

SECURITIES AND EXCHANGE COMMISSION

FORM 10-Q

Quarterly report pursuant to sections 13 or 15(d)

Filing Date: **1996-11-14** | Period of Report: **1996-09-30**
SEC Accession No. **0000865058-96-000003**

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FILER

NATIONAL SECURITY GROUP INC

CIK: **865058** | IRS No.: **631020300** | State of Incorporation: **DE** | Fiscal Year End: **1231**
Type: **10-Q** | Act: **34** | File No.: **000-18649** | Film No.: **96665277**
SIC: **6311** Life insurance

Business Address
661 E DAVIS ST
ELBA AL 36323
2058972273

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 1996

or

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

For the transition period from _____ to _____

Commission File Number: 0-18649

THE NATIONAL SECURITY GROUP, INC.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

63-1020300
(I.R.S. Employer
Identification No.)

661 East Davis Street, Elba, Alabama 36323
(Address of principal executive offices) (Zip code)

Registrant's telephone number, including area code (334) 897-2273

Not Applicable

(Former name, 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 (X) No ()

Number of Shares of Common Stock outstanding as of November 7, 1996: 2,319,763

THE NATIONAL SECURITY GROUP, INC.

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Part I. FINANCIAL INFORMATION

Item 1. Financial Statements
THE NATIONAL SECURITY GROUP, INC.CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share amounts)

	Three Months		Nine Months	
	Ended September 30		Ended September 30	
	1996	1995	1996	1995
	----	----	----	----
Revenues				
Net insurance premiums earned	\$ 7,177	\$ 5,983	\$19,505	\$18,413
Net investment income	1,047	1,012	2,879	2,959
Realized investment gains	(148)	1,188	1,034	1,638
Other income	161	112	392	424
	-----	-----	-----	-----
 Total revenues	 8,237	 8,295	 23,810	 23,434
	-----	-----	-----	-----
 Benefits and Expenses				
Policyholder benefits and settlement expenses	4,504	4,040	14,620	11,307

Policy acquisition costs	1,341	1,105	3,572	3,427
General insurance expenses	1,215	1,550	3,843	4,643
Insurance taxes, licenses and fees	281	405	1,166	1,134
	-----	-----	-----	-----
Total benefits and expenses	7,341	7,100	23,201	20,511
	-----	-----	-----	-----
Income Before Income Taxes	896	1,195	609	2,923
Income Taxes (Current and deferred)	111	453	138	978
	-----	-----	-----	-----
Net Income	\$ 785	\$ 742	\$ 471	\$ 1,945
	=====	=====	=====	=====
Earnings per share	\$ 0.34	\$ 0.32	\$ 0.20	\$ 0.83
	=====	=====	=====	=====
Dividends Declared per Share	\$ 0.16	\$ 0.15	\$ 0.48	\$ 0.45
	=====	=====	=====	=====

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

THE NATIONAL SECURITY GROUP, INC.

CONSOLIDATED BALANCE SHEET

(In thousands, except per share amounts)

	As of September 30, 1996	As of December 31, 1995
	-----	----
Assets		
Investments:		
Securities held-to-maturity at amortized cost (estimated fair value: 1996 - \$36,786; 1995 - 39,679) ..	\$ 36,368	\$ 38,427
Securities available-for-sale, at estimated fair value (cost: 1996 - 18,008; 1995 - 17,421)	28,080	27,451
Mortgage loans	420	484

Investment real estate, at cost	1,661	1,880
Policy loans	619	627
	-----	-----
Total investments	67,148	68,869
	-----	-----
Cash and cash equivalents	4,709	2,817
Accrued investment income	803	880
Reinsurance recoverable	6,185	11,892
Deferred policy acquisition costs	3,589	3,400
Current income tax recoverable	689	829
Prepaid reinsurance premiums	3,652	5,253
Other assets	2,113	3,326
	-----	-----
Total assets	\$ 88,888	\$ 97,266
	=====	=====
Liabilities		
Policy reserves	\$ 18,457	\$ 18,290
Claim reserves	13,367	16,538
Unearned premiums	11,867	12,467
Other policyholder funds	1,888	1,927
Deferred income tax	2,614	2,636
Other liabilities	1,498	5,634
	-----	-----
Total liabilities	\$ 49,691	\$ 57,492
	-----	-----
Shareholders' Equity		
Common stock, \$1 par value, 2,339,848 shares issued	2,340	2,340
Additional paid in capital	17	17
Net unrealized appreciation on securities		
available-for-sale, net of deferred taxes	7,112	6,973
Retained earnings	30,020	30,666
Treasury stock, at cost (20,085 shares)	(292)	(222)
	-----	-----
Total shareholders' equity	39,197	39,774
	-----	-----
Total liabilities and shareholder's equity	\$ 88,888	\$ 97,266
	=====	=====
Shareholders' Equity per Share	16.90	17.11
	=====	=====

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

THE NATIONAL SECURITY GROUP. INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Nine Months Ended September 30	
	1996	1995
	-----	----
Cash Flows from Operating Activities		
Income from continuing operations	\$ 471	\$ 1,945
Adjustments to reconcile income from continuing operations to net cash provided by (used in) operating activities:		
Accrued investment income	77	(23)
Reinsurance receivables	5,707	(901)
Deferred Policy acquisition costs	(189)	(344)
Income Taxes	118	(120)
Depreciation expense	90	112
Policy liabilities and claims	(3,604)	1,564
Other, net	(1,397)	(685)
	-----	-----
Net cash provided by operating activities	1,273	1,548
	-----	-----
Cash Flows from Investing Activities		
Cost of investments acquired	(5,247)	(3,353)
Sale and maturity of investments	7,106	4,994
Purchase of property and equipment	(15)	(91)
Proceeds from disposal of property and equipment	0	0
Other, net	0	0
	-----	-----
Net cash used in investing activities	1,844	1,550
	-----	-----
Cash Flows from Financing Activities		
Increase in other policyholder funds	(40)	(142)
Dividends paid	(1,114)	(1,053)
Purchase of treasury stock	(71)	0
	-----	-----
Net cash used in financing activities	(1,225)	(1,195)
	-----	-----
Net increase (decrease) in cash and cash equivalents	1,892	1,903

Cash and cash equivalents, beginning of period	2,817	5,314
	-----	-----
Cash and cash equivalents, end of period	\$ 4,709	\$ 7,217
	=====	=====

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

THE NATIONAL SECURITY GROUP, INC.

NOTES TO FINANCIAL STATEMENTS

NOTE 1-Basis of Presentation

The consolidated 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.

Note 2-Reinsurance

National Security Fire and Casualty Company ("NSFC") and National Security Insurance Company ("NSIC") wholly owned subsidiaries of the Company, reinsure certain portions of insurance risk which exceed various retention limits. NSFC 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 September 30, 1996 was 2,320, and for the period ending September 30, 1995 was 2,340.

Note 4-Changes in Shareholder's Equity

During the nine months ended September 30, 1996 and 1995, there were no changes in shareholders' equity except for net income of \$471 and \$1,945 respectively; dividends paid of \$1,114 and \$1,053 respectively; unrealized investment gains (losses), net of applicable taxes, of \$138 and \$1,945 respectively, and purchase of treasury stock of \$70 and \$0 respectively.

Note 5 - Deferred Taxes

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

	September 30, 1996	January 1, 1996
Deferred policy acquisition costs	(1,220)	(1,138)
Policy liabilities	513	499
Unearned premiums	422	353
Claims liabilities	351	291
General insurance expenses	313	314
Unrealized gains on securities available-for-sale	(2,960)	(2,983)
Other	(33)	28
	-----	-----
Net deferred tax assets (liability)	(2,614)	(2,636)
	=====	=====

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.

THE NATIONAL SECURITY GROUP, INC.

NOTES TO FINANCIAL STATEMENTS
(Continued)

Note 6-Contingencies

On October 4, 1996, a jury in the Circuit Court of Palm Beach County, Florida returned a verdict against National Security Fire & Casualty Company, a subsidiary of the Company, in the amount of \$1,046,540.96. The plaintiff, Leon B. King, had alleged that the Company's subsidiary had acted in bad faith in, among other actions, failing to timely deliver a settlement check in connection with a 1986 automobile accident. This same case was previously tried in 1993 with the jury returning a verdict in favor of the Company's subsidiary on all

counts alleged. This verdict was subsequently reversed on appeal which resulted in the subject trial. There are various post-trial motions pending, including a motion for a new trial. Barring relief being granted, it is anticipated that this verdict will be appealed.

The Company and its subsidiaries continue to be named as parties to other litigation related to the conduct of their insurance operations. These suits involve alleged breaches of contracts, torts, including bad faith and fraud claims based on alleged wrongful or fraudulent acts of agents of the Company's subsidiaries, and miscellaneous other causes of action. Most of these lawsuits include claims for punitive damages in addition to other specified relief. The frequency of these lawsuits has increased significantly over the past 36 months, particularly in Alabama where the Company conducts the majority of its business. Certain of these actions are filed in jurisdictions in Alabama where local juries have returned large punitive damage verdicts against insurance companies and financial institutions with, in many cases, the punitive damage award bearing little or no relation to the actual damages. It is not feasible to predict or determine the ultimate outcome of these matters.

A resolution of these matters may significantly impact consolidated earnings and may significantly impact the Company's consolidated financial position, although it remains management's opinion, based upon information presently available, that the ultimate resolution of these matters will not have a material impact on the Company's consolidated financial position. It should be noted, however, that we are unable to assess with any degree of accuracy the potential liability to the Company arising from these matters. The civil tort system, particularly in Alabama, must be presently regarded as unpredictable and as, for the most part, hostile to insurance companies.

Note 7-Accounting for certain investments in debt and equity securities

Effective January 1, 1994 the Company and its subsidiaries adopted Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities" (SFAS 115). This statement, among other things, requires investment securities (bonds, notes, common stock and preferred stocks) to be divided into one of three categories: held to maturity, available-for-sale, and trading.

The Company's securities are classified in two categories and accounted for as follows:

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

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

THE NATIONAL SECURITY GROUP, INC.

NOTES TO FINANCIAL STATEMENTS
(Continued)

Note 7-Accounting for certain investments in debt and equity securities
(continued)

The Company and its subsidiaries have no trading securities.

Unrealized holding gains and losses, net of tax, on securities available-for-sale are reported as a net amount in a separate component of shareholders' equity until realized.

Realized gains and losses on the sale of securities available-for-sale are determined using the specific-identification method.

Mortgage loans are stated at the unpaid principle balance of such loans. Investment real estate is reported at cost, less allowances for depreciation computed on the straight-line basis. Short-term Investments are carried at cost, which is approximate market value. Investments with other than temporary impairment in value are written down to estimated realizable values.

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

INTRODUCTION

The following discussion addresses the financial condition of The National Security Group, Inc. as of September 30, 1996, compared with December 31, 1995 and its results of operations and cash flows for the periods included on the accompanying consolidated condensed statements of income and cash flows. The reader is assumed to have access to the Company's 1995 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. Results for the 1996 third quarter and first nine months are not necessarily indicative of results which may be attained in the future.

Information is presented in whole dollars.

FINANCIAL CONDITION

Capital resources:

At September 30, 1996, the Company had aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of \$39.2 million, down \$577,000 from December 31, 1995. The decrease reflects net income of \$471,000 an increase in unrealized investment gains of \$138,000, dividends paid of \$1,114,000, and treasury stock purchased of \$71,000. The Company has no long term debt.

Liquidity:

The liquidity requirements of the Company are primarily met by funds provided

from operations of the life insurance and property/casualty subsidiaries. Premium and investment income, as well as maturities, calls, and sales of invested assets, provide the primary sources of cash for both subsidiaries. Cash is used by subsidiaries for payments of policy benefits, the acquisition of new business (principally commissions), operating expenses, and purchases of new investments.

The Company had \$4.7 million in cash and cash equivalents at September 30, 1996. Net cash provided by operating activities was \$1.2 million for the current period, compared to net cash provided of \$1.5 million for the period ended September 30, 1995. Cash provided by investing activities was \$1.8 million for the current period, generated primarily by the sale and maturity of investments. Cash dividends paid to stockholders of \$1.1 million are the primary use of cash used in financing activities.

Investments:

Investments decreased \$1.7 million during the first nine months of 1996. The decrease is offset by an increase in cash of \$1.9 million received primarily from stocks and bonds either sold or matured.

CONSOLIDATED RESULTS OF OPERATIONS

Premium revenues:

Earned premium for the nine month period ending September 30, 1996 was \$19.5 million versus \$18.4 million for the same period last year. The 6% increase in earned premium year to date and 20% increase for the quarter, compared to last year, is due to the property/casualty subsidiaries commercial auto program in Louisiana and private passenger auto programs in Georgia and Louisiana. The new commercial auto program is expected to produce around \$1.2 million in written premium during 1996. The property/casualty subsidiaries' new private passenger automobile programs in Georgia and Louisiana began in the first quarter of 1996, and are expected to produce around \$2 million in written premium by year end. The life insurance subsidiary's premium income is down 10% compared to last year.

Net investment income:

Net investment income is down \$80,000, a decrease of 5.9%, primarily due to maturities and calls of higher yield bond investments. However, the decline in investment income stabilized in the third quarter showing a slight increase compared to last year.

Realized capital gains and losses:

Investment gains of over \$1 million were realized in the first nine months of 1996, with most of the sales taking place in the first quarter. The Company's investment committee elected to sale select stocks from the insurance subsidiaries' portfolios following 1995's stock market run-up.

Other income:

Other income is down \$32,000 due to a decrease in policy fees.

Policyholder benefits and settlement expenses:

Policyholder benefits as a percent of net insurance premiums earned year to date were up considerably from last year, 74.9% versus 61.4%. The increase is due to a substantial increase in losses incurred by the property/casualty subsidiary's low value dwelling and homeowners insurance programs. These programs not only suffered losses from several tornadoes which hit the Southeastern United States early in the year, but also, incurred an unusually high number of fire losses due to the colder than normal winter. The percent of policy holder benefits to net insurance premiums earned improved considerably during the third quarter to 62.7% compared to 67.5% for the same period last year.

Policy acquisition cost:

Policy acquisition costs as a percent of net insurance premiums earned is unchanged from last year.

General insurance expenses:

General insurance expenses are down 17% from last year due to a decrease in litigation expenses and attorney fees in the insurance subsidiaries.

Insurance taxes, licenses, and fees:

Insurance taxes, licenses and fees are unchanged from last year at around 6% of earned premium. Premium taxes are down for the quarter because taxes for the increased premiums on new programs now being earned were booked in the first and second quarters when the new policies were first beginning to be written.

Income taxes:

Income taxes are down compared to last year because last year had a large decrease in a deferred tax asset which caused income taxes for the period to be higher.

Summary:

Net income is down nearly \$1.5 million from last year, even though revenues were up over \$470,000, primarily due to an increase in policyholder benefits of over \$3.3 million. The increase in policyholder benefits occurred as a result of

increased claims in the Company's property/casualty insurance subsidiary as explained above. Net income for the quarter was better than the third quarter of last year as claims dropped back down to a normal level. A decrease in general expenses also helped produce a third quarter profit.

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Part II. OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

See Exhibit Index

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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.

By /s/ M. L. Murdock
M.L. Murdock
Senior Vice President and
Chief Financial Officer

Dated: September 13, 1996

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EXHIBIT INDEX

Exhibit	Description	Page
(a)	11 Statement Regarding Computation of Per Share Earnings	Filed Herewith; See Note 3 to Financial
(b)	Form 8-K	None

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