

NATIONAL SECURITY GROUP INC

Form 10-Q

August 14, 2006

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF**

**THE SECURITIES EXCHANGE ACT OF 1934**

**For Quarterly Period Ended June 30, 2006**

**Commission File Number 0-18649**

**The National Security Group, Inc.**

(Exact name of registrant as specified in its charter)

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Delaware  
(State or Other Jurisdiction of

63-1020300  
(IRS Employer

Incorporation or Organization)

Identification No.)

661 East Davis Street

Elba, Alabama  
(Address of principal executive offices)

36323  
(Zip-Code)

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

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in rule 12b-2 of the Act). (Check One) Large accelerated Filer  Accelerated Filer  Non-accelerated Filer

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

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

Class

Outstanding June 30, 2006

Common Stock, \$1.00 par value

2,466,600 shares



THE NATIONAL SECURITY GROUP, INC

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**Part I. FINANCIAL INFORMATION**

## Item 1. Financial Statements

## THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED UNAUDITED STATEMENTS OF INCOME

(In thousands, except per share amounts)

|   | Three Months<br>Ended June 30 |                 | Six Months<br>Ended June 30 |                 |
|---|-------------------------------|-----------------|-----------------------------|-----------------|
|   | 2006                          | 2005            | 2006                        | 2005            |
| <b>REVENUES</b>   |                               |                 |                             |                 |
| Net premiums earned                                     | \$ 14,755                     | \$ 13,696       | \$ 29,246                   | \$ 27,360       |
| Net investment income                                   | 1,045                         | 1,174           | 2,210                       | 2,265           |
| Net realized investment gains                           | 540                           | 683             | 1,149                       | 881             |
| Net revenues from leasing operations                    | 472                           | 988             | 925                         | 1,590           |
| Other Income  | 302                           | 386             | 629                         | 746             |
| <b>Total Revenues</b>                                   | <b>17,114</b>                 | <b>16,927</b>   | <b>34,159</b>               | <b>32,842</b>   |
| <b>BENEFITS AND EXPENSES</b>                            |                               |                 |                             |                 |
| Policyholder benefits paid or provided                  | 9,566                         | 8,496           | 20,246                      | 16,609          |
| Policy acquisition costs                                | 2,974                         | 2,948           | 5,543                       | 5,565           |
| General insurance expenses                              | 2,222                         | 2,123           | 4,563                       | 3,723           |
| Expenses from leasing operations                        | 456                           | 850             | 897                         | 1,613           |
| Insurance taxes, licenses and fees                      | 445                           | 658             | 878                         | 1,207           |
| Interest expense  | 412                           | 30              | 1,068                       | 463             |
| <b>Total Benefits and Expenses</b>                      | <b>16,075</b>                 | <b>15,105</b>   | <b>33,195</b>               | <b>29,180</b>   |
| <b>Income Before Income Taxes and Minority Interest</b> | <b>1,039</b>                  | <b>1,822</b>    | <b>964</b>                  | <b>3,662</b>    |
| <b>INCOME TAX EXPENSE</b>                               |                               |                 |                             |                 |
| Current   | 448                           | 446             | 471                         | 889             |
| Deferred  | (301)                         | (13)            | (220)                       | 34              |
|   | 147                           | 433             | 251                         | 923             |
| <b>Income Before Minority Interest</b>                  | <b>\$ 892</b>                 | <b>\$ 1,389</b> | <b>\$ 713</b>               | <b>\$ 2,739</b> |
| <b>Loss (Income) of Minority Interest</b>               | <b>78</b>                     | <b>(43)</b>     | <b>116</b>                  | <b>(101)</b>    |
| <b>Net Income</b>                                       | <b>\$ 970</b>                 | <b>\$ 1,346</b> | <b>\$ 829</b>               | <b>\$ 2,638</b> |
| <b>EARNINGS PER COMMON SHARE</b>                        | <b>\$ 0.39</b>                | <b>\$ 0.55</b>  | <b>\$ 0.34</b>              | <b>\$ 1.07</b>  |
| <b>DIVIDENDS DECLARED PER SHARE</b>                     | <b>0.220</b>                  | <b>0.215</b>    | <b>0.440</b>                | <b>0.430</b>    |

*The Notes to Financial Statements are an integral part of these statements.*

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THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

|  | As of June 30,<br>2006<br><i>(unaudited)</i> | As of December<br>31,<br>2005 |
|--|--|-------------------------------|
| <b>ASSETS</b>  |  |                               |
| Investments  |  |                               |
| Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2006 - \$17,616;<br>2005 - \$18,204) | \$ 18,686                                    | \$ 18,831                     |
| Fixed maturities available-for-sale, at estimated fair value (cost: 2006 - \$54,506;<br>2005 - \$56,704)         | 52,670                                       | 56,124                        |
| Equity securities available-for-sale, at estimated fair value (cost: 2006 - \$8,235;<br>2005 - \$6,374)          | 16,780                                       | 15,169                        |
| Receivable for securities  | 0  | 677                           |
| Mortgage loans on real estate, at cost   | 412  | 387                           |
| Investment real estate, at book value (accumulated depreciation: 2006 - \$18; 2005 - \$18)                       | 3,685  | 3,842                         |
| Policy loans   | 833  | 793                           |
| Other invested assets  | 2,643  | 2,605                         |
| Short-term investments   | 3,764  | 699                           |
| <b>Total Investments</b>   | <b>99,473</b>                                | <b>99,127</b>                 |
| Cash   | 139  | 2,350                         |
| Accrued investment income  | 687  | 701                           |
| Receivable from agents, less allowance for credit losses (2006 - \$121; 2005 - \$110)                            | 3,209  | 2,663                         |
| Accounts receivable, less allowance for credit losses (2006 - \$48; 2005 - \$48)                                 | 189  | 2,848                         |
| Inventory  | 2,513  | 1,238                         |
| Reinsurance recoverable  | 6,336  | 10,193                        |
| Deferred policy acquisition costs  | 7,473  | 6,567                         |
| Property and equipment, net  | 11,472                                       | 12,393                        |
| Other assets   | 1,057  | 1,146                         |
| <b>Total Assets</b>  | <b>\$ 132,548</b>                            | <b>\$ 139,226</b>             |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |  |                               |
| Property and casualty benefit and loss reserves  | \$ 14,548                                    | \$ 19,511                     |
| Accident and health benefit and loss reserves  | 804  | 575                           |
| Life and annuity benefit and loss reserves   | 25,073                                       | 24,552                        |
| Unearned premiums  | 18,008                                       | 15,791                        |
| Policy and contract claims   | 349  | 351                           |
| Other policyholder funds   | 1,205  | 1,309                         |
| Short-term debt  | 11,713                                       | 0                             |
| Long-term debt   | 9,279  | 22,906                        |
| Other liabilities  | 6,746  | 7,284                         |
| Deferred income tax  | 1,872  | 2,502                         |
| <b>Total Liabilities</b>   | <b>89,597</b>                                | <b>94,781</b>                 |



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|  |                   |                   |
|--|-------------------|-------------------|
| Contingencies  | 0                 | 0                 |
| Minority interest  | 774               | 889               |
| Shareholders' Equity   |                   |                   |
| Preferred stock, \$1 par value, 500,000 shares authorized, none issued or outstanding                | 0                 | 0                 |
| Class A common stock, \$1 par value, 2,000,000 shares authorized, none issued or outstanding         | 0                 | 0                 |
| Common stock, \$1 par value, 10,000,000 shares authorized<br>2,466,600 shares issued and outstanding | 2,467             | 2,467             |
| Additional paid-in capital   | 4,951             | 4,951             |
| Accumulated other comprehensive income   | 4,737             | 5,860             |
| Retained earnings  | 30,022            | 30,278            |
| <b>Total Shareholders' Equity</b>  | <b>42,177</b>     | <b>43,556</b>     |
| <b>Total Liabilities and Shareholders' Equity</b>  | <b>\$ 132,548</b> | <b>\$ 139,226</b> |

*The Notes to the Financial Statements are an integral part of these statements.*

THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(In thousands, except per share amounts)

|  | Total     | Retained Earnings | Accumulated Other Comprehensive Income | Common Stock | Paid-in Capital |
|--|-----------|-------------------|--|--------------|-----------------|
| Balance at December 31, 2004   | \$ 46,676 | \$ 30,854         | \$ 8,404                               | \$ 2,467     | \$ 4,951        |
| Comprehensive income   |           |                   |  |              |                 |
| Net Income for 2005  | 1,558     | 1,558             |  |              |                 |
| Other comprehensive income (net of tax)                                      |           |                   |  |              |                 |
| Unrealized loss on securities, net of reclassification adjustment of \$2,504 | (2,544)   |                   | (2,544)                                |              |                 |
| Total Comprehensive Loss   | (986)     |                   |  |              |                 |
| Cash dividends   | (2,134)   | (2,134)           |  |              |                 |
| Balance at December 31, 2005   | \$ 43,556 | \$ 30,278         | \$ 5,860                               | \$ 2,467     | \$ 4,951        |
| Comprehensive Income   |           |                   |  |              |                 |
| Net income six months ended 6/30/2006  | 829       | 829               |  |              |                 |
| Other comprehensive income (net of tax)                                      |           |                   |  |              |                 |
| Unrealized loss on securities, net of reclassification adjustment of \$776   | (1,123)   |                   | (1,123)                                |              |                 |
| Total Comprehensive (Loss)   | (294)     |                   |  |              |                 |
| Cash dividends   | (1,085)   | (1,085)           |  |              |                 |
| Balance at June 30, 2006 (Unaudited)   | \$ 42,177 | \$ 30,022         | \$ 4,737                               | \$ 2,467     | \$ 4,951        |

*The Notes to the Financial Statements are an integral part of these statements.*



THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED UNAUDITED STATEMENTS OF CASH FLOWS

(In thousands)

|  | Six Months<br>Ended June 30, |          |
|--|------------------------------|----------|
|  | 2006                         | 2005     |
| Cash Flows from Operating Activities   |                              |          |
| Income from continuing operations  | \$ 829                       | \$ 2,638 |
| Adjustments to reconcile income from continuing operations to net cash provided by (used in) operating activities: |                              |          |
| Change in accrued investment income  | 14                           | (8)      |
| Change in reinsurance receivables  | 3,857                        | 1,153    |
| Change in deferred policy acquisition costs  | (906)                        | (675)    |
| Change in income tax payable   | (29)                         | 521      |
| Change in deferred income tax expense  | (220)                        | 889      |
| Depreciation expense   | 367                          | 465      |
| Change in policy liabilities and claims  | (1,998)                      | 1,431    |
| Other, net   | (1,015)                      | (2,485)  |
| Net cash provided by (used in) operating activities  | 899                          | 3,929    |
| Cash Flows from Investing Activities   |                              |          |
| Cost of investments acquired   | (9,987)                      | (15,384) |
| Sale and maturity of investments   | 9,549                        | 14,046   |
| (Purchase) sale of property and equipment  | 431                          | (783)    |
| Net cash provided by (used in) investing activities  | (7)                          | (2,121)  |
| Cash Flows from Financing Activities   |                              |          |
| Change in other policyholder funds   | (104)                        | 67       |
| Change in notes payable  | (1,914)                      | (151)    |
| Dividends paid   | (1,085)                      | (1,061)  |
| Net cash (used in) provided by financing activities  | (3,103)                      | (1,145)  |
| Net change in cash and cash equivalents  | (2,211)                      | 663      |
| Cash and cash equivalents, beginning of period   | 2,350                        | 360      |
| Cash and cash equivalents, end of period   | \$ 139                       | \$ 1,023 |

*The Notes to the Financial Statements are an integral part of these statements.*

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THE NATIONAL SECURITY GROUP, INC.

### NOTES TO FINANCIAL STATEMENTS

#### Note 1-Basis of Presentation

The consolidated unaudited financial statements have been prepared in conformity with generally accepted accounting principles. The interim financial statements include all adjustments necessary, in the opinion of management, for fair statement of financial position, results of operations and cash flows for the periods reported. These adjustments are all normal recurring adjustments. A summary of the more significant accounting policies are set forth in the notes to the audited consolidated financial statements for the year ended December 31, 2005.

The accompanying consolidated unaudited financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and Natsco, Inc. (Natsco). NSFC includes a wholly owned subsidiary, Omega One Insurance Company.

The accompanying consolidated unaudited financial statements also include an investment in affiliate, which consists of a fifty percent interest in The Mobile Attic, Inc and its wholly owned subsidiary established in January of 2004, Mobile Attic Franchising Company (MAFCO). The Mobile Attic, Inc. is a portable storage leasing company that began operations in 2001. MAFCO was established in the first quarter of 2004 to conduct the business of selling Mobile Attic portable storage leasing franchises. Effective in the first quarter of 2004 the Company consolidates the accounts Mobile Attic Inc and subsidiary MAFCO according to guidance in Financial Accounting Standards Board Interpretation 46 as revised December 2003 (FIN 46R).

#### Note 2-Reinsurance

National Security Fire and Casualty Company ("NSFC"), Omega One Insurance Company ( OMEGA ), and National Security Insurance Company ("NSIC") wholly owned subsidiaries of the Company, reinsure certain portions of insurance risk, which exceed various retention limits. NSFC, OMEGA, and NSIC are liable for these amounts in the event assuming companies are unable to meet their obligations.

#### Note 3-Calculation of Earnings Per Share

Earnings per share were based on net income divided by the weighted average common shares outstanding. The weighted average number of shares outstanding for the period ending June 30, 2006 was 2,466,600 and for the period ending June 30, 2005 was 2,466,600.

#### Note 4-Changes in Shareholder's Equity

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During the six months ended June 30, 2006 and 2005, there were no changes in shareholders' equity except for net income of \$829,000 and \$2,638,000 respectively; dividends paid of \$1,085,000 and \$1,061,000 respectively; and unrealized investment losses and gains, net of applicable taxes, of \$(1,123,000) and \$(973,000) respectively.

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO FINANCIAL STATEMENTS

(Continued)

Note 5 - Deferred Taxes

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

(in thousands)

|   | June 30,<br>2006 | January 1,<br>2006 |
|---|------------------|--------------------|
| General insurance expenses                        | 665              | 1,233              |
| Unearned premiums                                 | 1,225            | 1,061              |
| Claims liabilities                                | 235              | 255                |
| Policy liabilities                                | 14               | 70                 |
| Deferred tax assets                               | 2,139            | 2,619              |
| Depreciation                                      | (429)            | (534)              |
| Deferred policy acquisition costs                 | (1,638)          | (2,233)            |
| Unrealized gains on securities available-for-sale | (1,944)          | (2,354)            |
| Deferred tax liabilities                          | (4,011)          | (5,121)            |
| Net deferred tax liability                        | (1,872)          | (2,502)            |

Deferred taxes are determined based on the estimated future tax effects of differences between the financial statement and tax bases of assets and liabilities given the provisions of the enacted tax laws.

Note 7-Contingencies

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

On December 12, 2005, the United States District court for the Middle District of Alabama (the Court) entered an order preliminarily approving a proposed settlement of a case pending against a subsidiary of the Company styled Mary W. Williams, et al v. National Security Insurance Company (Williams Litigation) and preliminarily certifying such case as a class action. The Williams Litigation relates primarily to claims that a subsidiary of the Company sold industrial burial insurance policies to racial minorities on which it charged higher premiums or provided inferior benefits than premiums charged to or policy benefits provided to similarly situated non-minority policyholders. The Company's



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subsidiary has not sold industrial burial insurance for more than 20 years. The proposed settlement provides for the Company's subsidiary to, among other matters, provide additional policyholder benefits, including premiums adjustments and benefits enhancements on existing policies and additional benefits on matured policies and pay attorneys fees. The Company has previously established litigation reserves with respect to this matter and has taken a policy reserve charge with respect to adjustments to the subject policies that were voluntarily made in 2000. The costs associated with prospective enhancements will be based on actuarial analysis not yet completed and accordingly, no provision has yet been made for them. However, based on preliminary discussions with the Company's independent consulting actuary and the Alabama Department of Insurance, it is believed that the necessary reserve adjustments in the subsidiary will not have a material adverse impact on the Company's consolidated financial position.

The class, as preliminarily certified, would not permit any class members to opt out of the settlement and preliminarily enjoins all similar litigation against the Company's subsidiary. In the settlement, the Company's subsidiary denied all claims and allegations made in the lawsuit. The proposed settlement is subject to final approval by the Court following a fairness hearing which is presently scheduled to be held on August 22, 2006.

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The company establishes and maintains reserves on contingent liabilities. In many instances, however, it is not feasible to predict the ultimate outcome with any degree of accuracy. While a resolution of these matters may significantly impact consolidated earnings and the Company's consolidated financial position, it remains management's opinion, based on information presently available, that the ultimate resolution of these matters will not have a material impact on the Company's consolidated financial position.

Note 8 Debt

Short-term debt consisted of the following as of June 30, 2006 and December 31, 2005:

|   | (Dollars in thousands) |      |
|---|------------------------|------|
|   | 2006                   | 2005 |
| Note payable to bank with an interest rate based on LIBOR (7.96% at June 30, 2006) dated March, 2002; maturity March, 2007. Payments of \$112,953 due quarterly with balloon payment at maturity. Unsecured                 | 2,304                  | -    |
| Note payable to bank with an interest rate based on prime minus 25 basis points (7.57% at June 30, 2006) dated June, 2004; maturity June, 2007. Interest payments due quarterly. Secured by Mobile Attic leasing equipment. | 9,409                  | -    |
|   | 11,713                 | -    |

Long-term debt consisted of the following as of June 30, 2006 and December 31, 2005:

|   | (Dollars in thousands) |        |
|---|------------------------|--------|
|   | 2006                   | 2005   |
| Subordinated debentures issued on December 15, 2005 with fixed interest rate of 8.83% each distribution period thereafter until December 15, 2015 when the coupon rate shall equal the 3-month LIBOR plus 3.75% applied to the outstanding principal; maturity December, 2035. Interest payments due quarterly. Unsecured | 9,279                  | 9,279  |
| Note payable to bank with an interest rate based on LIBOR (7.12% at December 31, 2005) dated March, 2002; maturity March, 2007. Payments of \$112,953 due quarterly with balloon payment at maturity. Unsecured   | -                      | 2,439  |
|   | -                      | 11,188 |

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Note payable to bank with an interest rate based on prime minus 25 basis points (7.00% at December 31, 2005) dated June, 2004; maturity June, 2007. Interest payments due quarterly. Secured by Mobile Attic leasing equipment.

9,279

22,906

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and

Shareholders of The National Security Group, Inc.

We have reviewed the condensed consolidated balance sheet of The National Security Group, Inc. and subsidiaries as of June 30, 2006, and the related condensed consolidated statements of income and cash flows for the six month periods ended June 30, 2006 and 2005. These interim financial statements are the responsibility of the company's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying consolidated interim financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of The National Security Group, Inc. and subsidiaries as of December 31, 2005, and the related consolidated statements of income, shareholders' equity and cash flows for the year then ended (not presented herein); and in our report dated February 23, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2005, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/Barfield, Murphy, Shank & Smith. P.C.

Birmingham, Alabama

August 14, 2006



Item 2.

**MANAGEMENTS DISCUSSION AND ANALYSIS OF**

**FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion addresses the financial condition of The National Security Group, Inc. (referred to in this document as we, our, us, the Company or NSEC) as of June 30, 2006, compared with December 31, 2005 and its results of operations and cash flows for the quarter ending June 30, 2006, compared with the same period last year. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes thereto included in Part I, Item 1 of this report and with our audited consolidated financial statements and related notes thereto contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

This discussion contains forward-looking statements that are not historical facts, including statements about our beliefs and expectations. These statements are based upon current plans, estimates and projections. Our actual results may differ materially from those projected in these forward-looking statements as a result of various factors. See *Note Regarding Forward-Looking Statement* contained on Page 3 included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005 filed with the Securities and Exchange Commission.

The reader is assumed to have access to the Company's 2005 Annual Report. This discussion should be read in conjunction with the Annual Report and with consolidated financial statements on pages 3 through 6 of this form

10-Q.

Information is presented in whole dollars.

**OVERVIEW**

The National Security Group operates in the property and casualty and life, accident and supplemental health insurance businesses and markets products primarily through independent agents. The Company operates in eleven states with over 60% of total premium revenue generated in the states of Alabama and Mississippi. Over 70% of total premium revenue is generated from dwelling property (fire and extended coverage), homeowners and mobile homeowners lines of business. Property and casualty insurance is the most significant segment accounting for 88.8% of total insurance premium revenue in the first six months of 2006.

While second quarter 2006 results were much improved over the first quarter of 2006, a very active spring storm season caused results to lag behind the results of the second quarter of 2005. Coupled with a higher frequency of storm and fire related losses in the first quarter, 2006 first six month earnings were down 68.6% compared to the first six months of 2005.

Premium revenue for the 2006 second quarter was up 7.7% compared to the second quarter of 2005. For the year to date, 2006 premium revenue was up 6.9%. The primary source of premium revenue growth continues to be in the property and casualty segment in the dwelling property lines of business. Premium revenue growth for the year 2006 is expected to remain in the range of 6%.

CONSOLIDATED RESULTS OF OPERATIONS

Premium revenues:

Three wholly owned subsidiaries, National Security Insurance Company (NSIC), National Security Fire & Casualty Company (NSFC), and Omega One Insurance Company (Omega) generate premium revenue of the Company. NSIC is a life, accident and health insurance company. NSFC and Omega write property and casualty lines of insurance, primarily dwelling fire, homeowners, and private passenger auto.

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The following table sets forth premium revenue by major line of business for the six months ended June 30, 2006 compared to the same period last year:

|  | Six months ended June 30, |               | Percent             |   |
|--|---------------------------|---------------|---------------------|---|
|  | 2006                      | 2005          | increase (decrease) |   |
| Life, accident and health operations:    |                           |               |                     |   |
| Traditional life insurance               | \$ 2,591,227              | \$ 2,426,660  | 6.78                | % |
| Accident and health insurance            | 689,159                   | 677,026       | 1.79                | % |
| Other                                    | -                         | -             | -                   | % |
| Total life, accident and health          | 3,280,386                 | 3,103,686     | 5.69                | % |
| Property and Casualty operations:        |                           |               |                     |   |
| Dwelling fire & extended coverage        | 12,598,353                | 11,221,195    | 12.27               | % |
| Homeowners (Including mobile homeowners) | 11,066,221                | 9,844,093     | 12.41               | % |
| Ocean marine                             | 828,607                   | 901,235       | (8.06)              | % |
| Other liability                          | 765,734                   | 555,992       | 37.72               | % |
| Private passenger auto liability         | 1,289,427                 | 1,839,199     | (29.89)             | % |
| Commercial auto liability                | 508,655                   | 579,140       | (12.17)             | % |
| Auto physical damage                     | 986,207                   | 1,343,698     | (26.61)             | % |
| Reinsurance premium ceded                | (2,077,415)               | (2,028,205)   | 2.43                | % |
| Total property and casualty              | 25,965,788                | 24,256,347    | 7.05                | % |
| Total earned premium revenue             | \$ 29,246,174             | \$ 27,360,033 | 6.89                | % |

Premium revenue in the life insurance subsidiary, NSIC accounts for 11.2% of total premium income of the Company. NSIC has two primary methods of distribution of insurance products, employee agents and independent agents. Employee agents primarily consist of home service agents that sell policies and collect premium primarily in the insured's home. Revenue from business in-force serviced by home service agents accounts for 44% of total NSIC premium revenue. This has been the primary method of product distribution for NSIC since its founding in 1947. Independent agents now account for over 90% of all new business production in NSIC. Revenue from business in-force serviced by independent agents now accounts for 48.7% of total NSIC premium revenue. In addition to the two primary methods of product distribution, approximately 7.3% of premium revenue is generated from the servicing of discontinued books of business and inactive programs. The most significant of these discontinued books of business is a block of policies acquired by NSIC from another carrier in 2000.

Premium revenue in NSIC consists of traditional life insurance products and supplemental accident and health products. As set forth in the preceding table, traditional life insurance premium revenue increased 6.8% in the first six months of 2006 compared to the same period last year. Accident and health insurance premium revenue increased 1.79%. In total NSIC premium revenue is up 5.7% in the first six months of 2006 compared to the same period last year. A 13.4% increase in premium revenue from the independent agent distribution channel is the primary reason for the increase in first quarter premium revenue in this segment.

Premium revenue in the property/casualty insurance subsidiaries increased 7.05% in the six months ended June 30, 2006 compared to the same period last year. After several years of rapid growth from 2001 through 2004, premium revenue has slowed to a more modest pace. Property/casualty premium revenue in the dwelling fire and homeowners lines of business continued to grow at double digit paces for the quarter at 12.27% and 12.41% respectively. The gains in the dwelling lines of business were partially offset by declines in the automobile liability and physical damage lines of business. Increased price competition in the auto lines of business has depressed premium revenue. Reinsurance premium ceded increased moderately in the first six months of 2006 compared to





the same period last year. An 18% increase in catastrophe reinsurance rates significantly increased catastrophe reinsurance ceded but this increase was partially offset by a decline in ceded reinsurance premium in the ocean marine line of business.

As mentioned in the overview of this discussion, we expect our premium revenue growth rate to remain at modest levels of growth over the next year. The personal lines property and casualty insurance business, in which 89% of total premium revenue is derived, has historically been cyclical in nature with periods of intense price competition among insurers followed by periods of increased pricing flexibility. Due to the increase in hurricane activity over the last year, we feel that we are entering a period of increased price flexibility in the coastal market that we serve. Unfortunately, due to regulatory hurdles in developing rates and submitting to various state regulatory agencies, we are unable to adjust the rates we charge as rapidly as reinsurance companies can adjust the rates we pay for catastrophe reinsurance. Because of the inherent lag time in getting rate adjustments submitted and approved, we will experience an increase in cost for reinsurance this year that we will be unable to fully recover through increased pricing of our insurance products.

#### Revenues from leasing operations:

Revenues from leasing operations are generated by the Company's 50% owned subsidiary, Mobile Attic, Inc. Mobile Attic's revenues are generated from the rental of portable storage containers for industrial and household consumers through its dealer network as well as the sale of franchises and storage units to franchisees through its wholly-owned subsidiary Mobile Attic Franchising Company. Mobile Attic retains ownership of rental storage containers rented through its dealer network. Mobile Attic sells storage containers to franchisees and collect rental royalty and marketing support fees from each franchisee.

For the six months ended June 30, 2006 total revenues from leasing operations were down 41.8% to \$925,000 compared to \$1,590,000 the same period last year. The primary factor leading to the decline in revenue is continued efforts to transition the business from the dealer network to independently owned franchise locations. This transition will serve a twofold purpose of reducing debt in Mobile Attic and transfer tax benefits and incentive to increase utilization rates of storage units to the franchisee. In early 2006, Mobile Attic sold approximately \$2,000,000 in corporate owned portable storage units to franchisees. The proceeds of this sale was used to reduce Mobile Attic debt but also reduced direct revenue received by Mobile Attic leading to the decline in leasing revenue for the six months. Mobile Attic will collect a royalty fee for each unit rented by a franchisee but due to the relative immaturity of the franchise business model, it will take some time to build this revenue base.

#### Net investment income:

Net investment income declined 2.48% to \$2,210,000 for the six month period ended June 30, 2006 compared to \$2,265,000 for the same period last year. The slight decline in investment income is primarily due to a change in investment mix and short term lag times between the payments of catastrophe related claims by the company subsequent reimbursement by reinsurance companies.

#### Realized capital gains and losses:

Realized capital gains were down 20.1% for the quarter but are up 30.4% for the year to date. Capital gains are subject to significant variability from period to period due to the amount and timing of disposals of equity investments and overall stock market conditions.

Other income:

Other income decreased 15.7% compared to last year. Other income is primarily composed of insurance related fees. The decrease was primarily due to a decrease in fees associated with the automobile lines of business. The non-standard auto line of business in which the Company operates is subject to significant variability due to competitive market conditions. The Company has experienced a decline in non-standard automobile premium in the last six months leading to the decline in fee revenue associated with this line of business.

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Policyholder benefits and settlement expenses:

Policyholder benefits and settlement expenses increased \$3,637,000 in the first six months of 2006 compared to the same period last year. As a percentage of premium revenue, policyholder benefits and settlement expenses were 69.2% for the six month period ended June 30, 2006 compared to 60.7% for the same period last year. As discussed in the overview at the opening of this management discussion and analysis, an increase in claims activity in the property and casualty subsidiaries was the primary factor contributing to this increase in benefits and settlement expenses.

Two primary factors contributed to the increase in policyholder benefits and settlement expenses:

1. Fire related losses increased \$1.1 million in the first quarter of 2006 compared to the same period last year. In the first quarter of 2006, NSFC experienced a significant increase in frequency of fire losses in the dwelling fire and homeowners lines of business. While frequency declined in the second quarter, fire claims continue to be up significantly compared to last year. Fire related losses were up 20% in the first quarter of 2006 and were up 8% in the second quarter of 2006 compared to the same periods last year.
2. Wind, tornado and hail losses, primarily concentrated in Arkansas, Tennessee and Georgia is the primary contributor to the increase in claims for the first six months of 2006 compared to last year. Catastrophe related windstorm claims were up \$1.2 million in 2006 compared to 2005. Two separate catastrophe events in early April in Arkansas and Tennessee were the primary contributors to the increase in catastrophe losses. Also, NSFC incurred an increase of \$981,000 in hail storm related losses during the first six months of 2006. 70% of these hail storm claims were incurred in three separate events in one Georgia County in January and April of 2006.

Policy acquisition costs:

Policy acquisition costs are directly related to the production of earned premium and as a percentage of premiums earned, policy acquisition costs are down primarily due to a reduction in commission rates on an automobile program operated by a general agent in Alabama and Mississippi.

General insurance expenses:

General expenses as a percent of earned premium was up moderately for the quarter at 15.6% of earned premium compared to 15.3% of earned premium for the same period last year. There were no significant changes in the makeup of general expenses.

Taxes, licenses, and fees:

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Taxes, licenses and fees are 3.0% of premium revenue in the first six months of 2006 compared to 4.4% in the first six months of last year, a decrease of \$329,000. The most significant item contributing to this decrease was non-deductible fees incurred in the prior year associated with a periodic examination of insurance subsidiaries conducted by the Alabama Department of Insurance.

### Interest Expense:

Interest expense increased \$605,000 in the first six months of 2006 compared to last year due to increased interest cost associated with the issuance of \$9.2 million in trust preferred securities. The issuance was completed in December of 2005. Mobile Attic also experienced an increase in interest cost due to rising interest rates of floating rate debt.

Summary:

The Company has net income for the first six months of 2006 of \$829,000 compared to net income of \$2,638,000 for the first six months of 2005. As discussed under the caption "Policyholder benefits and settlement expenses" earlier in this report, a significant increase in claims incurred in the property and casualty subsidiaries was the primary factor contributing to the decline in earnings.

Investments:

Investments at June 30, 2006 were up \$346,000 compared to December 31, 2005. Reimbursements of amounts due to us under catastrophe reinsurance agreements produced additional funds for investment but were partially offset by increased claims payments during the first six months of 2006.

The Company considers any fixed income investment with a Standard & Poor's rating of BB+ or lower to be below investment grade (Commonly referred to as "Junk Bonds"). At June 30, 2006 less than 1% of the Company's investment portfolio was invested in fixed income investments rated below investment grade. The Company currently has no bonds in the investment portfolio in default.

The Company monitors its level of investments in debt and equity securities held in issuers of below investment grade debt securities. Management believes the level of such investments is not significant to the Company's financial condition.

Income taxes:

Income taxes for the six month period ended June 30, 2006 was 26% of income before tax, down slightly compared to income taxes of 28% for the same period last year.

Liquidity and capital resources:

At June 30, 2006, the Company had aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of \$42,177,000 down \$1,379,000 compared to December 31, 2005. The decrease reflects a net income of \$829,000, a decrease in accumulated unrealized investment gains of \$1,123,000, and dividends paid of \$1,085,000. The decline in unrealized capital gains is primarily due to market value related decline in debt securities available for sale. The rising short term interest rate environment over the last six months was the primary factor contributing to this decline.

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The Company has \$20.9 million in short and long term debt. The Company has \$11.6 million in debt held by the holding company, National Security Group, Inc (NSG), with \$2.3 million of this debt due in March of 2007. The Company intends to retire the \$2.3 million in debt at maturity. The remaining \$9.3 million in debt of NSG consists of trust preferred securities which were issued in December of 2005. These securities have a fixed interest rate of 8.83% until December of 2015 and a final maturity of December 15, 2035. The Company's 50% owned subsidiary, Mobile Attic, Inc. holds debt of \$9.4 million that is also set to mature in 2007. Mobile Attic intends to refinance this debt prior to maturity and management currently knows of no limitations in Mobile Attic's ability to refinance this debt prior to maturity.

The Company had \$139,000 in cash and cash equivalents at June 30, 2006. Net cash provided by operating activities totaled \$2,169,000 in the first six months of 2006. Recoveries of amounts due under catastrophe reinsurance agreements of \$3,857,000 was the primary factor contributing to the increase in cash provided by operating activities.

The liquidity requirements of the Company are primarily met by funds provided from operations of the life insurance and property/casualty subsidiaries. The Company receives funds from its subsidiaries consisting of dividends, payments for federal income taxes, and reimbursement of expenses incurred at the corporate level for the subsidiaries. These funds are used to pay stockholder dividends, corporate interest, corporate administrative expenses, federal income taxes, and for funding investments in subsidiaries.

The Company's subsidiaries require cash in order to fund policy acquisition costs, claims, other policy benefits, interest expense, general expenses, and dividends to the Company. Premium and investment income, as well as maturities, calls, and sales of invested assets, provide the primary sources of cash for both subsidiaries. A significant portion of the Company's investment portfolio consists of readily marketable securities, which can be sold for cash.

The Company's business is concentrated primarily in the Southeastern United States. Accordingly, unusually severe storms or other disasters in the Southeastern United States might have a more significant effect on the Company than on a more geographically diversified insurance company. Unusually severe storms, other natural disasters and other events could have an adverse impact on the Company's financial condition and operating results. However, the Company maintains a catastrophe reinsurance program to limit the effect of such catastrophic events on the Company's financial condition.

The Company experienced substantial losses during the 2005 hurricane season from hurricanes Dennis, Katrina and Rita. The Company maintained catastrophe reinsurance to cover such events. Management relies on hurricane models to establish coverage under catastrophe reinsurance agreements. Based on these models, the Company maintained coverage up to a \$37.5 million loss from a single event during 2005. Models indicated that a loss of this magnitude had a 0.4% chance of occurrence in any given year. Losses to date from Katrina have used all but \$1,353,000 of available reinsurance under the catastrophe reinsurance agreement with over \$9,000,000 of covered losses coming in the form of Mississippi Windstorm Underwriting Association assessments. Management does not expect any significant additional rise in claims from Katrina but should losses exceed the remaining \$1,353,000 in catastrophe coverage, we would incur additional losses to cover the losses in excess of \$37.5 million.

The company has reinsurance to cover a catastrophe in 2006 up to \$42.5 million subject to a \$3 million deductible. This facility has not been utilized in the first six months of 2006.



Item 3. Market Risk Disclosures

The Company's primary objectives in managing its investment portfolio are to maximize investment income and total investment returns while minimizing overall credit risk. Investment strategies are developed based on many factors including changes in interest rates, overall market conditions, underwriting results, regulatory requirements, and tax position. Investment decisions are made by management and reviewed by the Board of Directors. Market risk represents the potential for loss due to adverse changes in fair value of securities. The three potential risks related to the Company's fixed maturity portfolio are interest rate risk, prepayment risk, and default risk. The primary risk related to the Company's equity portfolio is equity price risk. There have been no material changes to the Company's market risk for the six months ended June 30, 2006. For further information reference is made to the Company's Form 10-K for the year ended December 31, 2005.

Item 4. Controls and Procedures

Company management, including the Chief Executive Officer and Chief Financial Officer, has conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective in ensuring that all material information required to be filed in this quarterly report has been made known to them in a timely fashion. There have been no significant changes in internal controls, or in factors that could significantly affect internal controls, subsequent to the date the Chief Executive Officer and Chief Financial Officer completed their evaluation.

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

Please refer to Note 7 to the financial statements.

Item 1A. Risk Factors

There has been no material change in risk factors previously disclosed under Item 1A. of the Company's annual report for 2005 on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

a. Exhibits

11. Computation of Earnings Per Share Filed Herewith, See Note 3 to Consolidated Financial Statements

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

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

32.1 Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

b. Reports on Form 8-K during the quarter ended June 30, 2006

| Date of Report | Date Filed     | Description  |
|----------------|----------------|--|
| April 20, 2006 | April 20, 2006 | Press release, dated April 20, 2006, issued by The National Security Group, Inc. |
| May 4, 2006    | May 12, 2006   | Notification of change in transfer agent effective May 4, 2006.                  |
| May 12, 2006   | May 12, 2006   | Press release, dated May 12, 2006, issued by The National Security Group, Inc.   |



SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed by the undersigned duly authorized officer, on its behalf and in the capacity indicated.

The National Security Group, Inc.

/s/ William L. Brunson, Jr.  
William L. Brunson, Jr.  
Treasurer and Chief Financial Officer

/s/ Brian R. McLeod  
Brian R. McLeod  
Treasurer and Chief Financial Officer

Dated: August 11, 2006



**Exhibit 31.1**

**CERTIFICATION**

I, William L. Brunson, Jr. certify that:

1. I have reviewed this quarterly report on Form 10-Q of The National Security Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 11, 2006

/s/William L. Brunson, Jr.

William L. Brunson, Jr.

Chief Executive Officer

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Exhibit 31.2

**CERTIFICATION**

I, Brian R. McLeod, certify that:

1. I have reviewed this quarterly report on Form 10-Q of The National Security Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 11, 2006

/s/Brian R. McLeod, CPA

Brian R. McLeod, CPA





**EXHIBIT 32.1**

**CERTIFICATION PURSUANT TO**

**18 U.S.C. SECTION 1350,**

**AS ADOPTED PURSUANT TO**

**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

Exhibit 32.1 Certification of Chief Executive Officer

Pursuant to 18 U.S.C. § 1350, the undersigned officer of the National Security Group, Inc. (the "Company"), hereby certifies, to such officer's knowledge, that the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2006 (the "Report") fully complies with the requirements of Section 13(a) or 15 (d), as applicable, of the Securities Exchange Act of 1934 and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 11, 2006

/s/ William L. Brunson, Jr.

Name: William L. Brunson, Jr.

Title: Chief Executive Officer

**EXHIBIT 32.2**

**CERTIFICATION PURSUANT TO**

**18 U.S.C. SECTION 1350,**

**AS ADOPTED PURSUANT TO**

**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

Exhibit 32.2 Certification of Chief Financial Officer

Pursuant to 18 U.S.C. § 1350, the undersigned officer of The National Security Group, Inc. (the "Company"), hereby certifies, to such officer's knowledge, that the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2006 (the "Report") fully complies with the requirements of Section 13(a) or 15 (d), as applicable, of the Securities Exchange Act of 1934 and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 11, 2006

/s/ Brian R. McLeod, CPA

Name: Brian R. McLeod, CPA

Title: Chief Financial Officer

