased sales of endowment products that build up reserves at a faster pace than whole life longer term mortality based products. Additionally, the sustained low interest rate environment also results in a higher reserve development due to the lower interest yield assumptions in the current period compared to prior years.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

September 30, 2012

## Our Operating Segments

Our business is comprised of three operating business segments, as detailed below.

- ☒ Life Insurance

- ☒ Home Service Insurance

- ☐ Other Non-Insurance Enterprises

Our insurance operations are the primary focus of the Company, as those operations generate the majority of our income. See the discussion under Segment Operations for detailed analysis. The amount of insurance, number of policies, and average face amounts of ordinary life policies issued during the periods indicated are shown below.

|              | Nine Months Ended September 30,<br>2012 |                                 |  | 2011                             |                                 |  |
|--------------|---|---------------------------------|--|----------------------------------|---------------------------------|--|
|              | Amount of<br>Insurance<br>Issued        | Number of<br>Policies<br>Issued | Average<br>Policy<br>Face Amount<br>Issued | Amount of<br>Insurance<br>Issued | Number of<br>Policies<br>Issued | Average<br>Policy<br>Face Amount<br>Issued |
| Life         | \$243,529,971                           | 4,234                           | \$57,518                                   | \$265,605,986                    | 4,181                           | \$63,527                                   |
| Home Service | 151,309,545                             | 21,895                          | 6,911                                      | 152,408,350                      | 21,285                          | 7,160                                      |

Note: All discussions below compare or state results for the three and nine-month periods ended September 30, 2012 compared to the three and nine-month periods ended September 30, 2011.

## Consolidated Results of Operations

A discussion of consolidated results is presented below, followed by a discussion of segment operations and financial results by segment.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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## Revenues

Revenues are generated primarily by insurance premiums and investment income on invested assets.

|   | Three Months Ended<br>September 30,<br>2012 |        | Nine Months Ended<br>September 30,<br>2011 |          |
|---|---|--------|--|----------|
|   | 2012  | 2011   | 2012                                       | 2011     |
|   | (In thousands)                              |        |  |          |
| Revenues:                                       |   |        |  |          |
| Premiums:                                       |   |        |  |          |
| Life insurance                                  | \$41,257                                    | 38,639 | 118,608                                    | 112,481  |
| Accident and health insurance                   | 414   | 383    | 1,244                                      | 1,151    |
| Property insurance                              | 1,281                                       | 1,277  | 3,792                                      | 3,781    |
| Net investment income                           | 8,114                                       | 7,478  | 23,303                                     | 22,281   |
| Realized investment gains, net                  | 763   | 35     | 1,107                                      | 41       |
| Decrease in fair value of warrants              | 241   | 239    | 314  | 1,454    |
| Other income                                    | 112   | 282    | 321  | 509      |
| Total revenues                                  | 52,182                                      | 48,333 | 148,689                                    | 141,698  |
| Exclude fair value adjustments                  | (241  | ) (239 | ) (314                                     | ) (1,454 |
| Total revenues excluding fair value adjustments | \$51,941                                    | 48,094 | 148,375                                    | 140,244  |

Premium Income. Premium income derived from life, accident and health, and property insurance sales increased 6.6% and 5.3% in 2012 for the three and nine months compared to the same periods ending September 30, 2011, primarily resulting from the life segment as discussed under Segment Operations.

Net investment income performance is summarized as follows.

|   | September 30,<br>2012        | December 31,<br>2011 | September 30,<br>2011 |   |
|---|------------------------------|----------------------|-----------------------|---|
|   | (In thousands, except for %) |                      |                       |   |
| Net investment income, annualized           | \$31,071                     | 30,099               | 29,708                |   |
| Average invested assets, at amortized cost  | 829,936                      | 767,079              | 744,234               |   |
| Annualized yield on average invested assets | 3.74                         | % 3.92               | % 3.99                | % |

Yields on invested assets vary between segment operations due to different portfolio mixes in the segments. The life segment typically invests more in U.S. government securities than the home service segment which has a larger percentage of holdings in the corporate and municipal sectors. The weighted effective yield for new money invested by the Company for the first nine months of 2012 was approximately 3.1% compared to new money yields of 3.4% for the same nine months ended in 2011.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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Investment income from debt securities accounted for approximately 82.7% and 82.4% of total investment income for the three and nine months ended September 30, 2012. We have reduced bond holdings of U.S.

Government-sponsored enterprises, such as Federal National Mortgage Association (“FNMA”) and Federal Home Loan Mortgage Corporation (“FHLMC”), which comprised 18.7% of the total fixed maturity portfolio based on amortized cost at September 30, 2012 compared to 42.7% at December 31, 2011 due to the low yields in the current environment. We have increased our investment purchases of corporate and municipal securities over the past several quarters, focusing on utility service sectors in corporate securities. State and political subdivision holdings at September 30, 2012 increased to 46.9% and corporate holdings totaled 32.2% based upon amortized cost compared to 29.1% and 25.6% at December 31, 2011, respectively. In addition, we have invested in short duration bond mutual funds as these securities offer a competitive yield.

|                           | Three Months Ended<br>September 30,<br>2012 |       | Nine Months Ended<br>September 30,<br>2012 |         |
|---------------------------|---|-------|--|---------|
|                           | 2011  | 2011  | 2011                                       | 2011    |
|                           | (In thousands)                              |       |  |         |
| Gross investment income:  |   |       |  |         |
| Fixed maturity securities | \$7,048                                     | 6,740 | 20,247                                     | 19,990  |
| Equity securities         | 487   | 311   | 1,496                                      | 886     |
| Mortgage loans            | 31  | 22    | 76   | 73      |
| Policy loans              | 841   | 756   | 2,454                                      | 2,175   |
| Long-term investments     | 96  | 61    | 217  | 168     |
| Other investment income   | 19  | 23    | 76   | 106     |
| Total investment income   | 8,522                                       | 7,913 | 24,566                                     | 23,398  |
| Investment expenses       | (408)                                       | (435) | (1,263)                                    | (1,117) |
| Net investment income     | \$8,114                                     | 7,478 | 23,303                                     | 22,281  |

The average consolidated invested asset portfolio has increased approximately 8.2% with primarily investments in the fixed maturity securities portfolio accounting for the most significant increase in the investment income, despite the decline in overall portfolio yield. The purchase of bond mutual funds has resulted in increased dividend income for the three and nine months ended in the current year compared to the same periods a year ago. In addition, the increase in policy loans, which represents policyholders utilizing their accumulated policy cash value, contributed to the increase to investment income.

**Change in Fair Value of Warrants.** The Company adjusts the liability related to its outstanding warrants to purchase shares of Class A common stock at each reporting date to reflect the current fair value of the warrants computed based on the Class A common stock value calculated using the Black-Scholes option pricing model. As the Class A common stock value increases and decreases, the change in the warrant liability also increases and decreases in inverse order. The adjustment to fair value is recorded as an increase or decrease in the fair value of the warrants in the consolidated statement of operations. The remaining warrants were the subject of a cashless exercise transaction whereby the Company issued 12,487 Class A shares on October 6, 2012. See Note 8 - Convertible Preferred Stock: Warrants of the accompanying financial statements for further discussion.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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## Benefits and Expenses

|   | Three Months Ended<br>September 30,<br>2012 |         | 2011     |          | Nine Months Ended<br>September 30,<br>2012 |  | 2011 |  |
|---|---|---------|----------|----------|--|--|------|--|
|   | (In thousands)                              |         |          |          |  |  |      |  |
| Benefits and expenses:                                  |   |         |          |          |  |  |      |  |
| Insurance benefits paid or provided:                    |   |         |          |          |  |  |      |  |
| Claims and surrenders                                   | \$ 15,627                                   | 14,803  | 46,490   | 44,587   |  |  |      |  |
| Increase in future policy benefit reserves              | 16,901                                      | 14,365  | 47,793   | 39,683   |  |  |      |  |
| Policyholders' dividends                                | 2,600                                       | 2,169   | 6,755    | 5,751    |  |  |      |  |
| Total insurance benefits paid or provided               | 35,128                                      | 31,337  | 101,038  | 90,021   |  |  |      |  |
| Commissions   | 9,769                                       | 9,224   | 28,164   | 28,226   |  |  |      |  |
| Other general expenses                                  | 6,055                                       | 6,642   | 19,013   | 19,743   |  |  |      |  |
| Capitalization of deferred policy acquisition costs     | (7,547)                                     | (6,531) | (20,530) | (20,536) |  |  |      |  |
| Amortization of deferred policy acquisition costs       | 4,134                                       | 4,171   | 12,693   | 12,480   |  |  |      |  |
| Amortization of cost of customer relationships acquired | 598   | 708     | 1,834    | 2,113    |  |  |      |  |
| Total benefits and expenses                             | \$ 48,137                                   | 45,551  | 142,212  | 132,047  |  |  |      |  |

Claims and Surrenders. A detail of claims and surrender benefits is provided below.

|                              | Three Months Ended<br>September 30,<br>2012 |        | 2011   |        | Nine Months Ended<br>September 30,<br>2012 |  | 2011 |  |
|------------------------------|---|--------|--------|--------|--|--|------|--|
|                              | (In thousands)                              |        |        |        |  |  |      |  |
| Death claims                 | \$ 5,053                                    | 4,917  | 16,530 | 15,531 |  |  |      |  |
| Surrender benefits           | 5,068                                       | 5,166  | 14,735 | 14,915 |  |  |      |  |
| Endowments                   | 3,812                                       | 3,576  | 11,445 | 10,595 |  |  |      |  |
| Property claims              | 1,017                                       | 586    | 1,880  | 1,601  |  |  |      |  |
| Accident and health benefits | 91  | 79     | 229    | 334    |  |  |      |  |
| Other policy benefits        | 586   | 479    | 1,671  | 1,611  |  |  |      |  |
| Total claims and surrenders  | \$ 15,627                                   | 14,803 | 46,490 | 44,587 |  |  |      |  |

Increase in Future Policy Benefit Reserves. The increase in future policy benefit reserves for the three and nine months ended September 30, 2012, was influenced by the current low interest rate environment necessitating higher reserves for policies issued in the last few years due to lower long term yield projections compared to prior assumptions, resulting in higher reserve build up compared to prior issue years. In addition, we continue to experience growth in new sales of endowment products, which require higher initial reserve levels, than whole life products.

Policyholder Dividends. The majority of our international policies are participating, and the dividends are factored into the premium rates charged. As policy provisioned dividend rates generally increase each year that a policy is in force, dividend expense is expected to increase as this block of insurance becomes more seasoned.

Commissions. Commission expense is directly related to new and renewal insurance premium fluctuations and production levels by agents and associates. Commission expense for the three months ended September 30, 2012 increased due to higher first year premiums in the life segment compared to 2011 premium levels. Commission

expense for the nine months ended in 2012 decreased

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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slightly from the prior year primarily due to a reduction in expense of \$0.4 million related to commissions payable that were held pending validation that are no longer considered payable. When the payable was reduced, this resulted in a reduction in commission expense.

Capitalized and Amortized Deferred Policy Acquisition Costs. Costs capitalized under current accounting guidance include certain commissions, policy issuance costs, and underwriting and agency expenses that relate to successful sales efforts for insurance contracts. The increase for the three months ended September 30, 2012 compared to the same period in 2011 is the result of an increase in first year premium production in the current year which increased capitalized amounts. Though premium revenue increased for the nine months ended in 2012, it was primarily related to an increase in renewal premiums compared to the prior year. Commissions paid on renewal premiums are significantly lower than that paid on first year business and therefore result in muting the impact of the third quarter sales to leave the nine months ended in 2012 at comparable levels with 2011 year to date amounts.

Amortization for the nine months ended September 30, 2012, include certain adjustments to refine estimates that increased amortization by \$0.7 million which affects current year comparability. Amortization of deferred policy acquisition costs is impacted by persistency and may fluctuate from year to year.

Federal Income Tax. The effective tax rates for the three and nine-month periods ended September 30, 2012, were 28.0% and 25.5% versus 26.2% and 30.7% for the same periods in 2011. Differences between our effective tax rate and the statutory tax rate result from income and expense items that are treated differently for financial reporting and tax purposes. See Note 9 - Income Taxes in the consolidated financial statements for further discussion.

## Segment Operations

The Company has three reportable segments: Life Insurance, Home Service Insurance and Other Non-Insurance Enterprises. These segments are reported in accordance with U.S. GAAP. The Company evaluates profit and loss performance of its segments based on net income or loss before income taxes.

|                                 | Income (Loss) Before Income Taxes |       |                   |       |
|---------------------------------|-----------------------------------|-------|-------------------|-------|
|                                 | Three Months Ended                |       | Nine Months Ended |       |
|                                 | September 30,                     |       | September 30,     |       |
|                                 | 2012                              | 2011  | 2012              | 2011  |
|                                 | (In thousands)                    |       |                   |       |
| Life Insurance                  | \$2,355                           | 1,729 | 1,492             | 3,920 |
| Home Service Insurance          | 1,566                             | 1,207 | 5,804             | 5,576 |
| Other Non-Insurance Enterprises | 124                               | (154) | (819)             | 155   |
| Total                           | \$4,045                           | 2,782 | 6,477             | 9,651 |

## Life Insurance

Our Life Insurance segment issues ordinary whole life insurance domestically and U.S. Dollar-denominated ordinary whole-life policies to foreign residents. These contracts are designed to provide a fixed amount of insurance coverage over the life of the insured. Additionally, the Company issues endowment contracts, which are principally accumulation contracts that incorporate an element of life insurance protection. For the majority of our business, we retain only the first \$100,000 of risk on any one life. We operate this segment through CICA and CNLIC insurance subsidiaries.



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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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International Sales

We focus our sales of U.S. Dollar-denominated ordinary whole life insurance and endowment policies to high net worth, high income residents in Latin America and the Pacific Rim. We have successfully participated in the foreign marketplace since 1975, and we continue to seek opportunities for expansion of our foreign operations. We believe positive attributes of our international insurance business include:

- larger face amount policies typically issued when compared to our U.S. operations, which results in lower underwriting and administrative costs per unit of coverage;
- premiums typically paid annually rather than monthly or quarterly, which reduces our administrative expenses, accelerates cash flow and results in lower policy lapse rates than premiums with more frequently scheduled payments; and
- comparable persistency levels and mortality rates as experienced with U.S. policies.

International Products

We offer several ordinary whole life insurance and endowment products designed to meet the needs of our non-U.S. policyowners. These policies have been structured to provide:

- U.S. Dollar-denominated cash values that accumulate, beginning in the first policy year, to a policyholder during his or her lifetime;
- premium rates that are competitive with or better than most foreign local companies;
- a hedge against local currency inflation;
- protection against devaluation of foreign currency;
- capital investment in the United States' more secure economic environment; and
- lifetime income guarantees for an insured or for surviving beneficiaries.

Our international products have living benefit features. Every policy contains guaranteed cash values and most are participating (i.e., provides for cash dividends as apportioned by the board of directors). Once a policyowner pays the annual premium and the policy is issued, we immediately pay the owner a cash dividend as well as an annual guaranteed endowment, if elected. The policyowner has several options with regard to the dividend and annual guaranteed endowments, including the right to assign policy values to our stock investment plan, registered under the Securities Act of 1933 (the "Securities Act") and administered in the United States by our unaffiliated transfer agent.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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The following table sets forth, by country, our direct premiums from our international life insurance business for the periods indicated.

| Country        | Three Months Ended |        | Nine Months Ended |        |
|----------------|--------------------|--------|-------------------|--------|
|                | September 30,      |        | September 30,     |        |
|                | 2012               | 2011   | 2012              | 2011   |
|                | (In thousands)     |        |                   |        |
| Venezuela      | \$5,874            | 5,165  | 17,570            | 14,505 |
| Colombia       | 5,667              | 5,457  | 17,062            | 16,135 |
| Taiwan         | 3,284              | 3,382  | 10,753            | 10,341 |
| Ecuador        | 3,372              | 3,432  | 10,305            | 9,851  |
| Argentina      | 2,670              | 2,349  | 6,950             | 6,882  |
| Other Non-U.S. | 8,138              | 7,092  | 22,490            | 21,694 |
| Total          | \$29,005           | 26,877 | 85,130            | 79,408 |

We continue to report increased sales from our top producing countries as noted above. Our international business and premium collections could be impacted by future changes relative to laws, regulations or economic events in the countries from which we accept applications.

## Domestic Sales

In the Midwest and the southern United States, we seek to serve middle income households through the sale of cash accumulation ordinary whole life insurance products. The majority of our inforce business results from blocks of business of insurance companies we have acquired over the past fifteen years.

## Domestic Products

Our domestic life insurance products focus primarily on living needs and provide benefits focused toward accumulating money for living benefits while providing a modest death benefit for the policyowner. The features of our domestic life insurance products include:

- cash accumulation/living benefits;
- tax-deferred annuity interest earnings;
- guaranteed lifetime income or monthly income options for the policyowner or surviving family members;
- accidental death benefit coverage options; and
- an option to waive premium payments in the event of disability.

Our life insurance products are principally designed to address the insured's concern about outliving his or her monthly income, while at the same time providing death benefits. The primary purpose of our product portfolio is to help the insured create capital for needs such as retirement income, children's higher education funds, business opportunities, emergencies and extraordinary health care needs.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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The following table sets forth our direct premiums by state for the periods indicated.

| State        | Three Months Ended |       | Nine Months Ended |       |
|--------------|--------------------|-------|-------------------|-------|
|              | September 30,      |       | September 30,     |       |
|              | 2012               | 2011  | 2012              | 2011  |
|              | (In thousands)     |       |                   |       |
| Texas        | \$1,162            | 1,113 | 3,554             | 3,694 |
| Indiana      | 397                | 356   | 1,218             | 1,288 |
| Mississippi  | 223                | 265   | 702               | 814   |
| Oklahoma     | 188                | 236   | 594               | 722   |
| Missouri     | 132                | 167   | 489               | 588   |
| Other States | 897                | 757   | 2,211             | 2,141 |
| Total        | \$2,999            | 2,894 | 8,768             | 9,247 |

A number of domestic life insurance companies we acquired had blocks of accident and health insurance policies, which we did not consider to be a core part of our business. We have ceded this business to an unaffiliated insurance company under a coinsurance agreement, under which it assumes substantially all of our accident and health policies. The premium amounts ceded under the coinsurance agreement for the nine months ended September 30, 2012 and 2011 were \$2.9 million and \$3.5 million, respectively.

The results of operations for the life insurance segment for the periods indicated are as follows.

|   | Three Months Ended |         | Nine Months Ended |          |
|---|--------------------|---------|-------------------|----------|
|   | September 30,      |         | September 30,     |          |
|   | 2012               | 2011    | 2012              | 2011     |
|   | (In thousands)     |         |                   |          |
| Revenue:  |                    |         |                   |          |
| Premiums  | \$31,876           | 29,491  | 90,646            | 85,027   |
| Net investment income                                   | 4,538              | 4,094   | 12,949            | 12,019   |
| Realized investment gains, net                          | 720                | 25      | 909               | 29       |
| Other income  | 56                 | 240     | 188               | 404      |
| Total revenue   | 37,190             | 33,850  | 104,692           | 97,479   |
| Benefits and expenses:                                  |                    |         |                   |          |
| Insurance benefits paid or provided:                    |                    |         |                   |          |
| Claims and surrenders                                   | 10,213             | 9,834   | 30,912            | 29,691   |
| Increase in future policy benefit reserves              | 16,058             | 13,133  | 45,477            | 36,957   |
| Policyholders' dividends                                | 2,395              | 2,152   | 6,525             | 5,696    |
| Total insurance benefits paid or provided               | 28,666             | 25,119  | 82,914            | 72,344   |
| Commissions   | 6,115              | 5,516   | 17,127            | 16,916   |
| Other general expenses                                  | 2,622              | 2,875   | 7,953             | 8,614    |
| Capitalization of deferred policy acquisition costs     | (6,090)            | (5,026) | (16,109)          | (15,763) |
| Amortization of deferred policy acquisition costs       | 3,358              | 3,431   | 10,758            | 10,743   |
| Amortization of cost of customer relationships acquired | 164                | 206     | 557               | 705      |
| Total benefits and expenses                             | 34,835             | 32,121  | 103,200           | 93,559   |
| Income before income tax expense                        | \$2,355            | 1,729   | 1,492             | 3,920    |



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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Premiums. Premium revenues increased for the three and nine month periods ended September 30, 2012, compared to the same periods in 2011 due primarily to international renewal business, which experienced strong persistency as this block of insurance ages. First year premium revenues rebounded in the third quarter as we saw improved sales in all products internationally.

Life insurance premium breakout is detailed below.

|                | Three Months Ended<br>September 30,<br>2012 |        | September 30,<br>2011 |        |
|----------------|---|--------|-----------------------|--------|
|                |   |        | 2012                  |        |
|                |   |        | 2011                  |        |
|                | (In thousands)                              |        |                       |        |
| Premiums:      |   |        |                       |        |
| First year     | \$4,997                                     | 3,957  | 12,629                | 12,678 |
| Renewal        | 26,879                                      | 25,534 | 78,017                | 72,349 |
| Total premiums | \$31,876                                    | 29,491 | 90,646                | 85,027 |

Net Investment Income. Net investment income increased but was negatively impacted by the low interest rate environment, which has resulted in declining yields.

|   | Nine Months Ended<br>September 30,<br>2012 | Year Ended<br>December 31,<br>2011 | Nine Months Ended<br>September 30,<br>2011 |   |
|---|--|------------------------------------|--|---|
|   | (In thousands, except for %)               |                                    |  |   |
| Net investment income, annualized           | \$17,265                                   | 16,401                             | 16,025                                     |   |
| Average invested assets, at amortized cost  | \$489,730                                  | 443,707                            | 427,059                                    |   |
| Annualized yield on average invested assets | 3.53                                       | % 3.70                             | % 3.75                                     | % |

Realized investment gains, net. Realized gains in the current year resulted primarily from the sale of one stock mutual fund holding during the quarter ended September 30, 2012 that had been previously impaired. This sale resulted in a gain of approximately \$0.6 million. The remaining net gains resulted from calls of bonds.

Claims and Surrenders. These amounts fluctuate from period to period but were within anticipated ranges based upon management's expectations.

|                              | Three Months Ended<br>September 30,<br>2012 |       | September 30,<br>2011 |        |
|------------------------------|---|-------|-----------------------|--------|
|                              |   |       | 2012                  |        |
|                              |   |       | 2011                  |        |
|                              | (In thousands)                              |       |                       |        |
| Death claims                 | \$1,466                                     | 1,447 | 5,232                 | 4,793  |
| Surrender benefits           | 4,403                                       | 4,372 | 12,746                | 12,808 |
| Endowment benefits           | 3,806                                       | 3,573 | 11,426                | 10,587 |
| Accident and health benefits | 74  | 64    | 180                   | 221    |
| Other policy benefits        | 464   | 378   | 1,328                 | 1,282  |
| Total claims and surrenders  | \$10,213                                    | 9,834 | 30,912                | 29,691 |

Death claims expense was higher for the three and nine months in 2012 due to more reported claims. Mortality experience is closely monitored by the Company as a key performance indicator and these amounts were within expected levels.

The majority of policy surrender benefits paid is attributable to our international business and was related to policies that have been in force over fifteen years, where surrender charges are no longer applicable.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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Endowment benefit expense primarily results from the election by policyholders of a product feature providing an annual guaranteed benefit. This is a fixed benefit over the life of the contract, thus this expense will increase with new sales and improved persistency.

Other policy benefits result primarily from interest paid on premium deposits and policy benefit accumulations.

**Increase in Future Policy Benefit Reserves.** Policy benefit reserves increased for the three and nine months ended September 30, 2012 compared to the same period in 2011, primarily from the effect of the current low interest rate environment on reserve development for policies issued in the last few years which have higher reserve build up compared to prior issue years. The accounting guidance of long duration contracts we sell requires the Company to "lock in" the original assumptions such as mortality, interest, surrenders and expenses at the time the initial policies are written, therefore gains or losses attributable to actual experience that differs from the original assumptions flows through the income statement in the period where in the differences occur.

We continue to experience growth in new sales of endowment products, which require higher initial reserve levels than whole life products. Endowment sales have become more popular among our international sales in the past few years, representing approximately 80% and 75% of total new first year premium through the nine months ended in 2012 and 2011, respectively.

**Commissions.** Commission expense increased for the three and nine months ended September 30, 2012, compared to the same periods in 2011. This expense fluctuates directly with new premium revenues, which were higher for the periods in 2012 compared to 2011. Commission rates paid to agents are higher on first year premium sales, which were up 26.3% for the three months ended September 30, 2012 compared to 2011. Renewal premiums for the three and nine months ended, which pay commissions at lower rates, are up \$1.3 million and \$5.7 million, respectively, in 2012 from the prior year. Also impacting current quarter expense is a reduction of approximately \$0.4 million in commission expense for the three and nine months ended September 30, 2012 due to balances that were held pending validation that are no longer considered payable.

**Other General Expenses.** The expenses are allocated by segment, based upon an annual expense study performed by the Company, and were down period to period for the nine months due to lower audit and actuarial fees.

**Capitalization of Deferred Policy Acquisition Costs ("DAC").** Capitalized costs increased for the three and nine months ended September 30, 2012, due to higher first year premiums and an increase in renewal commissions paid compared to 2011. DAC capitalization is directly correlated to fluctuations in first year commissions.

**Amortization of Deferred Policy Acquisition Costs.** Amortization for 2012 included adjustments to refine estimates that increased amortization by \$0.3 million for the nine months ended September 30, 2012. This impact is offset by the fact that overall persistency is up which results in lower amortization expense.

#### Home Service Insurance

We operate in the Home Service market through our subsidiaries Security Plan Life Insurance Company ("SPLIC") and Security Plan Fire Insurance Company ("SPFIC"), and focus on the life insurance needs of the middle and lower income markets, primarily in Louisiana, Mississippi and Arkansas. Our policies are sold and serviced through a home service marketing distribution system of employee-agents who work full time on a route system and through funeral homes that sell policies, collect premiums and service policyholders.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

September 30, 2012

The following table sets forth our direct premiums by state for the periods indicated.

| State        | Three Months Ended<br>September 30,<br>2012 |        | Nine Months Ended<br>September 30,<br>2012 |        |
|--------------|---|--------|--|--------|
|              | 2011  | 2011   | 2011                                       | 2011   |
|              | (In thousands)                              |        |  |        |
| Louisiana    | \$10,514                                    | 10,282 | 31,326                                     | 30,810 |
| Arkansas     | 481   | 465    | 1,446                                      | 1,434  |
| Mississippi  | 116   | 92     | 337  | 271    |
| Other States | 231   | 258    | 695  | 740    |
| Total        | \$11,342                                    | 11,097 | 33,804                                     | 33,255 |

## Home Service Insurance Products

Our home service insurance products consist primarily of small face amount ordinary whole life and pre-need policies, which are designed to fund final expenses for the insured, primarily consisting of funeral and burial costs. To a much lesser extent, our home service insurance segment sells limited-liability, named-peril property policies covering dwellings and contents. We provide \$30,000 maximum coverage on any one dwelling and contents, while content only coverage and dwelling only coverage is limited to \$20,000, respectively.

We provide final expense ordinary life insurance and annuity products primarily to middle and lower income individuals primarily in Louisiana, Mississippi and Arkansas. New products were approved for sale in Mississippi since the beginning of 2012 and we expect to increase sales as we expand our marketing force in this state.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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The results of operations for the home service insurance segment for the periods indicated are as follows.

|   | Three Months Ended |         | Nine Months Ended |         |
|---|--------------------|---------|-------------------|---------|
|   | September 30,      |         | September 30,     |         |
|   | 2012               | 2011    | 2012              | 2011    |
|   | (In thousands)     |         |                   |         |
| Revenue:  |                    |         |                   |         |
| Premiums  | \$11,076           | 10,808  | 32,998            | 32,386  |
| Net investment income                                   | 3,273              | 3,178   | 9,503             | 9,690   |
| Realized investment gains, net                          | 43                 | 4       | 170               | 6       |
| Other income  | 5                  | 6       | 17                | 20      |
| Total revenue   | 14,397             | 13,996  | 42,688            | 42,102  |
| Benefits and expenses:                                  |                    |         |                   |         |
| Insurance benefits paid or provided:                    |                    |         |                   |         |
| Claims and surrenders                                   | 5,414              | 4,969   | 15,578            | 14,896  |
| Increase in future policy benefit reserves              | 843                | 1,232   | 2,316             | 2,726   |
| Policyholders' dividends                                | 205                | 17      | 230               | 55      |
| Total insurance benefits paid or provided               | 6,462              | 6,218   | 18,124            | 17,677  |
| Commissions   | 3,654              | 3,708   | 11,037            | 11,310  |
| Other general expenses                                  | 2,962              | 3,126   | 8,932             | 9,167   |
| Capitalization of deferred policy acquisition costs     | (1,457)            | (1,505) | (4,421)           | (4,773) |
| Amortization of deferred policy acquisition costs       | 776                | 740     | 1,935             | 1,737   |
| Amortization of cost of customer relationships acquired | 434                | 502     | 1,277             | 1,408   |
| Total benefits and expenses                             | 12,831             | 12,789  | 36,884            | 36,526  |
| Income before income tax expense                        | \$1,566            | 1,207   | 5,804             | 5,576   |

Premiums. The premiums increased 1.9% for the nine month period in 2012 as this segment is continuing to report marginal growth primarily in Louisiana. Also, there is an increase of approximately \$180,000 of single premium in the three and nine months ended September 30, 2012 due to a one time adjustment as noted below under Policyholders' dividends.

Net Investment Income. Net investment income for our home service insurance segment portfolio yields are as follows.

|   | Nine Months Ended            | Year Ended   | Nine Months Ended |   |
|---|------------------------------|--------------|-------------------|---|
|   | September 30,                | December 31, | September 30,     |   |
|   | 2012                         | 2011         | 2011              |   |
|   | (In thousands, except for %) |              |                   |   |
| Net investment income, annualized           | \$12,671                     | 12,861       | 12,920            |   |
| Average invested assets, at amortized cost  | 293,374                      | 287,553      | 284,887           |   |
| Annualized yield on average invested assets | 4.32                         | % 4.47       | % 4.53            | % |

Realized Investment Gains (Losses), Net. Net realized gains for the three and nine months ended September 30, 2012 were due to calls of debt securities.



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Claims and Surrenders. Claims and surrenders increased for the three and nine months ended September 30, 2012, compared to the same period in 2011, as reported claims increased compared to the prior year, but were within expected ranges.

|                              | Three Months Ended<br>September 30,<br>2012 |       | Nine Months Ended<br>September 30,<br>2012 |        |
|------------------------------|---|-------|--|--------|
|                              | 2012  | 2011  | 2012                                       | 2011   |
|                              | (In thousands)                              |       |  |        |
| Death claims                 | \$3,587                                     | 3,470 | 11,298                                     | 10,738 |
| Surrender benefits           | 665   | 794   | 1,989                                      | 2,107  |
| Endowment benefits           | 6   | 3     | 19   | 8      |
| Property claims              | 1,017                                       | 586   | 1,880                                      | 1,601  |
| Accident and health benefits | 17  | 15    | 49   | 113    |
| Other policy benefits        | 122   | 101   | 343  | 329    |
| Total claims and surrenders  | \$5,414                                     | 4,969 | 15,578                                     | 14,896 |

Death claims expense increased for the three months in 2012 due to an increase in reported claims. The Company released \$0.7 million of incurred but unreported death claims liability through September 30, 2011. Mortality experience is closely monitored by the Company as a key performance indicator and these amounts were within expected levels.

Property claims increased 73.5% for the three months ended related to Hurricane Isaac. Gross Isaac losses recorded during the three months ended September 30, 2012 were approximately \$751,000 with reinsurance recoverable of \$251,000.

Policyholders' dividends. The increase in the three and nine months ended September 30, 2012 results from a manual adjustment that has now been properly set up in the policy administration system to properly reflect increasing policy values from annual paid up additions. This one time increase in dividends paid and single premium revenue of approximately \$180,000 has no impact on the overall segment earnings for the quarter or nine months. The reserve liability had been previously set up relative to this policy feature and was decreased by \$35,000 based upon the system calculated value.

Increase in Future Policy Benefit Reserves. The Company recorded a decrease relative to the change made from ungrouping certain prior issue year reserve model plans from six groups to twenty-eight groups due to non-homogeneous policy characteristics determined after further actuarial review of experience. This resulted in a decrease to reserves of approximately \$0.2 million for the nine months in 2012.

Commissions. Commission expense decreased for the three and nine months ended September 30, 2012, compared to the same periods in 2011 because agents are compensated based upon month-to-month route premium growth that has been impacted by increased policy lapses. This results in a lower commission to premium relationship as compensation is reduced. In addition, we have consolidated some collection routes, which resulted in elimination of one district office and its related staffing thereby also reducing the commission expense for the nine months ended September 30, 2012.

Other General Expenses. The expenses are allocated by segment based upon an annual expense study performed by the Company and remained relatively flat between 2012 and 2011.

Capitalization of Deferred Policy Acquisition Costs ("DAC"). Capitalized costs decreased slightly for the three and nine months ended September 30, 2012, as commissions expense also decreased during the period. DAC capitalization is directly correlated to fluctuations in commissions.

Amortization of Deferred Policy Acquisition Costs. Amortization for the three and nine months ended in the current year increased as this segment experienced lower persistency compared to the prior year, which results in higher amortization. In addition, a change was made relative to ungrouping certain plans for developing actuarial derived values, as noted above, which had an impact

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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of increasing amortization for the nine months ended in the current year by \$0.4 million. Amortization for the nine month period of 2011 includes an adjustment that resulted in an increase of \$0.3 million due to a refinement in an estimate using system generated information related to SPLIC assumptions.

## Other Non-Insurance Enterprises

This segment represents the administrative support entities to the insurance operations whose revenues are primarily intercompany and have been eliminated in consolidation under GAAP. The segment loss reported for the nine months of 2012 was primarily due to significantly lower gains from the change in fair value of warrants.

## Investments

The administration of our investment portfolios is handled by our management, pursuant to board-approved investment guidelines, with all trading activity approved by a committee of the respective boards of directors of our insurance company subsidiaries. The guidelines used require that fixed maturities, both government and corporate, are investment grade and comprise a majority of the investment portfolio. State insurance statutes prescribe the quality and percentage of the various types of investments that may be made by insurance companies and generally permit investment in qualified state, municipal, federal and foreign government obligations, high quality corporate bonds, preferred and common stock, mortgage loans and real estate within certain specified percentages. The assets are intended to mature in accordance with the average maturity of the insurance products and to provide the cash flow for our insurance company subsidiaries to meet their respective policyholder obligations.

The following table shows the carrying value of our investments by investment category and cash and cash equivalents, and the percentage of each to total invested cash, cash equivalents and investments.

|   | September 30, 2012               |                           | December 31, 2011                |                           |
|---|----------------------------------|---------------------------|----------------------------------|---------------------------|
|   | Carrying Value<br>(In thousands) | % of Total Carrying Value | Carrying Value<br>(In thousands) | % of Total Carrying Value |
| Marketable securities:                                  |                                  |                           |                                  |                           |
| U.S. Treasury and U.S. Government-sponsored enterprises | \$158,871                        | 17.0                      | \$321,186                        | 36.8                      |
| States and political subdivisions                       | 368,848                          | 39.4                      | 216,202                          | 24.8                      |
| Corporate   | 262,776                          | 28.0                      | 195,374                          | 22.4                      |
| Mortgage-backed <sup>(1)</sup>                          | 7,219                            | 0.8                       | 8,849                            | 1.0                       |
| Foreign governments                                     | 143                              | —                         | 142                              | —                         |
| Short-term investments                                  | 2,356                            | 0.3                       | 2,048                            | 0.2                       |
| Total marketable securities                             | 800,213                          | 85.5                      | 743,801                          | 85.2                      |
| Cash and cash equivalents                               | 39,830                           | 4.2                       | 33,255                           | 3.8                       |
| Other investments:                                      |                                  |                           |                                  |                           |
| Policy loans  | 42,784                           | 4.6                       | 39,090                           | 4.5                       |
| Equity securities                                       | 44,091                           | 4.7                       | 46,137                           | 5.3                       |
| Mortgage loans  | 1,521                            | 0.1                       | 1,557                            | 0.2                       |
| Real estate   | 8,530                            | 0.9                       | 8,539                            | 1.0                       |
| Other long-term investments                             | 178                              | —                         | 105                              | —                         |
| Total cash, cash equivalents and investments            | \$937,147                        | 100.0                     | \$872,484                        | 100.0                     |

<sup>(1)</sup> Includes \$6.7 million and \$8.1 million of U.S. Government-sponsored enterprises at September 30, 2012, and December 31, 2011, respectively.

The Company increased holdings in investment grade municipals and corporate securities during the nine months of 2012 while

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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reducing holdings in U.S. Treasury and U.S. Government-sponsored enterprises due to the very low yield environment. Cash and cash equivalents increased as of September 30, 2012 due to timing of cash inflows and investment into marketable securities.

The held-to-maturity portfolio as of September 30, 2012, represented 25.5% of the total fixed maturity securities owned based upon carrying values, with the remaining 74.5% classified as available-for-sale. Held-to-maturity securities are reported in the financial statements at amortized cost and available-for-sale securities are reported at fair value.

The following table sets forth the distribution of the credit ratings of our portfolio of fixed maturity securities by carrying value as of September 30, 2012 and December 31, 2011.

|              | September 30, 2012               |                           | December 31, 2011                |                           |
|--------------|----------------------------------|---------------------------|----------------------------------|---------------------------|
|              | Carrying Value<br>(In thousands) | % of Total Carrying Value | Carrying Value<br>(In thousands) | % of Total Carrying Value |
| AAA          | \$53,413                         | 6.7                       | \$46,663                         | 6.3                       |
| AA           | 416,483                          | 52.2                      | 482,869                          | 65.1                      |
| A            | 188,734                          | 23.7                      | 99,266                           | 13.4                      |
| BBB          | 125,271                          | 15.7                      | 95,558                           | 12.9                      |
| BB and other | 13,956                           | 1.7                       | 17,397                           | 2.3                       |
| Totals       | \$797,857                        | 100.0                     | \$741,753                        | 100.0                     |

The Company made new investments in the A and BBB credit categories of state municipals and corporate bonds, primarily public utility issues substantially replacing bond call proceeds related to holdings in U.S. Government-sponsored enterprises that had a credit rating of AA.

Credit ratings reported for the periods indicated are assigned by a Nationally Recognized Statistical Rating Organization (“NRSRO”) such as Moody’s Investors Service, Standard & Poor’s or Fitch Ratings. A credit rating assigned by an NRSRO is a quality based rating, with AAA representing the highest quality and D the lowest, with BBB and above being considered investment grade. In addition, the Company may use credit ratings of the National Association of Insurance Commissioners (“NAIC”) Securities Valuation Office (“SVO”) as assigned, if there is no NRSRO rating. Securities rated by the SVO are grouped in the equivalent NRSRO category as stated by the SVO and securities that are not rated by an NRSRO are included in the “other” category.

The Company has no direct sovereign European debt exposure as of September 30, 2012. We do have indirect exposure in one bond mutual fund holding, but the amount is deemed immaterial to the current investment holdings and consolidated financials.

As of September 30, 2012, the Company held municipal securities that include third party guarantees. Detailed below is a presentation by NRSRO rating of our municipal holdings by funding type.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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## Municipals shown including third party guarantees

|              | September 30, 2012 |                   | Special Revenue |                   | Total<br>Fair<br>Value | Amortized<br>Cost | % Based on<br>Amortized<br>Cost |
|--------------|--------------------|-------------------|-----------------|-------------------|------------------------|-------------------|---------------------------------|
|              | General Obligation |                   | Fair<br>Value   | Amortized<br>Cost |                        |                   |                                 |
|              | Fair<br>Value      | Amortized<br>Cost |                 |                   |                        |                   |                                 |
|              | (In thousands)     |                   |                 |                   |                        |                   |                                 |
| AAA          | \$22,892           | 21,701            | 11,464          | 10,605            | 34,356                 | 32,306            | 9.2                             |
| AA           | 91,930             | 85,152            | 126,401         | 116,383           | 218,331                | 201,535           | 57.0                            |
| A            | 15,100             | 15,017            | 88,061          | 86,182            | 103,161                | 101,199           | 28.7                            |
| BBB          | 544                | 515               | 12,215          | 12,175            | 12,759                 | 12,690            | 3.6                             |
| BB and other | —                  | —                 | 4,929           | 5,188             | 4,929                  | 5,188             | 1.5                             |
| Total        | \$130,466          | 122,385           | 243,070         | 230,533           | 373,536                | 352,918           | 100.0                           |

## Municipals shown excluding third party guarantees

|              | September 30, 2012 |                   | Special Revenue |                   | Total<br>Fair<br>Value | Amortized<br>Cost | % Based on<br>Amortized<br>Cost |
|--------------|--------------------|-------------------|-----------------|-------------------|------------------------|-------------------|---------------------------------|
|              | General Obligation |                   | Fair<br>Value   | Amortized<br>Cost |                        |                   |                                 |
|              | Fair<br>Value      | Amortized<br>Cost |                 |                   |                        |                   |                                 |
|              | (In thousands)     |                   |                 |                   |                        |                   |                                 |
| AAA          | \$22,892           | 21,701            | 11,464          | 10,605            | 34,356                 | 32,306            | 9.2                             |
| AA           | 88,182             | 81,522            | 91,816          | 83,941            | 179,998                | 165,463           | 46.9                            |
| A            | 18,848             | 18,647            | 118,111         | 114,209           | 136,959                | 132,856           | 37.6                            |
| BBB          | 544                | 515               | 20,812          | 20,982            | 21,356                 | 21,497            | 6.1                             |
| BB and other | —                  | —                 | 867             | 796               | 867                    | 796               | 0.2                             |
| Total        | \$130,466          | 122,385           | 243,070         | 230,533           | 373,536                | 352,918           | 100.0                           |

The Company held investments in special revenue bonds that had a greater than 10% exposure based upon activity as noted in the table below.

|                     | Fair Value     | Amortized<br>Cost | % of Total<br>Fair Value |
|---------------------|----------------|-------------------|--------------------------|
|                     | (In thousands) |                   |                          |
| Public improvements | \$47,075       | 45,601            | 12.6                     |



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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The tables below represent the Company's exposure of municipal holdings in Louisiana and Texas, which exceed 10% of the total municipal portfolio as of September 30, 2012.

|   | September 30, 2012 |                |                 |                |            |                |
|---|--------------------|----------------|-----------------|----------------|------------|----------------|
|   | General Obligation |                | Special Revenue |                | Total      |                |
|   | Fair Value         | Amortized Cost | Fair Value      | Amortized Cost | Fair Value | Amortized Cost |
| (In thousands)  |                    |                |                 |                |            |                |
| Louisiana securities including third party guarantees |                    |                |                 |                |            |                |
| AA  | \$9,691            | 8,895          | 24,392          | 23,188         | 34,083     | 32,083         |
| A   | 655                | 649            | 15,705          | 14,782         | 16,360     | 15,431         |
| BBB   | 544                | 515            | 4,804           | 4,795          | 5,348      | 5,310          |
| BB and other  | —                  | —              | 4,929           | 5,189          | 4,929      | 5,189          |
| Total   | \$10,890           | 10,059         | 49,830          | 47,954         | 60,720     | 58,013         |
| Louisiana securities excluding third party guarantees |                    |                |                 |                |            |                |
| AA  | \$8,572            | 7,851          | 16,969          | 16,270         | 25,541     | 24,121         |
| A   | 1,774              | 1,693          | 21,791          | 20,429         | 23,565     | 22,122         |
| BBB   | 544                | 515            | 6,141           | 6,066          | 6,685      | 6,581          |
| BB and other  | —                  | —              | 4,929           | 5,189          | 4,929      | 5,189          |
| Total   | \$10,890           | 10,059         | 49,830          | 47,954         | 60,720     | 58,013         |
| Texas securities including third party guarantees     |                    |                |                 |                |            |                |
| AAA   | \$22,892           | 21,701         | 6,931           | 6,382          | 29,823     | 28,083         |
| AA  | 21,497             | 19,556         | 11,776          | 11,254         | 33,273     | 30,810         |
| A   | 1,378              | 1,368          | 9,023           | 8,780          | 10,401     | 10,148         |
| BBB   | —                  | —              | 7,410           | 7,380          | 7,410      | 7,410          |
| Total   | \$45,767           | 42,625         | 35,140          | 33,796         | 80,907     | 76,421         |
| Texas securities excluding third party guarantees     |                    |                |                 |                |            |                |
| AAA   | \$22,892           | 21,701         | 6,931           | 6,383          | 29,823     | 28,084         |
| AA  | 19,488             | 17,591         | 8,338           | 7,917          | 27,826     | 25,508         |
| A   | 3,387              | 3,333          | 12,462          | 12,117         | 15,849     | 15,450         |
| BBB   | —                  | —              | 7,409           | 7,379          | 7,409      | 7,379          |
| Total   | \$45,767           | 42,625         | 35,140          | 33,796         | 80,907     | 76,421         |

The Company invests in municipal securities of issuers in the state of Louisiana and receives a credit that reduces its premium tax liability in that state. At September 30, 2012, total holdings of municipal securities in Louisiana represented 16.3% of all municipal holdings based upon fair value. The Company also holds 21.7% of its municipal holdings in Texas issuers. There were no other states or individual issuer holdings that represented or exceeded 10% of the total municipal portfolio as of September 30, 2012.

## Valuation of Investments

We evaluate the carrying value of our fixed maturity and equity securities at least quarterly. The Company monitors all debt and equity securities on an on-going basis relative to changes in credit ratings, market prices, earnings trends

and financial performance, in addition to specific region or industry reviews. The assessment of whether impairments have occurred is based on a case-by-case evaluation of underlying reasons for the decline in fair value. The Company determines other-than-temporary impairment

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by reviewing all relevant evidence related to the specific security issuer as well as the Company's intent to sell the security, or if it is more likely than not that the Company would be required to sell a security before recovery of its amortized cost.

When an other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis. If the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis, the other-than-temporary impairment is recognized in earnings equal to the entire difference between the investment's cost and its fair value at the balance sheet date. If the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis, the other-than-temporary impairment is separated into the following: a) the amount representing the credit loss; and b) the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to other factors is recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the other-than-temporary impairment recognized in earnings becomes the new amortized cost basis of the investment. The new amortized cost basis is not adjusted for subsequent recoveries in fair value.

The Company did not recognize any other-than-temporary impairments for the three and nine months ended September 30, 2012 or 2011.

Liquidity and Capital Resources

Liquidity refers to a company's ability to generate sufficient cash flows to meet the needs of its operations. Liquidity is managed on insurance operations and seeks to ensure stable and reliable sources of cash flows to meet obligations provided by a variety of sources.

Liquidity requirements of the Company are met primarily by funds provided from operations. Premium deposits and revenues, investment income and investment maturities are the primary sources of funds, while investment purchases, policy benefits, and operating expenses are the primary uses of funds. We historically have not had to liquidate investments relative to our insurance operations to provide cash flow and did not do so during the first nine months of 2012. Our investments as of September 30, 2012, consist of 66.3% of marketable debt securities classified as available-for-sale that could be readily converted to cash for liquidity needs.

A primary liquidity concern is the risk of an extraordinary level of early policyholder withdrawals. We include provisions within our insurance policies, such as surrender charges, that help limit and discourage early withdrawals. Since these contractual withdrawals, as well as the level of surrenders experienced, were largely consistent with our assumptions in asset liability management, our associated cash outflows have, to date, not had an adverse impact on our overall liquidity. Individual life insurance policies are less susceptible to withdrawal than annuity reserves and deposit liabilities because policyholders may incur surrender charges and undergo a new underwriting process in order to obtain a new insurance policy. Cash flow projections and cash flow tests under various market interest rate scenarios are also performed annually to assist in evaluating liquidity needs and adequacy. We currently anticipate that available liquidity sources and future cash flows will be adequate to meet our needs for funds.

Cash flows from our insurance operations have been sufficient to meet current needs. Cash flows from operating activities were \$47.6 million and \$43.6 million for the nine months ended September 30, 2012 and 2011, respectively. We have traditionally also had significant cash flows from both scheduled and unscheduled investment security maturities, redemptions, and prepayments. These cash flows, for the most part, are reinvested in fixed income securities. Net cash outflows from investing activities totaled \$43.6 million and \$32.4 million for the nine months ended September 30, 2012 and 2011, respectively.

The NAIC has established minimum capital requirements in the form of Risk-Based Capital ("RBC"). RBC factors the type of business written by an insurance company, the quality of its assets, and various other aspects of an insurance company's business to develop a minimum level of capital called "authorized control level risk-based capital" and compares this level to adjusted statutory capital that includes capital and surplus as reported under statutory accounting principles, plus certain investment

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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reserves. Should the ratio of adjusted statutory capital to control level RBC fall below 200%, a series of remedial actions by the affected company would be required.

All insurance subsidiaries were above the RBC minimums at December 31, 2011. The ratios of adjusted statutory capital to control level RBC are shown below.

|       | December 31,<br>2011 |   |
|-------|----------------------|---|
| CICA  | 628                  | % |
| CNLIC | 4,066                | % |
| SPFIC | 408                  | % |
| SPLIC | 1,298                | % |

## Contractual Obligations and Off-balance Sheet Arrangements

There have been no material changes in contractual obligations from those reported in the Company's Form 10-K for the year ended December 31, 2011. The Company does not have off-balance sheet arrangements at September 30, 2012, and does not expect any future effects on the Company's financial condition related to any such arrangements. We do not utilize special purpose entities as investment vehicles, nor are there any such entities in which we have an investment that engage in speculative activities of any nature, and we do not use such investments to hedge our investment positions.

## Parent Company Liquidity and Capital Resources

Citizens is a holding company and has had minimal operations of its own. Its assets consist primarily of the capital stock of its subsidiaries, cash, fixed income securities, mutual funds and investment real estate. Accordingly, Citizens' cash flows depend upon the availability of statutorily permissible payments, primarily payments under management agreements from its two primary life insurance subsidiaries, CICA and SPLIC. The ability to make payments is limited by applicable laws and regulations of Colorado, CICA's state of domicile, and Louisiana, SPLIC's state of domicile, which subject insurance operations to significant regulatory restriction. These laws and regulations require, among other things, that these insurance subsidiaries maintain minimum solvency requirements and limit the amount of dividends these subsidiaries can pay to the holding company. Citizens historically has not relied upon dividends from subsidiaries for its cash flow needs. However, CICA and SPLIC do dividend available funds from time to time in relation to new acquisition target strategies.

During the quarter ended September 30, 2012, CICA paid a cash dividend to its parent Citizens in the amount of \$5.4 million and SPLIC paid a cash dividend to CICA totaling \$2.3 million during the quarter. These payments do not impact the consolidated results of the Company.

## Critical Accounting Policies

We have prepared a current assessment of our critical accounting policies and estimates in connection with preparing our interim unaudited consolidated financial statements as of and for the three and nine months ended September 30, 2012 and 2011. We believe that the accounting policies set forth in the Notes to our Consolidated Financial Statements and "Critical Accounting Policies and Estimates" in the Management's Discussion and Analysis of

Consolidated Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2011 continue to describe the significant judgments and estimates used in the preparation of our consolidated financial statements except as specifically noted below.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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## Deferred Policy Acquisition Costs

Acquisition costs, consisting of commissions and policy issuance, underwriting and agency expenses that relate to the successful issuance of an insurance policy, are deferred. These deferred policy acquisition costs are amortized primarily over the estimated premium paying period of the related policies in proportion to the ratio of the annual premium recognized to the total premium revenue anticipated, using the same assumptions as were used in computing liabilities for future policy benefits.

## Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

## General

The nature of our business exposes us to market risk relative to our invested assets and policy liabilities. Market risk is the risk of loss that may occur when changes in interest rates and public equity prices adversely affect the value of our invested assets. Interest rate risk is our primary market risk exposure. Substantial and sustained increases and decreases in market interest rates can affect the fair value of our investments. The fair value of our fixed maturity portfolio generally increases when interest rates decrease and decreases when interest rates increase. For additional information regarding market risks to which we are subject, see "Item 1 Financial Statements - Note 5. Investments, - Valuation of Investments in Fixed Maturity and Equity Securities" above.

The following table summarizes net unrealized gains and losses for the periods indicated.

|   | September 30, 2012 |               | Net<br>Unrealized<br>Gains<br>(Losses) | December 31, 2011 |               | Net<br>Unrealized<br>Gains<br>(Losses) |
|---|--------------------|---------------|--|-------------------|---------------|--|
|   | Amortized<br>Cost  | Fair<br>Value |  | Amortized<br>Cost | Fair<br>Value |  |
|   | (In thousands)     |               |  |                   |               |  |
| Fixed maturities,<br>available-for-sale | \$549,205          | 594,620       | 45,415                                 | 484,809           | 514,253       | 29,444                                 |
| Fixed maturities, held-to-maturity      | 203,237            | 209,580       | 6,343                                  | 227,500           | 230,093       | 2,593                                  |
| Total fixed maturities                  | \$752,442          | 804,200       | 51,758                                 | 712,309           | 744,346       | 32,037                                 |
| Total equity securities                 | \$42,812           | 44,091        | 1,279                                  | 45,599            | 46,137        | 538                                    |

## Market Risk Related to Interest Rates

Our exposure to interest rate changes results from our significant holdings of fixed maturity investments, which comprised 88.9% of our investment portfolio based on carrying value as of September 30, 2012. These investments are mainly exposed to changes in U.S. Treasury rates. Our fixed maturities investments include U.S. Government-sponsored enterprises, U.S. Government bonds, securities issued by government agencies, municipal bonds and corporate bonds.

To manage interest rate risk, we perform periodic projections of asset and liability cash flows to evaluate the potential sensitivity of our investments and liabilities. We assess interest rate sensitivity annually with respect to our available-for-sale fixed maturities investments using hypothetical test scenarios that assume either upward or downward shifts in the prevailing interest rates. The changes in fair values of our debt and equity securities as of

September 30, 2012, were within the expected range of this analysis.

Changes in interest rates typically have a sizable effect on the fair values of our debt and equity securities. The interest rate of the ten-year U.S. Treasury bond decreased to 1.6% during the quarter ended September 30, 2012, from 1.9% at December 31, 2011. Net unrealized gains on fixed maturity securities totaled \$51.8 million at September 30, 2012, compared to \$32.0 million at December 31, 2011.



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The fixed maturity portfolio is exposed to call risk, as a significant portion of the current bond holdings are callable. A decreasing interest rate environment can result in increased call activity as experienced over the past several years, and an increasing rate environment will likely result in securities being paid at their stated maturity. The Company experienced bond issuer calls totaling approximately \$164.5 million and \$66.8 million in the life and home service segments, respectively. These securities that were called had a weighted average effective yield of 1.85% and 2.16% for the life and home service segment and were replaced with yields averaging to an effective rate of 3.06% and 3.02% in each segment, respectively.

There are no fixed maturities or other investments classified as trading instruments. Approximately 73.9% of fixed maturities were held in available-for-sale and 26.1% in held-to-maturity based upon fair value at September 30, 2012. At September 30, 2012, and December 31, 2011, we had no investments in derivative instruments, nor did we have any subprime or collateralized debt obligation risk.

Market Risk Related to Equity Prices

Changes in the level or volatility of equity prices affect the value of equity securities we hold as investments. Our equity investments portfolio represented 4.9% of our total investments at September 30, 2012, with 97.2% invested in diversified equity and bond mutual funds. We believe that significant decreases in the equity markets would not have a material adverse impact on our total investment portfolio.

Item 4. CONTROLS AND PROCEDURES

We have established disclosure controls and procedures to ensure, among other things, that material information relating to our Company, including its consolidated subsidiaries, is made known to our officers who certify our financial reports and to the other members of our senior management and the Board of Directors.

Our Chief Executive Officer and Chief Financial Officer are responsible for establishing and maintaining our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")). Based upon an evaluation at the end of the period, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

During the third quarter ended September 30, 2012, there were no changes in the Company's internal controls over financial reporting that materially affect or are reasonably likely to affect the Company's internal controls over financial reporting (as defined in rules 13a-15(f) and 15d-15(f) under the Exchange Act).

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PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

We are a defendant in a lawsuit filed on August 6, 1999, in the Texas District Court, Austin, Texas, now styled Delia Bolanos Andrade, et al., Plaintiffs, v. Citizens Insurance Company of America, et al., Defendants in which a class was originally certified by the trial court and reversed by the Texas Supreme Court in 2007 with an order to the trial court to conduct further proceedings consistent with its ruling. The underlying lawsuit alleged that certain life insurance policies CICA made available to non-U.S. residents, when combined with a policy feature that allowed certain cash benefits to be assigned to two non-U.S. trusts for the purpose of accumulating ownership of our Class A common stock, along with allowing the policyholders to make additional contributions to the trusts, were actually offers and sales of securities that occurred in Texas by unregistered dealers in violation of the Texas securities laws. The remedy sought was rescission and return of the insurance premium payments. On December 9, 2009, the trial court denied the recertification of the class after conducting additional proceedings in accordance with the Texas Supreme Court's ruling. The remaining plaintiffs must now proceed individually, and not as a class, if they intend to pursue their claims against us. Since the December 9, 2009 trial court ruling, no individual cases have been further pursued by the plaintiffs. The probability of the plaintiffs further pursuing their cases individually remains unknown. An estimate of any possible loss or range of losses cannot be made at this time in regard to individuals pursuing claims. However, should the plaintiffs further pursue their claims individually, we intend to vigorously defend any proceedings.

SPFIC is vigorously defending a lawsuit filed in the aftermath of Hurricane Katrina and currently pending in the United States District Court for the Eastern District of Louisiana. This matter was filed by the Louisiana Attorney General against SPFIC and every other homeowner insurer doing business in the State of Louisiana, on behalf of the State of Louisiana, as assignee, and on behalf of certain Road Home fund recipients. Although this lawsuit was originally filed as a class action, the Louisiana Attorney General moved to dismiss the class in 2011 and the motion was granted. In this matter the State alleged that the insurers failed to pay all damages owed under their policies. The claims currently pending in this matter are for breach of contract and for declaratory relief on the alleged underpayment of claims by the insurers. All other claims, including extra-contractual claims, have been dismissed.

There are many potential individual claims at issue in this matter, each of which will require individual analysis and a number of which may be subject to individual defenses, including release, accord and satisfaction, prescription, waiver, and estoppel. There has been no discovery in connection with this matter. The court has ordered the State to provide specificity as to its claims in this matter. SPFIC believes its claims practices in connection with Katrina homeowners claims were sound and in accordance with industry standards and state law. In SPFIC's judgment, an estimate of possible loss or range of loss cannot be made at this time. SPFIC intends to vigorously defend all claims asserted in any remaining proceedings.

SPFIC is vigorously defending a number of matters in various stages of development filed in the aftermath of Hurricane Katrina and Hurricane Rita in addition to the Road Home Litigation, including a number of individual lawsuits, which are immaterial to the Company's financial statements.

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Item 1A. RISK FACTORS

There are no updates to our risk factors as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2011 except as noted below.

We are a defendant in lawsuits, which may adversely affect our financial condition and detract from the time our management is able to devote to our business, and we are subject to risks related to litigation and regulatory matters.

We may from time to time be subject to a variety of legal and regulatory actions relating to our business operations, including, but not limited to:

- disputes over insurance coverage or claims adjudication;
- regulatory compliance with state laws;
- regulatory compliance with securities laws;
- disputes with our marketing firms, consultants and agents over compensation, termination of contracts and related claims;
- disputes regarding our tax liabilities;
- disputes relating to reinsurance and coinsurance agreements; and
- disputes relating to businesses acquired and operated by us.

In the absence of countervailing considerations, we would expect to defend any such claims vigorously. However, in doing so, we could incur significant defense costs, including attorneys' fees, other direct litigation costs and the expenditure of substantial amounts of management time that otherwise would be devoted to our business. If we suffer an adverse judgment as a result of any claim, it could have a material adverse effect on our business, results of operations and financial condition. See Item 1, Legal Proceedings and Note 7 to the Company's Consolidated Financial Statements.

By letter dated September 7, 2012, three state departments of treasury (or equivalent state agencies) notified the Company they intend to audit Citizens, Inc. and certain of its affiliates for compliance with unclaimed property laws. The Company believes it has unclaimed property practices and procedures in place which are reasonably designed to prevent violation of applicable state laws. However, it is possible the audits may result in additional payments to beneficiaries, additional escheatment of funds deemed abandoned under state laws, administrative penalties, interest, and changes to the Company's procedures for the identification and escheatment of abandoned property. It is anticipated that there will be expenses incurred with respect to responding to these audits and defending the Company's procedures for the identification and escheatment of abandoned property. At this time, the Company is not able to estimate any of these possible amounts, but such costs could be substantial for a Company our size.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

Item 3. DEFAULTS UPON SENIOR SECURITIES

None.

Item 4. MINE SAFETY DISCLOSURES

Not applicable.

Item 5. OTHER INFORMATION

On November 6, 2012, the Company issued a news release (the "Release") reporting, among things, results of operations for its third quarter of 2012. A copy of the Release is furnished as Exhibit 99.1 to this Quarterly Report on Form 10-Q. Citizens also announced that it would hold a conference call to discuss its financial results at 10:00 a.m. Central Standard Time on Wednesday, November 7, 2012.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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Item 6. EXHIBITS

Exhibit Number The following exhibits are filed herewith:

|         |  |
|---------|--|
| 11      | Statement re: Computation of per share earnings (see financial statements)                   |
| 31.1    | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act*  |
| 31.2    | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act*  |
| 32.1    | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act*  |
| 32.2    | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act*  |
| 99.1    | News Release reporting third quarter results issued on November 6, 2012 (furnished herewith) |
| 101.INS | XBRL Instance Document (furnished herewith)  |
| 101.SCH | XBRL Taxonomy Extension Schema (furnished herewith)  |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase (furnished herewith)                            |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase (furnished herewith)                             |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase (furnished herewith)                                  |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase (furnished herewith)                           |

\* Filed herewith.

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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.

CITIZENS, INC.

By: /s/ Harold E. Riley  
Harold E. Riley  
Chairman and Chief Executive Officer

By: /s/ Kay E. Osbourn  
Kay E. Osbourn  
Executive Vice President, Chief Financial Officer  
and Treasurer

Date: November 6, 2012

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