

CITIZENS INC
Form 10-Q
August 06, 2012

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

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 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 August 3, 2012, the Registrant had 49,019,157 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)

	June 30, 2012 (Unaudited)	December 31, 2011 (As adjusted)
Assets		
Investments:		
Fixed maturities available-for-sale, at fair value (cost: \$513,585 and \$484,809 in 2012 and 2011, respectively)	\$551,076	514,253
Fixed maturities held-to-maturity, at amortized cost (fair value: \$194,595 and \$230,093 in 2012 and 2011, respectively)	189,821	227,500
Equity securities available-for-sale, at fair value (cost: \$45,324 and \$45,599 in 2012 and 2011, respectively)	46,409	46,137
Mortgage loans on real estate	1,535	1,557
Policy loans	41,114	39,090
Real estate held for investment (less \$1,217 and \$1,149 accumulated depreciation in 2012 and 2011, respectively)	8,565	8,539
Other long-term investments	94	105
Short-term investments	4,385	2,048
Total investments	842,999	839,229
Cash and cash equivalents	68,916	33,255
Accrued investment income	8,686	7,787
Receivable for securities in process of settlement	7,030	—
Reinsurance recoverable	9,086	9,562
Deferred policy acquisition costs	128,878	124,542
Cost of customer relationships acquired	26,560	27,945
Goodwill	17,160	17,160
Other intangible assets	892	906
Federal income tax receivable	81	901
Property and equipment, net	7,671	7,860
Due premiums, net (less \$1,631 and \$1,698 allowance for doubtful accounts in 2012 and 2011, respectively)	8,770	9,169
Prepaid expenses	1,946	396
Other assets	786	800
Total assets	\$1,129,461	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)

	June 30, 2012 (Unaudited)	December 31, 2011 (As adjusted)
Liabilities and Stockholders' Equity		
Liabilities:		
Policy liabilities:		
Future policy benefit reserves:		
Life insurance	\$ 727,436	697,502
Annuities	49,369	47,060
Accident and health	5,521	5,612
Dividend accumulations	11,377	10,601
Premiums paid in advance	27,042	25,291
Policy claims payable	9,169	10,020
Other policyholders' funds	9,009	8,760
Total policy liabilities	838,923	804,846
Commissions payable	2,493	2,851
Deferred federal income tax	15,220	13,940
Payable for securities in process of settlement	8,701	—
Warrants outstanding	378	451
Other liabilities	8,323	9,382
Total liabilities	874,038	831,470
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Class A, no par value, 100,000,000 shares authorized, 52,098,676 shares issued in 2012 and 52,089,189 shares issued in 2011, including shares in treasury of 3,135,738 in 2012 and 2011	258,616	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	(19,936	) (21,851
Accumulated other comprehensive income:		
Unrealized gains on securities, net of tax	24,570	19,172
Treasury stock, at cost	(11,011	) (11,011
Total stockholders' equity	255,423	248,042
Total liabilities and stockholders' equity	\$ 1,129,461	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 June 30,

(In thousands, except share amounts)

(Unaudited)

	2012		2011
			(As adjusted)
Revenues:			
Premiums:			
Life insurance	\$39,945		38,231
Accident and health insurance	417		396
Property insurance	1,234		1,259
Net investment income	7,612		7,503
Realized investment gains (losses), net	246		(13)
Decrease in fair value of warrants	37		816
Other income	111		104
Total revenues	49,602		48,296
Benefits and expenses:			
Insurance benefits paid or provided:			
Claims and surrenders	16,109		14,905
Increase in future policy benefit reserves	16,751		13,000
Policyholders' dividends	2,281		1,920
Total insurance benefits paid or provided	35,141		29,825
Commissions	9,731		9,930
Other general expenses	6,342		6,698
Capitalization of deferred policy acquisition costs	(7,044)		(7,364)
Amortization of deferred policy acquisition costs	4,433		4,071
Amortization of cost of customer relationships acquired	660		758
Total benefits and expenses	49,263		43,918
Income before federal income tax	339		4,378
Federal income tax expense (benefit)	(64)		1,369
Net income	403		3,009
Per Share Amounts:			
Basic earnings per share of Class A common stock	\$0.01		0.06
Basic earnings per share of Class B common stock	—		0.03
Diluted earnings per share of Class A common stock	0.01		0.04
Diluted earnings per share of Class B common stock	—		0.03
Other comprehensive income:			
Unrealized gains on available-for-sale securities:			
Unrealized holding gains arising during period	6,003		10,495
Reclassification adjustment for (gains) losses included in net income	(121)		13
Unrealized gains on available-for-sale securities, net	5,882		10,508
Income tax expense on unrealized gains on available-for-sale securities	2,063		3,678
Other comprehensive income	3,819		6,830
Comprehensive income	\$4,222		9,839
See accompanying notes to consolidated financial statements.			

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Comprehensive Income

Six Months Ended June 30,

(In thousands, except share amounts)

(Unaudited)

	2012		2011
Revenues:			(As adjusted)
Premiums:			
Life insurance	\$77,351		73,842
Accident and health insurance	830		768
Property insurance	2,511		2,504
Net investment income	15,189		14,803
Realized investment gains, net	344		6
Decrease in fair value of warrants	73		1,215
Other income	209		227
Total revenues	96,507		93,365
Benefits and expenses:			
Insurance benefits paid or provided:			
Claims and surrenders	30,863		29,784
Increase in future policy benefit reserves	30,892		25,318
Policyholders' dividends	4,155		3,582
Total insurance benefits paid or provided	65,910		58,684
Commissions	18,395		19,002
Other general expenses	12,958		13,101
Capitalization of deferred policy acquisition costs	(12,983)	)	(14,005)
Amortization of deferred policy acquisition costs	8,559		8,309
Amortization of cost of customer relationships acquired	1,236		1,405
Total benefits and expenses	94,075		86,496
Income before federal income tax	2,432		6,869
Federal income tax expense	517		2,238
Net income	1,915		4,631
Per Share Amounts:			
Basic earnings per share of Class A common stock	\$0.04		0.09
Basic earnings per share of Class B common stock	0.02		0.05
Diluted earnings per share of Class A common stock	0.04		0.07
Diluted earnings per share of Class B common stock	0.02		0.04
Other comprehensive income:			
Unrealized gains on available-for-sale securities:			
Unrealized holding gains arising during period	8,564		12,121
Reclassification adjustment for gains included in net income	(207)	)	(6)
Unrealized gains on available-for-sale securities, net	8,357		12,115
Income tax expense on unrealized gains on available-for-sale securities	2,959		4,240
Other comprehensive income	5,398		7,875
Comprehensive income	\$7,313		12,506

See accompanying notes to consolidated financial statements.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Cash Flows

Six Months Ended June 30,

(In thousands)

(Unaudited)

	2012	2011	
Cash flows from operating activities:		(As adjusted)	
Net income	\$1,915	4,631	
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Realized gains on sale of investments and other assets	(344	) (6)
Net deferred policy acquisition costs	(4,424	) (5,696)
Amortization of cost of customer relationships acquired	1,236	1,405	
Decrease in fair value of warrants	(73	) (1,215)
Depreciation	607	451	
Amortization of premiums and discounts on fixed maturities and short-term investments	2,438	2,243	
Deferred federal income tax benefit	(1,679	) (167)
Change in:			
Accrued investment income	(899	) (1,182)
Reinsurance recoverable	476	289	
Due premiums	399	548	
Future policy benefit reserves	30,685	24,942	
Other policyholders' liabilities	1,925	1,050	
Federal income tax receivable	820	1,067	
Commissions payable and other liabilities	(1,417	) 786	
Other, net	(1,515	) (1,101)
Net cash provided by operating activities	30,150	28,045	
Cash flows from investing activities:			
Sale of fixed maturities, available-for-sale	503	—	
Maturities and calls of fixed maturities, available-for-sale	105,077	61,186	
Maturities and calls of fixed maturities, held-to-maturity	115,630	27,000	
Purchase of fixed maturities, available-for-sale	(118,558	) (51,507)
Purchase of fixed maturities, held-to-maturity	(94,276	) (54,174)
Calls of equity securities, available-for-sale	420	432	
Purchase of equity securities, available-for-sale	—	(1,000)
Principal payments on mortgage loans	22	23	
Increase in policy loans, net	(2,024	) (1,334)
Sale of other long-term investments	4	3	
Purchase of other long-term investments	(94	) (17)
Purchase of property and equipment	(350	) (1,342)
Purchase of short-term investments	(2,378) —	
Net cash provided by (used in) investing activities	3,976	(20,730)

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Cash Flows, Continued

Six Months Ended June 30,

(In thousands)

(Unaudited)

	2012	2011 (As adjusted)
Cash flows from financing activities:		
Warrants exercised	\$68	17
Annuity deposits	3,425	3,162
Annuity withdrawals	(1,958	) (1,841
Net cash provided by financing activities	1,535	1,338
Net increase in cash and cash equivalents	35,661	8,653
Cash and cash equivalents at beginning of year	33,255	49,723
Cash and cash equivalents at end of period	\$68,916	58,376
Supplemental disclosures of operating activities:		
Cash paid during the period for income taxes, net	\$1,377	1,338

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
June 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 June 30, 2012, the consolidated statements of comprehensive income for the three and six-month periods ended June 30, 2012 and 2011, and the consolidated statements of cash flows for the six-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 June 30, 2012 and for comparative periods have been made. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States 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 by accounting principles generally accepted in the United States 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 three and six month periods ending June 30, 2012 that relate to prior reporting periods in the amount of \$0.4 million and \$0.5 million, respectively, 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 \$0.2 million and \$0.3 million, net of tax, for the three and six 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.

Although the DAC and Benefit Reserves adjustments are material to the three and six months periods ending June 30, 2012, they are not expected to be material to the year ended December 31, 2012, nor are they material to any year preceding December 31, 2012.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Financial Statements, Continued

June 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 the 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 Financial Statements, Continued

June 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 Reported	Impact of Change in Accounting Principle	As 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 June 30, 2011:			
Capitalization of deferred policy acquisition costs	\$(7,884)	520	(7,364)
Amortization of deferred policy acquisition costs	4,229	(158)	4,071
Federal income tax expense	1,497	(128)	1,369
Net income	3,243	(234)	3,009
Per share of Class A common stock:			
Basic earnings per share	0.07	(0.01)	0.06
Diluted earnings per share	0.07	(0.03)	0.04
Six months ended June 30, 2011:			
Capitalization of deferred policy acquisition costs	\$(15,049)	1,044	(14,005)
Amortization of deferred policy acquisition costs	8,749	(440)	8,309
Federal income tax expense	2,450	(212)	2,238
Net income	5,023	(392)	4,631
Per share of Class A common stock:			
Basic earnings per share	0.10	(0.01)	0.09
Diluted earnings per share	0.08	(0.01)	0.07

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.

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 Financial Statements, Continued

June 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 June 30, 2012			
	Life Insurance	Home Service Insurance	Other Non-Insurance Enterprises	Consolidated
	(In thousands)			
Revenues:				
Premiums	\$30,601	10,995	—	41,596
Net investment income	4,253	3,075	284	7,612
Realized investment gains, net	187	40	19	246
Decrease in fair value of warrants	—	—	37	37
Other income	75	6	30	111
Total revenue	35,116	14,116	370	49,602
Benefits and expenses:				
Insurance benefits paid or provided:				
Claims and surrenders	10,772	5,337	—	16,109
Increase in future policy benefit reserves	16,201	550	—	16,751
Policyholders' dividends	2,268	13	—	2,281
Total insurance benefits paid or provided	29,241	5,900	—	35,141
Commissions	5,990	3,741	—	9,731
Other general expenses	2,411	3,006	925	6,342
Capitalization of deferred policy acquisition costs	(5,507)	(1,537)	—	(7,044)
Amortization of deferred policy acquisition costs	3,749	684	—	4,433
Amortization of cost of customer relationships acquired	184	476	—	660
Total benefits and expenses	36,068	12,270	925	49,263
Income (loss) before income tax expense	\$(952)	1,846	(555)	339

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Financial Statements, Continued

June 30, 2012

(Unaudited)

	Six Months Ended June 30, 2012			
	Life Insurance	Home Service Insurance	Other Non-Insurance Enterprises	Consolidated
	(In thousands)			
Revenues:				
Premiums	\$58,770	21,922	—	80,692
Net investment income	8,411	6,230	548	15,189
Realized investment gains, net	189	127	28	344
Decrease in fair value of warrants	—	—	73	73
Other income	132	12	65	209
Total revenue	67,502	28,291	714	96,507
Benefits and expenses:				
Insurance benefits paid or provided:				
Claims and surrenders	20,699	10,164	—	30,863
Increase in future policy benefit reserves	29,419	1,473	—	30,892
Policyholders' dividends	4,130	25	—	4,155
Total insurance benefits paid or provided	54,248	11,662	—	65,910
Commissions	11,012	7,383	—	18,395
Other general expenses	5,331	5,970	1,657	12,958
Capitalization of deferred policy acquisition costs	(10,019)	) (2,964	) —	(12,983)
Amortization of deferred policy acquisition costs	7,400	1,159	—	8,559
Amortization of cost of customer relationships acquired	393	843	—	1,236
Total benefits and expenses	68,365	24,053	1,657	94,075
Income (loss) before income tax expense	\$(863)) 4,238	(943)) 2,432

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Financial Statements, Continued

June 30, 2012

(Unaudited)

	Three Months Ended June 30, 2011			
	Life Insurance	Home Service Insurance	Other Non-Insurance Enterprises	Consolidated
	(In thousands)			
Revenues:				
Premiums	\$29,016	10,870	—	39,886
Net investment income	4,058	3,275	170	7,503
Realized investment gains (losses), net	4	(17	) —	(13
Decrease in fair value of warrants	—	—	816	816
Other income	77	6	21	104
Total revenue	33,155	14,134	1,007	48,296
Benefits and expenses:				
Insurance benefits paid or provided:				
Claims and surrenders	10,456	4,449	—	14,905
Increase in future policy benefit reserves	12,015	985	—	13,000
Policyholders' dividends	1,901	19	—	1,920
Total insurance benefits paid or provided	24,372	5,453	—	29,825
Commissions	6,058	3,872	—	9,930
Other general expenses	2,885	3,066	747	6,698
Capitalization of deferred policy acquisition costs	(5,672	) (1,692	) —	(7,364
Amortization of deferred policy acquisition costs	3,660	411	—	4,071
Amortization of cost of customer relationships acquired	283	475	—	758
Total benefits and expenses	31,586	11,585	747	43,918
Income before income tax expense	\$1,569	2,549	260	4,378

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Financial Statements, Continued

June 30, 2012

(Unaudited)

	Six Months Ended June 30, 2011			Consolidated
	Life Insurance	Home Service Insurance	Other Non-Insurance Enterprises	
	(In thousands)			
Revenues:				
Premiums	\$55,536	21,578	—	77,114
Net investment income	7,925	6,512	366	14,803
Realized investment gains, net	4	2	—	6
Decrease in fair value of warrants	—	—	1,215	1,215
Other income	164	14	49	227
Total revenue	63,629	28,106	1,630	93,365
Benefits and expenses:				
Insurance benefits paid or provided:				
Claims and surrenders	19,857	9,927	—	29,784
Increase in future policy benefit reserves	23,824	1,494	—	25,318
Policyholders' dividends	3,544	38	—	3,582
Total insurance benefits paid or provided	47,225	11,459	—	58,684
Commissions	11,400	7,602	—	19,002
Other general expenses	5,739	6,041	1,321	13,101
Capitalization of deferred policy acquisition costs	(10,737)	(3,268)	—	(14,005)
Amortization of deferred policy acquisition costs	7,312	997	—	8,309
Amortization of cost of customer relationships acquired	499	906	—	1,405
Total benefits and expenses	61,438	23,737	1,321	86,496
Income before income tax expense	\$2,191	4,369	309	6,869

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Financial Statements, Continued

June 30, 2012

(Unaudited)

(4) Earnings Per Share

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

	Three Months Ended	
	June 30, 2012	June 30, 2011
	(In thousands, except per share amounts)	
Basic and diluted earnings per share:		
Numerator:		
Net income	\$403	3,009
Net income allocated to Class A common stock	\$399	2,978
Net income allocated to Class B common stock	4	31
Net income	\$403	3,009
Denominator:		
Weighted average shares of Class A outstanding - basic	48,963	48,689
Weighted average shares of Class A outstanding - diluted	48,989	48,690
Weighted average shares of Class B outstanding - basic and diluted	1,002	1,002
Basic earnings per share of Class A common stock	\$0.01	0.06
Basic earnings per share of Class B common stock	—	0.03
Diluted earnings per share of Class A common stock	0.01	0.04
Diluted earnings per share of Class B common stock	—	0.03

	Six Months Ended	
	June 30, 2012	June 30, 2011
	(In thousands, except per share amounts)	
Basic and diluted earnings per share:		
Numerator:		
Net income	\$1,915	4,631
Net income allocated to Class A common stock	\$1,895	4,584
Net income allocated to Class B common stock	20	47
Net income	\$1,915	4,631
Denominator:		
Weighted average shares of Class A outstanding - basic	48,961	48,688
Weighted average shares of Class A outstanding - diluted	48,997	48,704
Weighted average shares of Class B outstanding - basic and diluted	1,002	1,002
Basic earnings per share of Class A common stock	\$0.04	0.09
Basic earnings per share of Class B common stock	0.02	0.05
Diluted earnings per share of Class A common stock	0.04	0.07
Diluted earnings per share of Class B common stock	0.02	0.04

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 six months ended June 30, 2012.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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(Unaudited)

(5) Investments

The Company invests primarily in fixed maturity securities, which totaled 81.2% of total investments and cash and cash equivalents at June 30, 2012.

	June 30, 2012		December 31, 2011		
	Carrying Value	% of Total Carrying Value	Carrying Value	% of Total Carrying Value	
	(In thousands)		(In thousands)		
Fixed maturity securities	\$740,897	81.2 %	\$741,753	85.0 %	
Equity securities	46,409	5.1 %	46,137	5.3 %	
Mortgage loans	1,535	0.2 %	1,557	0.2 %	
Policy loans	41,114	4.5 %	39,090	4.5 %	
Real estate and other long-term investments	8,659	0.9 %	8,644	1.0 %	
Short-term investments	4,385	0.5 %	2,048	0.2 %	
Cash and cash equivalents	68,916	7.6 %	33,255	3.8 %	
Total cash, cash equivalents and investments	\$911,915	100.0 %	\$872,484	100.0 %	

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.

	June 30, 2012			
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
Fixed maturities:				
Fixed maturities available-for-sale:				
U.S. Treasury securities	\$10,198	3,949	—	14,147
U.S. Government-sponsored enterprises	91,422	3,600	16	95,006
States and political subdivisions	192,446	14,558	937	206,067
Foreign governments	105	38	—	143
Corporate	212,140	17,206	1,438	227,908
Commercial mortgage-backed	610	22	1	631
Residential mortgage-backed	6,664	517	7	7,174
Total available-for-sale securities	513,585	39,890	2,399	551,076
Held-to-maturity securities:				
U.S. Government-sponsored enterprises	79,401	622	24	79,999
States and political subdivisions	77,373	3,964	111	81,226
Corporate	33,047	404	81	33,370
Total held-to-maturity securities	189,821	4,990	216	194,595
Total fixed maturities	\$703,406	44,880	2,615	745,671
Equity securities:				
Stock mutual funds	\$12,686	624	284	13,026
Bond mutual funds	31,504	256	49	31,711
Common stock	17	—	—	17

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Preferred stock	1,117	538	—	1,655
Total equity securities	\$45,324	1,418	333	46,409

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(Unaudited)

	December 31, 2011			
	Cost or Amortized Cost (In thousands)	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
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 June 30, 2012, the Company had \$7.3 million of mortgage-backed security holdings based on amortized cost, of which \$6.7 million, or 91.8%, 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

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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June 30, 2012

(Unaudited)

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 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 six months ended June 30, 2012 and 2011.

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(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.

	June 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	\$19,217	16	11	—	—	—	19,217	16	11
States and political subdivisions	36,039	328	40	6,510	609	3	42,549	937	43
Corporate	46,647	620	33	6,445	818	5	53,092	1,438	38
Commercial mortgage-backed	189	1	1	—	—	—	189	1	1
Residential mortgage-backed	493	4	1	62	3	2	555	7	3
Total available-for-sale securities	102,585	969	86	13,017	1,430	10	115,602	2,399	96
Held-to-maturity securities:									
U.S.									
Government-sponsored enterprises	12,281	19	8	1,110	5	1	13,391	24	9
States and political subdivisions	15,045	111	14	—	—	—	15,045	111	14
Corporate	15,087	81	11	—	—	—	15,087	81	11
Total held-to-maturity securities	42,413	211	33	1,110	5	1	43,523	216	34
Total fixed maturities	\$144,998	1,180	119	14,127	1,435	11	159,125	2,615	130
Equity securities:									
Stock mutual funds	\$7,250	284	2	—	—	—	7,250	284	2
Bond mutual funds	6,375	49	3	—	—	—	6,375	49	3
Total equities	\$13,625	333	5	—	—	—	13,625	333	5

As of June 30, 2012, the Company had 10 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

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June 30, 2012

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	December 31, 2011								
	Less than 12 months		Greater than 12 months	Total		Unrealized # of			
	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
Commercial mortgage-backed	—	—	—	—	—	—	—	—	—
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 June 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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(Unaudited)

The amortized cost and fair value of fixed maturity securities at June 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.

	June 30, 2012	
	Amortized Cost	Fair Value
	(In thousands)	
Available-for-sale securities:		
Due in one year or less	\$ 13,230	13,421
Due after one year through five years	69,249	71,870
Due after five years through ten years	118,898	125,391
Due after ten years	304,934	332,589
Securities not due at a single maturity date	7,274	7,805
Total available-for-sale securities	513,585	551,076
Held-to-maturity securities:		
Due in one year or less	7,004	7,018
Due after one year through five years	31,308	31,297
Due after five years through ten years	38,895	40,970
Due after ten years	112,614	115,310
Total held-to-maturity securities	189,821	194,595
Total fixed maturities	\$ 703,406	745,671

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 six months ended June 30, 2012 and 2011 are summarized as follows.

	Fixed Maturities Available-for-Sale				Equity Securities			
	Three Months Ended		Six Months Ended		Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
	(In thousands)							
Proceeds	\$—	—	503	—	—	—	—	—
Gross realized gains	\$—	—	4	—	—	—	—	—
Gross realized losses	\$—	—	3	—	—	—	—	—

During the six months ended June 30, 2012, one security was sold which resulted in a realized loss. There were no securities sold at a loss during the three months ended June 30, 2012. There were no securities sold from the held-to-maturity portfolio for the six months ended June 30, 2012 and 2011.

(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.

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(Unaudited)

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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June 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	June 30, 2012			Total Fair Value
	Level 1	Level 2	Level 3	
	(In thousands)			
Financial assets:				
Fixed maturities:				
U.S. Treasury and U.S. Government-sponsored enterprises	\$ 14,147	95,006	—	109,153
States and political subdivisions	—	206,067	—	206,067
Corporate	—	227,908	—	227,908
Commercial mortgage-backed	—	—	426	426
Residential mortgage-backed	—	7,379	—	7,379
Foreign governments	—	143	—	143
Total fixed maturities	14,147	536,503	426	551,076
Equity securities:				
Stock mutual funds	13,026	—	—	13,026
Bond mutual funds	31,711	—	—	31,711
Common stock	17	—	—	17
Preferred stock	1,655	—	—	1,655
Total equity securities	46,409	—	—	46,409
Total financial assets	\$ 60,556	536,503	426	597,485
Financial liabilities:				
Warrants outstanding	\$—	378	—	378

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Available-for-sale investments	December 31, 2011			Total 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 June 30, 2012, our fixed maturity securities, valued using a third-party pricing source, totaled \$536.5 million for Level 2 assets and comprised 89.8% 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 six months ended June 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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June 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.

	June 30, 2012 (In thousands)	December 31, 2011
Balance at beginning of period	\$459	519
Total realized and unrealized gains (losses)		
Included in net income	—	—
Included in other comprehensive income	(1	) 6
Principal paydowns	(32	) (66
Transfer in and (out) of Level 3	—	—
Balance at end of period	\$426	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.

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:

	June 30, 2012		December 31, 2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
	(In thousands)			
Financial assets:				
Fixed maturities, held-to-maturity	\$189,821	194,595	227,500	230,093
Mortgage loans	1,535	1,349	1,557	1,428
Policy loans	41,114	41,114	39,090	39,090
Short-term investments	4,385	4,385	2,048	2,048
Cash and cash equivalents	68,916	68,916	33,255	33,255
Financial liabilities:				
Annuities	49,369	50,932	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% per year as of June 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 June 30, 2012. Our mortgage loans are

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Financial Statements, Continued

June 30, 2012

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considered Level 3 assets in the fair value hierarchy.

Policy loans had a weighted average annual interest rate of 7.7% as of June 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 June 30, 2012 using discounted cash flows with an interest rate 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 is 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 ("District Court"). 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. SPFIC had moved to dismiss the complaint on the grounds that the State had no standing to bring the lawsuit as an assignee of insureds because of anti-assignment language in the underlying insurance policies. Now, however, due to a ruling by the Louisiana Supreme Court, SPFIC will not pursue a motion to dismiss, but will preserve the anti-assignment issue in a defense.

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

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Financial Statements, Continued

June 30, 2012

(Unaudited)

matter. SPFIC believes its adjusting practices in connection with Katrina homeowners claims were sound and in accordance with industry standards and state law. There remain significant questions of Louisiana law that have yet to be decided. 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 and 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.

(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.

There are outstanding warrants to purchase the Company's stock at prices ranging from \$6.72 to \$7.93, which were issued to investors of the Series A-2 Preferred. These warrants will expire this year unless exercised. On July 5, 2012, the 56,219 warrants due to expire on July 12, 2012 were exercised and the Company received approximately \$378,000 in cash.

As of 6/30/2012

Warrants Outstanding	Expiration Date	Exercise Price	Fair Value (In thousands)
56,219	7/12/2012	\$6.72	\$170
51,657	9/30/2012	7.93	102
52,121	10/6/2012	7.86	106
159,997			\$378

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 \$378 thousand and \$451 thousand at June 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 (18.9)% and 31.3% for the second quarter of 2012 and 2011, respectively and 21.3% and 32.6% for the six months ended June 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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(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 six months ended June 30, 2012. See our Annual Report on Form 10-K as of December 31, 2011 for a comprehensive discussion of these transactions.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 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;
- Our success at managing risks involved in the foregoing;
- 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
- 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."

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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

June 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 June 30, 2012, we had approximately \$1 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 six-month periods ended June 30, 2012 compared to the same period in 2011 were:

Insurance premiums rose 4.3% and 4.6% for the three and six month period to \$41.6 million and \$80.7 million in 2012 from \$39.9 million and \$77.1 million in 2011, primarily from renewal premiums in our life insurance segment. Net investment income increased 1.5% and 2.6%. The average yield on the consolidated portfolio was 3.77% for the quarter ended in 2012 compared to 3.92% at December 31, 2011. For the six month period, the increase in the invested assets due to premium revenue growth offset the decrease in yield.

Claims and surrenders expense increased 8.1% and 3.6% for the three and six months ended 2012 as we experienced higher claims activity in the current year compared to 2011.

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 the prior years. As well as, the fact that policyholder persistency for the periods in 2012 is higher than assumed which results in more reserves in the life segment compared to the prior year periods.

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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.

	Six Months Ended June 30, 2012			2011		
	Amount of Insurance Issued	Number of Policies Issued	Average Policy Face Amount Issued	Amount of Insurance Issued	Number of Policies Issued	Average Policy Face Amount Issued
Life	\$150,810,098	2,669	\$56,504	\$181,852,410	2,765	\$65,769
Home Service	107,567,079	15,390	6,989	106,882,545	14,726	7,258

Note: All discussions below compare or state results for the three and six-month periods ended June 30, 2012 compared to the three and six-month periods ended June 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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Revenues

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