

CITIZENS INC  
Form 10-K  
March 12, 2013

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

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2012

Commission File Number: 000-16509

CITIZENS, INC.  
(Exact name of registrant as specified in its charter)

Colorado 84-0755371  
(State or other jurisdiction of incorporation or (I.R.S. Employer Identification No.)  
organization)

400 East Anderson Lane, Austin, TX 78752  
(Address of principal executive offices) (Zip Code)  
(512) 837-7100  
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class  | Name of Each Exchange on Which Registered |
|----------------------|---|
| Class A Common Stock | New York Stock Exchange                   |

Securities registered pursuant to Section 12(g) of the Act:

None

(Title of class)

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.  Yes  No

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 requirement for the past 90 days.  Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 or Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K).

Indicate by check mark whether the registrant is a large accelerated file, an accelerated filer, a non-accelerated filer or a smaller reporting company.

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 Act).  Yes  No

As of June 30, 2012, the aggregate market value of the Class A common stock held by non-affiliates of the registrant was approximately \$512,940,061.

Number of shares of common stock outstanding as of March 4, 2013.

Class A: 49,080,114

Class B: 1,001,714

DOCUMENTS INCORPORATED BY REFERENCE

Part III of this Report incorporates by reference certain portions of the definitive proxy materials to be delivered to stockholders in connection with the 2013 Annual Meeting of Shareholders.

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## FORWARD-LOOKING STATEMENTS

Certain statements contained in this Annual Report on Form 10-K 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 or regulatory oversight, 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 the Company's products;
  - The performance of our investment portfolio, which may be adversely affected by changes in interest rates, adverse developments and ratings of issuers whose debt securities we may hold, and other adverse macroeconomic events;
  - Results of litigation we may be involved in;
  - Changes in assumptions related to deferred acquisition costs and the value of any businesses we may acquire;
  - Regulatory, accounting or tax changes that may affect the cost of, or the demand for, the Company's products or services;
  - Our concentration of business from persons residing in Latin America and the Pacific Rim;
  - Changes in tax laws;
  - Effects of acquisitions and restructuring, including possible difficulties in integrating and realizing the projected results of acquisitions; and
  - Changes in statutory or U.S. GAAP accounting principles, policies or practices.
- Our success at managing risks involved in the foregoing;

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 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 Annual Report on Form 10-K.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

PART I

Item 1. BUSINESS

Overview

Citizens, Inc. ("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. We had approximately \$1.2 billion of assets at December 31, 2012 and approximately \$5.0 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, located 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, Mississippi and Arkansas 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 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 serving our policyholders.

Our business has grown, both internationally and domestically, in recent years. Revenues rose from \$145.8 million in 2008 to \$202.8 million in 2012. During the five years ended December 31, 2012, our assets grew from \$822.3 million to \$1.2 billion. Total stockholders' equity increased from \$172.7 million at December 31, 2008 to \$263.1 million at December 31, 2012. See Item 6. "Selected Financial Data" in this Report.

The following pages describe the operations of our three business segments: Life Insurance, Home Service and Other Non-Insurance Enterprises. Revenues derived from any single customer did not exceed 10% of consolidated revenues in any of the last three years.

Life Insurance

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

International Sales

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

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



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persistence experience and mortality rates that are comparable to our U.S. policies.

We have implemented several policies and procedures to reduce the risks of asset and premium loss relating to our international business. Approvals for policy issuance are made in our Austin, Texas office and policies are issued and delivered to our independent consultants, who deliver the policies to the insureds. We have no offices, employees or assets outside of the United States. Insurance policy applications and premium payments are submitted by the independent consultants or customers to us and we review the applications in our home offices in Austin, Texas. Premiums are paid in U.S. Dollars through a U.S. financial institution by check, wire or credit card. The policies we issue contain limitations on benefits for certain causes of death, such as homicide and careless driving. We have also developed disciplined underwriting criteria, which include medical reviews of applicants as well as background and reference checks. In addition, we have a claims policy that requires investigation of substantially all death claims. Furthermore, we perform background reviews and reference checks of prospective marketing firms and consultants.

Independent marketing firms and consultants specialize in marketing life insurance products and generally have several years of insurance marketing experience. We maintain standard contracts with the independent marketing firms pursuant to which they provide recruitment, training and supervision of their managers and associates in the service and placement of our products; however, all associates of these firms also contract directly with us as independent contractors and receive their compensation directly from us. Accordingly, should an arrangement between any independent marketing firm and us be terminated for any reason, we believe we would continue with the existing marketing arrangements with the associates of these firms without a material loss of sales. Our standard agreement with independent marketing firms and consultants provides they are independent contractors responsible for their own operation expenses, and that they are the representative of the prospective insured. In addition, the marketing firms guarantee any debts of their associates to us. The marketing firms receive commissions on all new and renewal policies serviced or placed by them or their associates. All of these contracts provide that the independent marketing firms and consultants are aware of and responsible for compliance with local laws.

International Products

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

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

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

## International Competition

The life insurance business is highly competitive. We compete with a large number of stock and mutual life companies internationally and domestically, as well as with financial institutions that offer insurance products. There are more than 1,000 life insurance companies in the United States, some of which also provide insurance to foreign residents.

We face competition primarily from companies formed and operated in the country in which the insureds reside, from companies that operate in the same manner as we do and from companies that are foreign to the countries in which policies are sold, but issue insurance policies denominated in the local currency of those countries. A substantial number of companies may be deemed to have a competitive advantage over us due to their significantly greater financial resources, histories of successful operations and larger marketing forces. However, we believe that our experience, combined with our product portfolio features, allows us to compete effectively in pursuing new business.

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Because premiums on our international policies are paid in U.S. Dollars drawn on U.S. financial institutions, and we pay claims and benefits in U.S. Dollars, we provide a product that is different from the products offered by foreign-domiciled companies. Our international policies are usually acquired by individuals with significant net worth and earnings that place them in the top income brackets of their respective countries. The policies sold by our foreign competitors are generally offered broadly and are priced using the mortality of the entire population of the geographic region. Our mortality charges are therefore typically lower, which provides a competitive advantage. Additionally, the assets backing the reserves for our foreign competitors' policies must be substantially invested in their respective countries and, therefore, are exposed to the inflationary risks and social or economic crises that have been more common in these foreign countries.

Domestic Sales

The majority of our inforce business results from blocks of business of insurance companies we have acquired over the past 15 years. Our acquisition transition strategy focuses on the introduction of our cash accumulation ordinary whole life products to independent marketing consultants associated with companies we have acquired, while continuing to service the needs of acquired policyholders.

In the Midwest and the southern United States, we seek to serve middle income households through the sale of cash accumulation ordinary whole life insurance products. Our distribution strategy is through marketing consultants, comprised primarily of part-time, second-career sales associates (such as teachers, coaches, community leaders and others) in rural and urban areas. Over the past few years, new product sales have remained flat while existing policies have been running off at a greater pace resulting in compressing the block of insurance in force.

Domestic Products

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

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

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

Domestic Competition

The U.S. life insurance industry is a mature industry that, in recent years, has experienced little to no growth. Competition is intense because the life insurance industry is consolidating, with larger, more efficient and more effective organizations emerging from consolidation.

Many domestic life insurance companies have significantly greater financial, marketing forces and other resources, longer business histories and more diversified lines of insurance products than we do. We also face competition from companies marketing in person as well as with direct mail and Internet sales campaigns. Although we may be at a competitive disadvantage to these entities, we believe our premium rates and policy features are generally competitive with those of other life insurance companies selling similar types of ordinary whole life insurance.

#### Home Service Insurance

Our Home Service segment operates in this market through our subsidiaries Security Plan Life Insurance Company ("SPLIC") and Security Plan Fire Insurance Company ("SPFIC"), and focus on the life insurance needs of the middle and lower income markets, primarily in Louisiana, Mississippi and Arkansas. Our policies are sold and serviced through a home service marketing distribution system of approximately 320 employee-agents who work on a route system and through over 230 funeral homes and

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### CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

independent agents to sell policies, collect premiums and service policyholders. To a lesser extent, our Home Service segment sells limited-liability, named peril property policies covering dwelling and contents.

#### Home Service Products and Competition

Our home service insurance products consist primarily of small face amount ordinary whole life and pre-need policies, which are designed to fund final expenses for the insured, primarily consisting of funeral and burial costs. The average life insurance policy face amount issued was approximately \$6,600 in 2012; therefore, the underwriting performed on these applications is limited. Our property coverages are limited to \$30,000 maximum coverage on any one dwelling and contents, while content-only coverage and dwelling-only coverage is limited to \$20,000. We face competition in Louisiana, Mississippi and Arkansas from other companies specializing in home service distribution of insurance. We seek to compete based upon our emphasis on personal service to our customers. We intend to continue premium growth within this segment via direct sales and acquisitions.

#### Other Non-Insurance Enterprises

Other Non-insurance Enterprises includes Computing Technology, Inc., which provides data processing services to the Company, and Insurance Investors, Inc., which provides aviation transportation to the Company. This segment also includes the results of Citizens, Inc., the parent Company.

#### Operations and Technology

Our administrative operations primarily serve our life insurance segment and are conducted primarily at our executive offices in Austin, Texas through approximately 115 administrative, operating and underwriting personnel. Our Home Service operations are conducted to a large degree from our district offices in Louisiana, Arkansas and Mississippi, as well as our support center in Donaldsonville, Louisiana through approximately 67 operations personnel. At our executive offices, we also perform policy design, marketing oversight, underwriting, accounting and reporting, customer service, administration and investing activities.

Our senior management has significant experience in insurance company application system design and implementation. Since the mid-1960's, our senior management has been leading development of evolving insurance applications. We have a single integrated system for our entire Company, which is a centrally-controlled, mainframe-based administrative system. Functions of our administrative system include policy set up, administration, billing and collections, commission calculation, valuation, automated internal audit functions, storage backup, image management and other related functions. Each company we acquire is ultimately converted onto our administrative system. This system has been in place for many years, and we believe it is a significant asset to us. We update our administrative system on an ongoing basis. This system is also capable of significant expansion without substantial capital outlay or increase in staff. Therefore, we believe we can achieve additional growth without costly administrative system expenditures, delays, failures or the addition of substantial staffing.

#### Regulation

Our U.S. insurance operations are subject to a wide variety of laws and regulations. State insurance laws establish supervisory agencies with broad regulatory authority to regulate most aspects of our U.S. insurance businesses, and our insurance subsidiaries are regulated by the insurance departments of each state in which they are licensed. In addition, U.S. laws, such as the USA Patriot Act of 2001, the Foreign Corrupt Practices Act ("FCPA"), the Gramm-Leach-Bliley Act of 1999, the International Money Laundering Abatement and Financial Anti-Terrorism Act

of 2001, the Sarbanes-Oxley Act of 2002 and the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Dodd-Frank Act"), are examples of U.S. regulation that affect our business. We are subject to comprehensive regulations under the USA Patriot Act with respect to money laundering, as well as federal regulations regarding privacy and confidentiality. Our insurance products and thus our businesses also are affected by U.S. federal, state and local tax laws. The Dodd-Frank Act focuses on financial reform and may result in significant changes to the regulation of institutions operating in the financial services industry, including the Company. Legislative or regulatory requirements imposed by or promulgated in connection with this Act may make it more expensive for the Company to conduct its business, may have a material adverse effect on the overall business climate and could materially affect the profitability of the results of operations and financial condition of financial institutions. The Company is uncertain as to all of the impacts this new legislation will have and cannot provide assurance it will not adversely affect its results of operations and financial condition. In general, government regulation at the federal level may increase and may result in unpredictable consequences for the Company. In addition, other federal laws and regulations apply to us in areas such as pension regulations, privacy, tort reform and taxation.

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The purpose of the laws and regulations that affect our insurance business is primarily to protect our insureds and not our stockholders. Many of the laws and regulations to which we are subject are regularly re-examined, and existing or future laws and regulations may become more restrictive or otherwise adversely affect our operations. In addition, insurance regulatory authorities (including state law enforcement agencies and attorneys general) periodically make inquiries and regularly conduct examinations regarding compliance by us and our subsidiaries with insurance, and other laws and regulations regarding the conduct of our insurance businesses. We cooperate with such inquiries and examinations and take corrective action when warranted.

Our insurance subsidiaries are collectively licensed to transact business in 32 states. We have insurance subsidiaries domiciled in the states of Colorado, Louisiana and Texas. Our U.S. insurance subsidiaries are licensed and regulated in all U.S. jurisdictions in which they conduct insurance business. The extent of this regulation varies, but most jurisdictions have laws and regulations based upon the National Association of Insurance Commissioners ("NAIC") model rules governing the financial condition of insurers, including standards of solvency, types and concentration of investments, establishment and maintenance of reserves, credit for reinsurance and requirements of capital adequacy, and the business conduct of insurers, including marketing and sales practices and claims handling. In addition, statutes and regulations usually require the licensing of insurers and their agents, the approval of policy forms and related materials and the approval of rates for certain types of insurance products.

All U.S. jurisdictions in which our U.S. insurance subsidiaries conduct insurance business have enacted legislation that requires each U.S. insurance company in a holding company system, except captive insurance companies, to register with the insurance regulatory authority of its jurisdiction of domicile and to furnish that regulatory authority financial and other information concerning the operations of, and the interrelationships and transactions among, companies within its holding company system that may materially affect the operations, management or financial condition of the insurers within the system. These laws and regulations also regulate transactions between insurance companies and their parents and affiliates. Generally, these laws and regulations require that all transactions within a holding company system between an insurer and its affiliates be fair and reasonable and that the insurer's statutory capital and surplus following any transaction with an affiliate be both reasonable in relation to its outstanding liabilities and adequate to its financial needs. Statutory surplus is the excess of admitted assets over the sum of statutory liabilities and capital. For certain types of agreements and transactions between an insurer and its affiliates, these laws and regulations require prior notification to, and non-disapproval or approval by, the insurance regulatory authority of the insurer's jurisdiction of domicile.

The payment of dividends or other distributions to us by our insurance subsidiaries is regulated by the insurance laws and regulations of their respective states of domicile. The laws and regulations of some of these jurisdictions also prohibit an insurer from declaring or paying a dividend except out of its earned surplus or require the insurer to obtain regulatory approval before it may do so. In addition, insurance regulators may prohibit the payment of ordinary dividends or other payments by our insurance subsidiaries to us (such as a payment under a tax sharing agreement or for employee or other services) if they determine such payment could be adverse to policyholders or insurance contract holders of the subsidiary.

The laws and regulations of the jurisdictions in which our U.S. insurance subsidiaries are domiciled require that a controlling party obtain the approval of the insurance commissioner of the insurance company's jurisdiction of domicile prior to acquiring control of the insurer and may delay, deter or prevent a transaction our shareholders might consider desirable.

Risk-based capital ("RBC") requirements are imposed on life and property and casualty insurance companies. The NAIC has established minimum capital requirements in the form of RBC. RBC factors the type of business written by

an insurance company, the quality of its assets, and various other aspects of an insurance company's business to develop a minimum level of capital called "authorized control level risk-based capital" and compares this level to adjusted statutory capital that includes capital and surplus as reported under statutory accounting principles, plus certain investment reserves. Should the ratio of adjusted statutory capital to control level risk-based capital fall below 200%, a series of actions by the affected company would begin.

#### Potential Changes in Regulation

Government actions in response to the recent financial crisis and market volatility could significantly impact our current regulations. As part of a comprehensive reform of financial services regulation known as the Dodd-Frank Act, Congress established an office within the federal government to collect information about the insurance industry, recommend standards, and represent the United States in dealing with foreign insurance regulators.



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Item 1A. RISK FACTORS

Investing in our Company involves certain risks. Set forth below are certain risks with respect to our Company. Readers should carefully review these risks, together with the other information contained in this report. The risks and uncertainties we have described in this report are not the only ones we face. Additional risks and uncertainties not presently known to us, or that we currently deem not material, may also adversely affect our business. Any of the risks discussed in this report or that are presently unknown or not material, if they were to actually occur, could result in a significant adverse impact on our business, operating results, prospects or financial condition. References in the risk factors below to "we," "us," "our," "Citizens" and like terms relate to Citizens, Inc. and its subsidiaries on a U.S. GAAP consolidated financial statement basis, unless specifically identified otherwise. We operate our subsidiaries as separate and distinct entities with respect to corporate formalities.

Risks Relating to Our Business

A substantial amount of our revenue comes from foreign residents and is subject to risks associated with foreign insurance laws, political instability and asset transfer restrictions.

A substantial part of our insurance policy sales are from foreign countries, primarily those in Latin America and the Pacific Rim. There is a risk that we may lose a significant portion of these sales should adverse events occur in these countries. We seek to address this risk by, among other things, not accepting insurance applications outside of the U.S., maintaining all of our assets in the U.S. and requiring policy premiums be paid to us in U.S. Dollars drawn on U.S. financial institutions. Accordingly, we have never qualified to do business in any foreign country and have never submitted our insurance policies issued to foreign residents for approval by any foreign or domestic insurance regulatory agency. We sell our policies to foreign residents using foreign independent marketing firms and independent consultants, and we rely on those persons to comply with applicable laws in marketing our insurance products.

The government of a foreign country could determine its residents may not buy life insurance from us unless we became qualified to do business in that country or unless our policies purchased by its residents receive prior approval from its insurance regulators. Also, new laws or regulations could be implemented or new applications of existing laws or regulations could occur, which could result in the cessation of marketing activities by our independent marketing firms and consultants. From time to time we have become aware of new foreign laws, regulations or new interpretations of foreign laws or regulations that may have an adverse effect on the marketing efforts of our foreign independent marketing firms and consultants. We cannot assure you any of these laws, regulations, or application of them by foreign regulatory authorities will not have an adverse effect on the marketing efforts of our independent marketing firms and consultants and, in turn, on our revenues. Further, there is no assurance we would be able to qualify to do business in any foreign country or that its insurance regulatory authorities would approve our policies if we decided to submit our insurance policies for approval. We could also face sanctions, including fines and penalties, if a country's authorities determined any failure to qualify or otherwise comply with its laws was willful or ongoing. Any of the foregoing could reduce our revenues and materially adversely affect our results of operations and financial condition. Additionally, we do not determine whether our independent consultants are required to be licensed to sell insurance in the countries in which they market our policies. If our independent consultants were not in compliance with applicable laws, including licensing laws, they could be required to cease operations, which would reduce our revenues. We have not obtained any advice of counsel in any foreign jurisdictions with respect to these matters. We are unable to quantify the effect of foreign regulation on our business if regulation were to be imposed on us, but we believe we could expend substantial amounts of time and incur substantial expense in complying with any foreign regulation, and we may decide to withdraw from or avoid a market if foreign regulation were imposed.

Additionally, if economic or political crises were to occur in any of the countries where our foreign policyowners reside, our revenues could be adversely affected. Also, currency control laws, regulations and decrees in foreign countries, if implemented, could materially adversely affect our revenues by imposing restrictions on asset transfers outside of a country where our insureds reside.

There can be no assurance that such situations will not occur and that our revenues, results of operations and financial condition will not be materially, adversely affected if they do occur.

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The majority of our foreign policyholders choose to invest their policy dividends or other cash benefits in our Class A common stock through the Citizens, Inc. Stock Investment Plan (the "Plan"). If a securities regulatory authority were to deem the Plan's operation contrary to applicable securities laws, we risk facing fines and penalties and cease and desist orders which would create a reduction in the amount of Class A common stock purchased on the open market through the Plan.

The offer and sale of our Class A common stock through the Plan is not registered under the laws of any foreign jurisdiction. Most all of our foreign policyholders participate in the Plan and choose to invest dividends paid on their insurance policies in our Class A common stock pursuant to the Plan. We have not obtained any advice of counsel in any foreign jurisdiction as to whether such participation by foreign residents in the Plan is subject to foreign securities laws or regulations or whether our independent consultants in these jurisdictions are subject to licensing requirements in connection with foreign policyholder participation in the Plan. If a foreign securities regulatory authority were to determine the offer and sale of our Class A common stock under the Plan were contrary to applicable laws and regulations of its jurisdiction, we could be faced with cease and desist orders, fines and penalties, or reduced participation in the Plan by our foreign policyholders. This also could materially reduce the amount of our Class A common stock purchased and sold in the open market under the Plan, as historically a significant volume of shares have been purchased under the Plan through issuance of policy cash benefits assigned to the Plan. We could also be faced with private disputes relating to the Plan, including the possibility of securities law claims within the United States. In the absence of countervailing considerations, we would expect to defend any such claims and we could incur significant defense costs, including not only attorneys' fees and other direct litigation costs, but also the expenditure of substantial amounts of management time that otherwise would be devoted to our business. This could materially adversely affect our results of operations and financial condition.

The previous registration statement covering the Plan was not declared effective under the Securities Act of 1933 and sales under the Plan may not have fully complied with an exemption from registration under that Act. As a result, security holders who purchased shares of Class A common stock may have a right to rescind their purchases or other damages.

In 2001, we filed a Registration Statement on Form S-3 under the Securities Act of 1933 ("Securities Act") covering the sale of shares of Class A common stock pursuant to a predecessor to the Plan. In 2006, the Plan was amended and an agent independent of us was appointed to administer the Plan. On December 18, 2006, the registration statement was amended to increase the number of shares registered and to reflect the amendments to the Plan. On December 18, 2009, we filed a further amendment to the registration statement. The registration statement and amendments treated the Plan and its predecessors as a dividend or interest reinvestment plan and, accordingly, the registration statements on Form S-3 were filed in a manner so that they would be deemed effective upon filing with the Securities and Exchange Commission ("Commission"). Upon further analysis and consideration in connection with the preparation of a further amendment to the registration statement, on December 17, 2012 we determined that the Plan may not meet the criteria of a "dividend or interest reinvestment plan" as defined in Rule 405 of the Securities Act, and that previous sales may not have been exempt from registration under the Securities Act. Accordingly, we did not believe we could file an amendment to the registration statement on Form S-3 that would be effective upon filing with the Commission. As a result, as of the close of business on December 18, 2012, we suspended operation of the Plan with respect to the purchase of Class A common stock. On December 21, 2012, we filed with the Commission a Registration Statement on form S-3 with respect to the Plan (the "New Registration Statement"), which was declared effective by the Commission on January 14, 2013.

If and to the extent participants in the Plan were sold shares of Class A common stock that were not effectively registered under the Securities Act, or exempt from such registration, prior to the time the New Registration Statement

was declared effective such participants could have certain remedies available to them, including claims for rescission and damages. In the 12 months prior to December 19, 2012, a total of approximately 1,544,250 shares of Class A common stock were purchased in the open market under the Plan for participants in the Plan for an aggregate of approximately \$15,210,000, or an average of \$9.85 per share. In addition, the Commission could commence an enforcement action against us seeking injunctive or other relief and civil damages. Should a significant number of these purchasers bring claims for rescission or damages, or should the Commission commence an enforcement action, it could have a material and adverse effect on our business and reputation and our results of operations and financial condition.

We face financial and capital market risks in our operations

As an insurance holding company with significant investment exposure, we face material financial and capital markets risk in our operations. Due to the low interest rate environment over the past three years, we experienced significant call activity on our fixed income portfolio which has decreased our investment yields compared to prior years. Also, we recorded other-than-temporary impairments ("OTTI") in the past several years due to credit related market declines. In addition, the significant increase in worldwide economic instability and unemployment rates could result in decreased persistency of our insurance policies in force,

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as well as reduced new insurance policy sales, which may materially adversely affect our results of operations and financial condition.

Economic uncertainty has recently been exacerbated by the increased potential for default by one or more European sovereign debt issuers, the potential partial or complete dissolution of the Eurozone and its common currency and the negative impact of such events on global financial institutions and capital markets generally. Actions or inactions of European governments may impact these actual or perceived risks. In the recent past, one rating agency downgraded the U.S.'s long-term debt credit rating from AAA. Future actions or inactions of the United States government, including a shutdown of the federal government, could increase the actual or perceived risk that the U.S. may not ultimately pay its obligations when due and may disrupt financial markets.

Changes in market interest rates may significantly affect our profitability.

Some of our products, principally traditional whole life insurance with annuity riders, expose us to the risk that changes in interest rates will reduce our "spread," or the difference between the amounts we are required to pay under our contracts to policyholders and the rate of return we are able to earn on our investments intended to support obligations under the contracts. Our spread is a key component of our net income.

As interest rates decrease or remain at low levels, we may be forced to reinvest proceeds from investments that have matured, prepaid, been sold, or called at lower yields, reducing our investment margin. Our fixed income bond portfolio is exposed to interest rate risk as a significant portion of the portfolio is callable. Lowering interest crediting rates can help offset decreases in investment margins on some of our products. However, our ability to lower these rates could be limited by competition or contractually guaranteed minimum rates, and may not match the timing or magnitude of changes in asset yields. Our expectation of future spreads is an important component in amortization of deferred acquisition costs and significantly lower spreads may result in increasing amortization, thereby reducing net income for the period.

Our investment portfolio is subject to various risks that may result in realized investment losses. In particular, decreases in the fair value of fixed maturities may significantly reduce the value of our investments, and as a result, our financial condition may suffer.

We are subject to credit risk in our investment portfolio. Defaults by third parties in the payment or performance of their obligations under these securities could reduce our investment income and realized investment gains or result in the recognition of investment losses. The value of our investments may be materially adversely affected by increases in interest rates, downgrades in the bonds included in our portfolio and by other factors that may result in the recognition of other-than-temporary impairments. Each of these events may cause us to reduce the carrying value of our investment portfolio.

In particular, at December 31, 2012, fixed maturities represented \$791.5 million or 87.9% of our total investments of \$900.7 million. The fair value of fixed maturities and the related investment income fluctuates depending on general economic and market conditions. The fair value of these investments generally increases or decreases in an inverse relationship with fluctuations in interest rates, while net investment income realized by us will generally increase or decrease in line with changes in market interest rates. In addition, actual net investment income and/or cash flows from investments that carry prepayment risk, such as mortgage-backed and other asset-backed securities, may differ from those anticipated at the time of investment as a result of interest rate fluctuations. An investment has prepayment risk when there is a risk that the timing of cash flows resulting from the repayment of principal might occur earlier than anticipated because of declining interest rates or later than anticipated because of rising interest rates. We

experienced significant prepayments of bonds in our investment portfolio over the past three years. The impact of value fluctuations affects our consolidated financial statements, as a large portion of our fixed maturities are classified as available-for-sale, with changes in fair value reflected in our stockholders' equity (accumulated other comprehensive income or loss). No similar adjustment is made for liabilities to reflect a change in interest rates. Therefore, interest rate fluctuations and economic conditions could adversely affect our stockholders' equity, total comprehensive income and/or cash flows. For mortgage-backed securities, credit risk exists if mortgagees default on the underlying mortgages. Although at December 31, 2012, approximately 97.3% of our fixed maturities were investment grade with 55.2% rated AA or above, all of our fixed maturities are subject to credit risk. If any of the issuers of our fixed maturities suffer financial setbacks, the ratings on the fixed maturities could fall (with a concurrent fall in fair value) and, in a worst case scenario, the issuer could default on its financial obligations. If the issuer defaults, we could have realized losses associated with the impairment of the securities.

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A substantial portion of our investment portfolio is concentrated in U.S. Government sponsored corporations and agencies.

At December 31, 2012, we had investments with a carrying value of \$114.2 million (14.4% of our total invested assets) in U.S. Government sponsored corporations and agencies, including the Federal Home Loan Mortgage Corporation ("Freddie") and the Federal National Mortgage Association ("Fannie"). Both Freddie and Fannie are currently in conservatorship, certain of their operations are being combined and the federal government is considering proposals to phase them out, or allow them to continue as private corporations, among other things. If they are wound down, it is not clear how investments sponsored by them might be affected; however, the direct and indirect impact on our investment portfolio could be material and could be adverse.

Gross unrealized losses on fixed maturity and equity securities may be realized or result in future impairments, resulting in a reduction in our net income.

Fixed maturity and equity securities classified as available-for-sale are reported at fair value. Unrealized gains and losses on available-for-sale securities are recognized as a component of other comprehensive income (loss) and are, therefore, excluded from our net income. Our total gross unrealized losses on our available-for-sale securities portfolio at December 31, 2012 were \$1.1 million. The accumulated change in estimated fair value of these securities is recognized in net income when the gain or loss is realized upon sale of the security or in the event that the decline in estimated fair value is determined to be other-than-temporary and an impairment charge to earnings is taken. Realized losses or impairments may have a material adverse effect on our net income in a particular quarterly or annual period.

Our actual claims losses may exceed our reserves for claims and we may be required to establish additional reserves, which in turn may adversely impact our results of operations and financial condition.

We maintain reserves to cover our estimated exposure for claims relating to our issued insurance policies. Reserves, whether calculated under U.S. generally accepted accounting principles ("U.S. GAAP") or statutory accounting practices prescribed by various state insurance regulators, do not represent an exact calculation of exposure, but instead represent our best estimates, generally involving actuarial projections, of what we expect claims will be based on mortality assumptions that are determined by various regulatory authorities. Many reserve assumptions are not directly quantifiable, particularly on a prospective basis. In addition, when we acquire other domestic life insurance companies, our assessment of the adequacy of acquired policy liabilities is subject to our estimates and assumptions. Reserve estimates are refined as experience develops, and adjustments to reserves are reflected in our statements of operations for the period in which such estimates are updated. Because establishing reserves is an inherently uncertain process involving estimates of future losses, future developments may require us to increase claims reserves, which may have a material adverse effect on our results of operations and financial condition in the periods in which such increases occur.

We may be required to accelerate the amortization of deferred acquisition costs and the costs of customer relationships acquired, which would increase our expenses and adversely affect our results of operations and financial condition.

At December 31, 2012, we had \$135.6 million of deferred policy acquisition costs, or DAC. DAC represents costs that vary with and are primarily related to the successful sale and issuance of our insurance policies and are deferred and amortized over the estimated life of the related insurance policies. These costs include commissions in excess of ultimate renewal commissions, solicitation and printing costs, sales material costs and some support costs, such as underwriting and contract and policy issuance expenses. Under U.S. GAAP, DAC is amortized to income over the lives of the underlying policies, in relation to the anticipated recognition of premiums.

In addition, when we acquire a block of insurance policies, we assign a portion of the purchase price to the right to receive future net cash flows from existing insurance and investment contracts and policies. This intangible asset, called the cost of customer relationships acquired, or CCRA, represents the actuarially estimated present value of future cash flows from the acquired policies. At December 31, 2012, we had \$25.1 million of CCRA. We amortize the value of this intangible asset in a manner similar to the amortization of DAC.

Our amortization of DAC and CCRA generally depends upon anticipated profits from investments, surrender and other policy charges, mortality, morbidity, persistency and maintenance expense margins. For example, if our insurance policy lapse and surrender rates were to exceed the assumptions upon which we priced our insurance policies, or if actual persistency proves to be less than our persistency assumptions, especially in the early years of a policy, we would be required to accelerate the amortization of expenses we deferred in connection with the acquisition of the policy. We regularly review the quality of our DAC and CCRA



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to determine if they are recoverable from future income. If these costs are not recoverable, they are charged to expenses in the financial period in which we make this determination.

Unfavorable experience with regard to expected expenses, investment returns, surrender and other policy charges, mortality, morbidity, lapses or persistency may cause us to increase the amortization of DAC or CCRA, or both, or to record a current period expense to increase benefit reserves, any of which could have a material adverse effect on our results of operations and financial condition.

We may be required to recognize an impairment on the value of our goodwill, which would increase our expenses and materially adversely affect our results of operations and financial condition.

Goodwill represents the excess of the amount paid by us to acquire various life insurance companies over the fair value of their net assets at the date of the acquisition. Under U.S. GAAP, we test the carrying value of goodwill for impairment at least annually at the "reporting unit" level, which is either an operating segment or a business that is one level below the operating segment. Goodwill is impaired if its carrying value exceeds its implied fair value. This may occur for various reasons, including changes in actual or expected earnings or cash flows of a reporting unit, generation of earnings by a reporting unit at a lower rate than similar businesses or declines in market prices for publicly traded businesses similar to our reporting units. If any portion of our goodwill becomes impaired, we would be required to recognize the amount of the impairment as a current-period expense, which could have a material adverse effect on our results of operations and financial condition. Goodwill in our consolidated financial statements was \$17.2 million as of December 31, 2012.

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

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

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

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

By letter dated September 7, 2012, three state departments of treasury (or equivalent state agencies) notified the Company they intend to audit Citizens, Inc. and certain of its affiliates for compliance with unclaimed property laws. As of December 31, 2012, all three states have agreed to allow the Company to complete its own internal audit before the end of the second quarter of 2013. The audits may result in additional payments to beneficiaries, additional

escheatment of funds deemed abandoned under state laws, administrative penalties, interest, and changes to the Company's procedures for the identification and escheatment of abandoned property. At this time, the Company is not able to estimate any of these possible amounts, but such costs could be substantial for a company our size.

Reinsurers with which we do business could increase their premium rates and may not honor their obligations, leaving us liable for the reinsured coverage.

We reinsure certain risks underwritten by our various insurance subsidiaries. Market conditions beyond our control determine the availability and cost of the reinsurance protection we purchase. The high cost of reinsurance or lack of affordable coverage could adversely affect our results of operations and financial condition.

Our reinsurance facilities are generally subject to annual renewal. We may not be able to maintain our current reinsurance facilities and, even if highly desirable or necessary, we may not be able to obtain replacement reinsurance facilities in adequate amounts

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or at rates economic to us. If we are unable to renew our expiring facilities or to obtain new reinsurance facilities, either our net exposures would increase or, if we are unwilling or unable to bear an increase in net exposures, we may have to reduce the level of our underwriting commitments. In addition, our reinsurance facilities may be cancelled, pursuant to their terms, upon the occurrence of certain specified events, including a change of control of our Company (generally defined as the acquisition of 10% or more of our voting equity securities) or the failure of our insurance company subsidiaries to maintain the minimum required levels of statutory surplus. Any of these potential developments could materially adversely affect our revenues, results of operations and financial condition.

In 2012, we reinsured \$466.9 million of face amount of our life insurance policies. Amounts reinsured in 2012 represented 10.1% of the face amount of direct life insurance in force in that year. Although the cost of reinsurance is, in some cases, reflected in premium rates, under certain reinsurance agreements, the reinsurer may increase the rate it charges us for reinsurance. If our cost of reinsurance were to increase, we might not be able to recover these increased costs, and our results of operations and financial condition could be materially adversely affected. See Note 5 to the Company's Consolidated Financial Statements.

We may not be able to continue our past strategy of acquiring other U.S. life insurance companies, and we may not realize improvements to our financial results as a result of our past or any future acquisitions.

We have acquired 16 U.S. life insurance companies since 1987. Our objective in this strategy has been to increase our assets, revenues and capital, improve our competitive position and increase our earnings, in part by realizing certain operating efficiencies associated with economies of scale.

We evaluate possible acquisitions of other insurance companies on an ongoing basis. While our business model is not dependent primarily upon acquisitions, the time frame for achieving or further improving our market positions can be shortened through acquisitions. There can be no assurance that suitable acquisitions presenting opportunities for continued growth and operating efficiencies will be available to us, or that we will realize the anticipated financial results from completed acquisitions. In addition, we face intense competition in seeking to make acquisitions, much of which is from companies with greater financial and human resources than we have.

Even if we identify and complete insurance company acquisitions, we may be unable to integrate them on an economically favorable basis. Implementation of an acquisition strategy entails a number of risks, including, among others, inaccurate assessment of assets, liabilities or contingent liabilities and the failure to achieve anticipated operating efficiencies, revenues, earnings or cash flow. The occurrence of any of these events could have a material adverse effect on our results of operations and financial condition.

Our international and domestic operations face significant competition.

Our international marketing plan focuses on making available U.S. Dollar-denominated life insurance products to high net worth, high income individuals residing in more than 30 countries. New competition could increase the supply of available insurance, which could affect our ability to price our products at attractive profitable rates to us, thereby adversely affecting our revenues, results of operations and financial condition. Existing barriers to entry in the foreign markets we serve may not be sufficient to impede potential competitors from entering such markets. In connection with our business with foreign nationals, we experience competition primarily from the following sources, many of which have substantially greater financial, marketing and other resources than we have:

• Foreign operated companies with U.S. Dollar policies. We face direct competition from companies that operate in the same manner as we operate in our international markets.

Companies foreign to the countries in which their policies are sold but that issue local currency policies. Another group of our competitors in the international marketplace consists of companies that are foreign to the countries in which their policies are sold but issue life insurance policies denominated in the local currencies of those countries. Local currency policies provide the benefit of assets located in the country of foreign residents, but entail risks of uncertainty due to local currency fluctuations, as well as the perceived instability and weakness of local currencies.

Locally operated companies with local currency policies. We compete with companies formed and operated in the country in which our foreign insureds reside. Generally, these companies are subject to risks of currency fluctuations, and they primarily use mortality tables based on experience of the local population as a whole. These mortality tables are typically based on significantly shorter life spans than those we use. As a result, the cost of insurance from these companies tends to be higher than ours. Although these companies typically market their policies to a broader section of the population

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than do our independent marketing firms and independent consultants, there can be no assurance that these companies will not endeavor to place a greater emphasis on our target market and compete more directly with us.

In the United States, we compete with more than 1,000 other life insurance companies of various sizes. The life insurance business in the United States is highly competitive, in part because it is a mature industry that, in recent years, has experienced little to no growth in life insurance sales. Many domestic life insurance companies have substantially greater financial resources, longer business histories and more diversified lines of insurance coverage than we do. These companies also have larger sales forces than we have. Competition in the United States has also increased recently because the life insurance industry is consolidating, with larger, more efficient organizations emerging from the consolidation.

In addition, from time to time, companies enter and exit the markets in which we operate, thereby increasing competition at times when there are new entrants. We may lose business to competitors offering competitive products at lower prices, or for other reasons.

There can be no assurance that we will be able to compete effectively in any of our markets. If we do not, our business, results of operations and financial condition will be materially adversely affected.

Sales of our products may be reduced if we are unable to (i) establish and maintain commercial relationships with independent marketing firms and independent consultants (ii) attract and retain employee agents or (iii) develop and maintain our distribution sources.

We distribute our insurance products through several distribution channels, including independent marketing firms and independent consultants and our employee agents. These relationships are significant for both our revenues and our profits. In our life insurance segment, we depend almost exclusively on the services of independent marketing firms and independent consultants. In our home service insurance segment, we depend on employee agents whose role in our distribution process is integral to developing and maintaining relationships with policyholders. Significant competition exists among insurers in attracting and maintaining marketers of demonstrated ability. Some of our competitors may offer better compensation packages for marketing firms, independent consultants and agents and broader arrays of products and have a greater diversity of distribution resources, better brand recognition, more competitive pricing, lower cost structures and greater financial strength or claims paying ratings than we do. We compete with other insurers for marketing firms, independent consultants and employee agents primarily on the basis of our compensation and support services. Any reduction in our ability to attract and retain effective sales representatives could materially adversely affect our revenues, results of operations and financial condition.

Loss of the services of our senior management team would likely hinder development of our operating and marketing programs and our strategy for expanding our business.

We rely on the active participation of our Chairman of the Board and Chief Executive Officer, Harold E. Riley (age 84), and our Vice Chairman of the Board and President, Rick D. Riley (age 59), in connection with the development and execution of our operating and marketing plans and strategy for expanding our business. We anticipate that their expertise will continue to be of substantial value in connection with our operations. The loss of the services of either of these individuals could have a significant adverse effect on our business and prospects. We do not have an employment agreement with either of these persons nor do we carry a key-man insurance policy on either of their lives.

We are subject to extensive governmental regulation in the United States, which increases our costs of doing business and could restrict the conduct of our business.

We are subject to extensive regulation and supervision in U.S. jurisdictions wherein we do business, as well as anti-money laundering regulations adopted under the USA Patriot Act. Insurance company regulation is generally designed to protect the interests of policyholders, with substantially lesser protections to shareholders of the regulated insurance companies. To that end, all the states in which we do business have insurance regulatory agencies with broad powers under law with respect to such things as: licensing companies to transact business; mandating capital and surplus requirements; regulating trade and claims practices; approving policy forms; and restricting companies' ability to enter and exit markets.

The capacity for an insurance company's growth in premiums is partially a function of its required statutory surplus. Maintaining appropriate levels of statutory surplus, as measured by statutory accounting practices prescribed or permitted by a company's state of domicile, is considered important by all state insurance regulatory authorities. Failure to maintain required levels of statutory surplus could result in increased regulatory scrutiny and enforcement action by regulatory authorities.

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Most insurance regulatory authorities have broad discretion to grant, renew, suspend and revoke licenses and approvals, and could preclude or temporarily suspend us from carrying on some or all of our activities, including acquisitions of other insurance companies, require us to add capital to our insurance company subsidiaries, or fine us. If we are unable to maintain all required licenses and approvals, or if our insurance business is determined not to comply fully with the wide variety of applicable laws and regulations and their interpretations, including the USA Patriot Act, our revenues, results of operations and financial condition could be materially adversely affected.

Although the U.S. federal government has not historically regulated the insurance business, the Dodd-Frank Act, enacted in July 2010, expands the federal presence in insurance oversight. The Act's requirements include streamlining the state-based regulation of reinsurance and non-admitted insurance (also known as surplus lines insurance, which is property or casualty insurance written by a company that is not licensed to sell policies of insurance in a given state). This legislation also establishes a new Federal Insurance Office within the U.S. Department of the Treasury with powers over all lines of insurance except health insurance, certain long-term care insurance and crop insurance. The Federal Insurance Office is authorized to, among other things, gather data and information to monitor aspects of the insurance industry, identify issues in the regulation of insurers about insurance matters and preempt state insurance measures under certain circumstances. As this Act calls for numerous studies and contemplates further regulation, the future impact of the Act on our results of operations or our financial condition cannot be determined at this time, but could have an adverse impact on profitable operations.

Changes in U.S. regulation may adversely affect our results of operations and financial condition and limit our prospective growth.

Currently, the U.S. Federal Government does not directly regulate the insurance business, although initiatives for Federal regulation of insurance are proposed by members of the U.S. Congress from time to time. However, Federal legislation and administrative policies in several other areas can materially and adversely affect insurance companies, including our business. These areas include the USA Patriot Act, financial services regulation, securities regulation, including the Sarbanes-Oxley Act of 2002, the Dodd-Frank Act, pension regulation, privacy, tort reform legislation and taxation. In addition, various forms of direct federal regulation of insurance have been proposed from time to time.

Our failure to maintain effective information systems could adversely affect our business.

We must maintain and enhance our existing information systems and develop new information systems in order to keep pace with continuing changes in information processing technology, evolving industry and regulatory standards and changing customer preferences. If we do not maintain adequate systems, we could experience adverse consequences, including products acquired through acquisition, inadequate information on which to base pricing, underwriting and reserve decisions, regulatory problems, failure to meet prompt payment obligations, increases in administrative expenses and loss of customers.

Some of our information technology systems and software are mainframe-based, legacy-type systems that require an ongoing commitment of resources to maintain current standards. Our systems utilize proprietary code requiring highly skilled personnel. Due to the unique nature of our proprietary operating environment, we could have difficulty finding personnel with the skills required to provide ongoing system maintenance and development as we seek to keep pace with changes in our products and business models, information processing technology, evolving industry and regulatory standards and policyholder needs. Our success is dependent upon, among other things, maintaining and enhancing the effectiveness of existing systems, as well as continuing to integrate, develop and enhance our

information systems to support business processes in a cost-effective manner.

Our failure to maintain effective and efficient information systems, or our failure to efficiently and effectively consolidate our information systems to eliminate redundant or obsolete applications, could have a material adverse effect on our results of operations and financial condition.

Our failure to protect confidential information and privacy could result in the loss of customers, subject us to fines and penalties and adversely affect our results of operations and financial condition.

Our insurance subsidiaries are subject to privacy regulations. The actions we take to protect confidential information include among other things: monitoring our record retention plans and policies and any changes in state or federal privacy and compliance requirements; maintaining secure storage facilities for tangible records; and limiting access to electronic information in order to safeguard certain information.



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In addition, the Gramm-Leach-Bliley Act requires that we deliver a notice regarding our privacy policy both at the delivery of an insurance policy and annually thereafter. Certain exceptions are allowed for sharing of information under joint marketing agreements. However, certain state laws may require us to obtain a policyholder's consent before we share information.

We have a written information security program with appropriate administrative, technical and physical safeguards to protect such confidential information. If we do not comply with privacy regulations and protect confidential information, we could experience adverse consequences, including regulatory sanctions, loss of reputation and litigation, any of which could have a material adverse effect on our business, results of operations and financial condition.

The insurance industry in which we operate may be subject to periodic negative publicity, which may negatively impact our financial results.

We interface with and distribute our products to individual consumers. There may be a perception that these purchasers may be unsophisticated and in need of consumer protection. Accordingly, from time to time, consumer advocate groups or the media may focus attention on our products, thereby subjecting the insurance industry to periodic negative publicity. We may also be negatively impacted if other insurance companies engage in practices resulting in increased public attention to our businesses. Negative publicity may result in lower sales of insurance, lower persistency of our insurance products, increased regulation and legislative scrutiny of industry practices as well as increased litigation, which may further increase our costs of doing business and impede our ability to market our products. As a result, our business, results of operations and financial condition could be materially adversely affected.

General economic, financial market and political conditions may materially adversely affect our results of operations and financial condition.

Our results of operations and financial condition may be materially adversely affected from time to time by general economic, financial market and political conditions, both in the United States and in the foreign countries where our policyowners reside. These conditions include economic cycles such as: levels of consumer spending; levels of inflation; movements of the financial markets; availability of credit; fluctuations in interest rates, monetary policy or demographics; and legislative and competitive changes.

During periods of economic downturn, such as the ones recently experienced, our insureds may choose not to purchase our insurance products, may terminate existing policies, permit policies to lapse or may choose to reduce the amount of coverage purchased, any of which could have a material adverse effect on our results of operations and financial condition. Also, our sales of new insurance policies might decrease.

Our insurance subsidiaries are restricted by applicable laws and regulations in the amounts of fees, dividends and other distributions they may make to us. The inability of our subsidiaries to make payments to us in sufficient amounts for us to conduct our operations could adversely affect our ability to meet our obligations or expand our business.

As a holding company, our principal asset is the stock of our subsidiaries. We rely primarily on statutorily permissible payments from our insurance company subsidiaries, principally through service agreements we have with our subsidiaries, to meet our working capital and other corporate expenses. The ability of our insurance company subsidiaries to make payments to us is subject to regulation by the states in which they are domiciled, and these

payments depend primarily on approved service agreements between us and these subsidiaries and, to a lesser extent, the statutory surplus (which is the excess of assets over liabilities as determined under statutory accounting practices prescribed by an insurance company's state of domicile), future statutory earnings (which are earnings as determined in accordance with statutory accounting practices) and regulatory restrictions.

Generally, the net assets of our insurance company subsidiaries available for dividends are limited to either the lesser or greater (depending on the state of domicile) of the subsidiary's net gain from operations during the preceding year and 10% of the subsidiary's net statutory surplus as of the end of the preceding year as determined in accordance with accounting practices prescribed by insurance regulatory authorities.

Except to the extent that we are a creditor with recognized claims against our subsidiaries, claims of our subsidiaries' creditors, including policyholders, have priority with respect to the assets and earnings of the subsidiaries over the claims of our creditors and shareholders. If any of our subsidiaries becomes insolvent, liquidates or otherwise reorganizes, our creditors and shareholders will have no right to proceed in their own right against the assets of that subsidiary or to cause the liquidation, bankruptcy or winding-up of the subsidiary under applicable liquidation, bankruptcy or winding-up laws.

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Adverse capital and credit market conditions may significantly affect our access to debt and equity capital and our cost of capital in seeking to expand our business.

The capital and credit markets experienced extreme volatility over the past several years. In some cases, the markets exerted significant downward pressure on availability of debt and equity capital for certain issuers (including short term liquidity and credit capacity). We believe the availability of debt and equity capital has decreased significantly compared to prior years.

The availability of equity and debt financing to us will depend on a variety of factors such as market conditions, the general availability of credit, the overall availability of credit to the financial services industry, our credit capacity, as well as the possibility that investors or lenders could develop a negative perception of our long- or short-term financial prospects. Disruptions, uncertainty or volatility in the capital markets may also limit our access to equity capital for us to seek to expand our business. As such, we may be forced to delay raising debt or equity capital, or bear an unattractive cost of capital, which could adversely affect our ability to seek any acquisitions and negatively impact profitability of an acquisition.

Unexpected losses in future reporting periods may require us to adjust the valuation allowance against our deferred tax assets.

We evaluate our deferred tax asset (“DTA”) quarterly for recoverability based on available evidence. This process involves management's judgment about assumptions, which are subject to change from period to period due to tax rate changes or variances between our projected operating performance and our actual results. Ultimately, future adjustments to the DTA valuation allowance, if any, will be determined based upon changes in the expected realization of the net deferred tax assets. The realization of the deferred tax assets depends on the existence of sufficient taxable income in either the carry back or carry forward periods under applicable tax law. Due to significant estimates utilized in establishing the valuation allowance and the potential for changes in facts and circumstances, it is reasonably possible that we may be required to record a valuation allowance in future reporting periods. Such an adjustment could have a material adverse effect on our results of operation, financial condition and capital position.

Risks Relating to Our Capital Stock

The price of our Class A common stock may be adversely affected by decreased participation in the Citizens, Inc. Stock Investment Plan (the "Plan").

Most all of our international policyholders participate in the Plan and they invest their policy dividends and benefits in our Class A common stock pursuant to the Plan. Once a policyholder elects to participate in the Plan, his or her policy benefits are assigned to purchase Citizens Class A common stock under the Plan in the open market. There is a risk our Class A common stock price could be negatively impacted by a decrease in our policyholders' participation in the Plan. If fewer policyholders elect to participate in the Plan, or our international premium collections were to decrease as a result of regulatory, economic, or marketing impediments, the trading volume of our Class A stock may decline from its present levels and the demand for our Class A common stock could be negatively impacted.

Control of our Company, through the ownership of our Class B Common Stock, may be held by a 501(c)(3) charitable foundation established by our Founder and we cannot determine whether any change in our management, operations, or operating strategies will occur as a result of such an ownership change.

Harold E. Riley, our Founder, Chairman and CEO, is the beneficial owner of 100% of the Citizens Class B common stock, which is held in the name of the Harold E. Riley Trust ("Trust"), of which he serves as Trustee. Citizens' Class A and Class B common stock are identical in all respects, except the Class B common stock elects a simple majority of the Board and receives one-half of any cash dividends paid, on a per share basis, to the Class A shares. Therefore, Mr. Riley controls our Company. The Class A common stock elects the remainder of the Board. The Trust documents provide that upon Mr. Riley's death, the Class B common stock will be transferred from the Trust to the Harold E. Riley Foundation, a charitable organization established under 501(c)(3) of the Internal Revenue Code (the "Foundation"). In addition, the Trust documents provide that Mr. Riley may at any time transfer the Class B common stock held by the Trust to the Foundation. It is unclear what, if any, changes would occur to our board, management structure, or corporate operating strategies as a result of different ownership of our Class B common stock.

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There are a substantial number of our issued shares of Class A common stock eligible for future sale in the public market. The sale of these shares could cause the market price of our Class A common stock to fall.

There were 49,080,114 shares of our Class A common stock issued as of December 31, 2012. Our executive officers, directors and management owned approximately 3,249,273 shares of our Class A common stock as of December 31, 2012, representing approximately 7% of our then outstanding Class A common stock. Almost all of these shares have been registered for public resale and generally may be sold freely. In the event of a sale of some or all of these shares or the perceived sale of these shares, the market price of our Class A common stock could fall substantially.

The price of our Class A common stock may be volatile and may be affected by market conditions beyond our control.

Our Class A common stock price has historically fluctuated and is likely to fluctuate in the future and could decline materially because of the volatility of the stock market in general, decreased participation in the Plan referred to above or a variety of other factors, many of which are beyond our control, including: quarterly or annual variations in actual or anticipated results of our operations; interest rate fluctuations; changes in financial estimates by securities analysts; competition and other factors affecting the life insurance business generally; and conditions in the U.S. and world economies.

Our Class A common shareholders do not control us and have a limited ability to influence our business policies and corporate actions and are not by themselves able to elect any of our directors.

It is difficult for Class A common shareholders to elect any of our directors or otherwise exert any significant influence over our business. The sole holder of our outstanding Class B common stock is entitled to elect a simple majority of our board of directors and therefore controls us. All of our Class B common stock is currently owned by the Harold E. Riley Trust, of which Harold E. Riley, our founder, Chairman of the Board and Chief Executive Officer, is the sole trustee. Additionally, Harold E. Riley beneficially owns approximately 5% of the issued shares of our Class A common stock.

Our articles of incorporation and bylaws, as well as applicable state insurance laws, may discourage takeovers and business combinations that our shareholders might consider to be in their best interests.

Our articles of incorporation and bylaws, as well as various state insurance laws, may delay, deter, render more difficult or prevent a takeover attempt our shareholders might consider in their best interests. As a result, our shareholders will be prevented from receiving the benefit from any premium to the market price of our Class A common stock that may be offered by a bidder in a takeover context. Even in the absence of a takeover attempt, the existence of these provisions may adversely affect the prevailing market price of our Class A common stock if they are viewed as discouraging takeover attempts in the future.

The following provisions in our articles of incorporation and bylaws make it difficult for our Class A shareholders to replace or remove our directors and have other anti-takeover effects that may delay, deter or prevent a takeover attempt:

- holders of shares of our Class B common stock elect a simple majority of our board of directors, and all of these shares are owned by the Harold E. Riley Trust; and
- our board of directors may issue one or more series of preferred stock without the approval of our shareholders.

State insurance laws generally require prior approval of a change in control of an insurance company. Generally, such laws provide that control over an insurer is presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing 10% or more of the voting securities of the insurer. In considering an application to acquire control of an insurer, an insurance commissioner generally will consider such factors as the experience, competence and financial strength of the proposed acquirer, the integrity of the proposed acquirer's board of directors and executive officers, the proposed acquirer's plans for the management and operation of the insurer, and any anti-competitive results that may arise from the acquisition. In addition, a person seeking to acquire control of an insurance company is required in some states to make filings prior to completing an acquisition if the acquirer and the target insurance company and their affiliates have sufficiently large market shares in particular lines of insurance in those states. These state insurance requirements may delay, deter or prevent our ability to complete an acquisition.

We have never paid any cash dividends on our Class A common stock and do not anticipate doing so in the foreseeable future.

We have never paid cash dividends on our Class A common stock, as it is our policy to retain earnings for use in the operation and expansion of our business. We do not expect to pay cash dividends on our Class A common stock for the foreseeable future.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

We own our principal office in Austin, Texas, consisting of an 80,000 square foot office building in addition to approximately one acre of land nearby that houses storage facilities. Approximately 50,000 square feet is occupied or reserved for our operations. We also own a training facility at Lake Buchanan, Texas. In addition, we own other properties in Texas, Arkansas and Louisiana that are incidental to our operations.

Item 3. 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. 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.

The District Court has issued a case management order requiring the State to produce specific detail by property supporting its breach of contract allegations. Additionally, the case management order requires the State to deliver a settlement proposal to SPFIC and the other defendant insurance companies. Since, there are many potential individual claims at issue in this matter, each 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. SPFIC believes its claims 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. SPFIC intends to vigorously defend all claims asserted in any remaining proceedings.

Therefore, in SPFIC's judgment given the issues discussed above, an estimate of probable loss cannot be made at this time.

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.

Item 4. MINE SAFETY DISCLOSURES

Not applicable.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## PART II

## Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

## Market Information

Our Class A common stock is traded on the New York Stock Exchange ("NYSE") under the symbol CIA.

Quarterly high and low closing prices per share of our Class A common stock as reported by the NYSE are shown below.

| Quarter Ended | 2012  |      | 2011 |      |
|---------------|-------|------|------|------|
|               | High  | Low  | High | Low  |
| March 31      | 11.33 | 9.52 | 7.79 | 6.95 |
| June 30       | 10.05 | 7.80 | 7.50 | 6.27 |
| September 30  | 11.05 | 9.22 | 7.23 | 6.06 |
| December 31   | 11.05 | 9.22 | 9.69 | 5.98 |

## Equity Security Holders

The number of stockholders on record on March 4, 2013 was as follows:

Class A Common Stock - 91,744

Class B Common Stock - 1

We have never paid cash dividends on our Class A or B common stock and do not expect to pay cash dividends in the foreseeable future. For restrictions on our present and future ability to pay dividends, see Note 6 of the "Notes to Consolidated Financial Statements."

We did not purchase any of our equity securities during any quarter in 2010, 2011 or 2012.

## Securities Authorized for Issuance Under Equity Compensation Plans

We do not maintain any equity compensation plans or arrangements. Thus, we do not have any securities authorized for issuance under these types of plans, nor have we issued any options, warrants or similar instruments to purchase any of our equity securities.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Performance Comparison

The following graph compares the change in the Company's cumulative total stockholder return on its common stock over a five-year period. The following graph assumes a \$100 investment on December 31, 2007, and reinvestment of all dividends in each of the Company's common shares, the New York Stock Exchange ("NYSE") Composite and the Hemscott Group Index, a peer group of major U.S.-based insurance companies.

|                | 2007   | 2008   | 2009   | 2010   | 2011   | 2012   |
|----------------|--------|--------|--------|--------|--------|--------|
| Citizens, Inc. | 100.00 | 175.41 | 118.08 | 134.72 | 175.23 | 199.82 |
| NYSE Composite | 100.00 | 60.74  | 77.92  | 88.36  | 84.96  | 98.55  |
| Peer Group     | 100.00 | 46.23  | 61.78  | 66.42  | 50.34  | 64.43  |

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

The peer group index weights individual company returns for stock market capitalization. The companies included in the peer group index are shown in the following table.

|   |                                  |                              |
|---|----------------------------------|------------------------------|
| American Equity Investment Life Holding | Investors Heritage Capital Corp. | Prudential Financial, Inc.   |
| Atlantic American Corp.                 | Kansas City Life Ins. Co.        | Prudential PLC               |
| Aviva PLC                               | Life Partners Holdings, Inc.     | Reins Group of America, Inc. |
| China Life Ins Co. Limited              | Lincoln National Corp.           | Sun Life Financial, Inc.     |
| Citizens, Inc.                          | Manulife Financial Corp.         | Symetra Financial Corp.      |
| FBL Financial Group, Inc.               | Metlife, Inc.                    | The Phoenix Companies, Inc.  |
| Genworth Financial, Inc.                | National Western Life Ins. Co.   | UTG, Inc.                    |
| Imperial Holdings, Inc.                 | Primerica, Inc.                  |                              |
| Independence Holding Co.                | Protective Life Corp.            |                              |

## Item 6. SELECTED FINANCIAL DATA

The following table presents selected financial data of the Company. This should be read in conjunction with Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Item 8. "Financial Statements and Supplementary Data" of this Form 10-K.

|   | Years ended December 31,              |                          |                          |                          |                          |
|---|---------------------------------------|--------------------------|--------------------------|--------------------------|--------------------------|
|   | 2012                                  | 2011<br>(As<br>adjusted) | 2010<br>(As<br>adjusted) | 2009<br>(As<br>adjusted) | 2008<br>(As<br>adjusted) |
|   | (In thousands, except per share data) |                          |                          |                          |                          |
| Operating items                                     |                                       |                          |                          |                          |                          |
| Insurance premiums                                  | \$ 169,873                            | 161,395                  | 152,052                  | 147,280                  | 141,297                  |
| Net investment income                               | 31,725                                | 30,099                   | 29,220                   | 28,745                   | 29,621                   |
| Realized investment gains (losses)                  | 196                                   | 765                      | 8,012                    | 8,040                    | (23,812 )                |
| Change in fair value of warrants                    | 451                                   | 1,136                    | 232                      | 3,154                    | (2,662 )                 |
| Total revenues                                      | 202,759                               | 194,156                  | 190,324                  | 188,123                  | 145,816                  |
| Net income (loss)                                   | 4,529                                 | 8,482                    | 14,704                   | 16,903                   | (15,882 )                |
| Balance sheet data                                  |                                       |                          |                          |                          |                          |
| Total assets  | 1,174,948                             | 1,079,512                | 974,583                  | 916,644                  | 822,266                  |
| Total liabilities                                   | 911,840                               | 831,470                  | 754,699                  | 707,512                  | 649,518                  |
| Total stockholders' equity                          | 263,108                               | 248,042                  | 219,884                  | 209,132                  | 172,748                  |
| Life insurance in force                             | 4,976,157                             | 5,244,200                | 5,115,662                | 4,997,043                | 4,666,868                |
| Per share data                                      |                                       |                          |                          |                          |                          |
| Book value per share                                | 5.25                                  | 4.97                     | 4.48                     | 4.21                     | 3.70                     |
| Basic and diluted earnings (loss) per Class A share | 0.09                                  | 0.17                     | 0.30                     | 0.30                     | (0.42 )                  |

See Item 1. "Business" and Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations," for information that may affect the comparability of the financial data contained in the above table.



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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is management's discussion and analysis of the consolidated financial condition and consolidated results of operations of the Company. It is intended to be a discussion of certain key financial information regarding the Company and should be read in conjunction with the Consolidated Financial Statements and related Notes to this report on Form 10-K.

Overview

We conduct operations as an insurance holding company emphasizing ordinary life insurance products in niche markets where we believe we can achieve competitive advantages. As an insurance provider, we collect premiums on an ongoing basis to pay future benefits to our policy and contract holders. Our core operations include issuing:

- whole life insurance;
- endowments;
- credit insurance;
- final expense; and
- limited liability property policies.

The Company derives its revenues principally from 1) premiums earned for insurance coverages provided to insureds; 2) net investment income; and 3) net realized capital gains and losses.

Profitability of our insurance operations depends heavily upon the Company's underwriting discipline, as we seek to manage exposure to loss through favorable risk selection and diversification, management of claims, use of reinsurance, the size of our in force block, actual mortality and morbidity experience, and our ability to manage our expense ratio, which we accomplish through economies of scale and management of acquisition costs and other underwriting expenses.

Pricing adequacy depends on a number of factors, including the ability to obtain regulatory approval for rate changes, proper evaluation of underwriting risks, the ability to project future losses based on historical loss experience adjusted for known trends, the Company's response to competitors, and expectations about regulatory and legal developments and expense levels. The Company seeks to price our insurance policies such that insurance premiums and future net investment income earned on premiums received will cover underwriting expenses and the ultimate cost of paying claims reported on the policies and provide for a profit margin. For many of our insurance products, the Company is required to obtain approval for the premium rates from state insurance departments. The profitability of fixed annuities, riders and other "spread-based" product features depends largely on the Company's ability to earn target spreads between earned investment rates on assets and interest credited to policyholders.

The investment return, or yield, on invested assets is an important element of the Company's earnings since insurance products are priced with the assumption that premiums received can be invested for a period of time before benefits are paid. The majority of the Company's invested assets have been held in available-for-sale and held-to-maturity securities, primarily in asset classes of corporate bonds, municipal bonds, and government obligation bonds. The current and projected low interest rate environment is having a significant impact on the determination of insurance contract liabilities and assets regarding reserves and deferred acquisition costs.

The primary investment objective for the Company is to maximize economic value, consistent with acceptable risk parameters, including the management of credit risk and interest rate sensitivity of invested assets, while generating sufficient after-tax income to meet policyholder and corporate obligations. The Company maintains a conservative investment strategy that may vary based on a variety of factors including business needs, regulatory requirements and tax considerations.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Current Financial Highlights

Our assets grew from \$1.1 billion as of December 31, 2011, to \$1.2 billion as of December 31, 2012. Total stockholders' equity increased from \$248.0 million at December 31, 2011, to \$263.1 million at December 31, 2012.

Insurance premiums rose 5.3% and 6.1% in 2012 and 2011, respectively, primarily from sales in our life insurance segment, which increased \$7.8 million from amounts reported in 2011.

Net investment income increased 5.4% and 3.0% for 2012 and 2011, respectively, and was flat in 2010. The average yield on the consolidated investment portfolio has declined significantly from a yield of 4.20% in 2010 down to 3.92% in 2011 and continued to decline at a more moderate pace to a yield of 3.81% in 2012. The increase in the investment asset balances due to premium revenue growth was sufficient to offset the lower yield in the declining rate environment and resulted in an increase in net investment income.

Realized net investment gains in the past three years resulted primarily from sales of securities that had been previously impaired due to declines in market values. These gains were partially offset by other-than-temporary impairments on investment securities and other long-term assets that were recorded in 2012, 2011 and 2010 of \$1,319,000, \$631,000 and \$27,000, respectively, reported as realized losses.

Claims and surrenders expense increased 7.7% from the comparable period in 2011 as the home service segment was impacted by Hurricane Isaac which hit the Louisiana coast on August 29, 2012 and caused increased property claims. In addition, death claims expense in the current year is higher compared to 2011 due to the release of incurred but unreported death claims liability in 2011 of \$0.7 million.

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

Life Insurance. For over thirty-five years, CICA and its predecessors have accepted policy applications from foreign nationals for U.S. Dollar-denominated ordinary whole life insurance and endowment policies. We make our insurance products available using third-party marketing organizations and independent marketing consultants.

Endowment product sales have been on the rise and represented approximately 81% of new sales. The Company offers a ten, fifteen and twenty year endowment and our top selling endowment is a product that matures at age sixty-five. We also introduced a new product in 2011 that is an endowment at age eighteen with a payout over four or five years.

Through the domestic market of our Life Insurance segment, we provide ordinary whole life, credit life insurance, and final expense policies to middle and lower income families and individuals in certain markets in the mid-west and southern U.S. The majority of our domestic revenues are generated by the operations of domestic life insurance companies we have acquired since 1987.

Home Service Insurance. We provide final expense ordinary life insurance to middle and lower income individuals in Louisiana, Mississippi and Arkansas. Our policies in this segment are sold and serviced through a home service marketing distribution system utilizing employee-agents who work on a route system to collect premiums and service policyholders, and through networks of funeral homes that collect premiums and provide personal policyholder

service.

#### Economic and Insurance Industry Developments

Significant economic issues impacting our business and industry currently and into the future are discussed below.

It is predicted that the interest rate environment will remain low for the foreseeable future, which translates into lower profit margins for insurers. We have been impacted by the historically low interest rate environment over the past several years as our fixed income investment portfolio, primarily invested in callable securities, has been reinvested at lower yields. The Company's conservative investment strategy has not changed, but it has been a challenging investment time, as the large number of bond calls resulted in significant cash balances to be reinvested. The Company experienced some delays in reinvesting the funds as management identified suitable bonds meeting our target characteristics of investment grade and yield parameters were identified. Our investment earnings also impact the reserve and Deferred Acquisition



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### CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Costs (“DAC”) balances, as assumptions are used in the development of the balances. Due to the recent decline in investment yields on our portfolio, our projection of long-term investment returns has declined. This has resulted in increasing the reserves on policies issued in the current year, as well as reducing the DAC asset.

As an increasing percentage of the world population reaches retirement age, we believe we will benefit from increased demand for living products rather than death products, as aging baby boomers will require cash accumulation to pay expenses to meet their lifetime needs. Our ordinary life products are designed to accumulate cash values to provide for living expenses in a policy owner's later years, while continuously providing a death benefit.

We believe there is a trend toward consolidation of domestic life insurance companies, due to significant losses incurred by the life insurance industry as a result of the credit crisis and recent economic pressures, as well as increasing costs of regulatory compliance for domestic life insurance companies. We believe this trend should be a benefit to our acquisition strategy as more complementary acquisition candidates may become available for us to consider.

Many of the events and trends affecting the life insurance industry have had an impact on the life reinsurance industry. These events have led to a decline in the availability of reinsurance. While we currently cede a limited amount of our primary insurance business to reinsurers, we may find it difficult to obtain reinsurance in the future, forcing us to seek reinsurers who are more expensive to us. If we cannot obtain affordable reinsurance coverage, either our net exposures will increase or we will have to reduce our underwriting commitments.

While our management has more than 40 years of experience in writing life insurance policies for foreign residents, changes related to foreign government laws and regulations and application of them, along with currency controls affecting our foreign resident insureds could adversely impact our revenues, results of operations and financial condition.

#### Acquisition History - Last Five Years

In 2008, the Company acquired Ozark National Life Insurance Company (“ONLIC”), an Arkansas domiciled life company. This entity provided an Arkansas field force of home service agents and funeral homes selling pre-need and final expense policies and was merged into SPLIC as of October 1, 2009, and is included in the Home Service segment. In the first quarter of 2009, the Company completed its acquisition of Integrity Capital Corporation (“ICC”). ICC is the parent of Integrity Capital Insurance Company (“ICIC”), an Indiana life insurance company. Both ICC and ICIC were merged into CICA effective April 1, 2011.

On August 1, 2011, SPLIC entered into assumption reinsurance agreements with Escude Life Insurance Company in Rehabilitation, and Benton Life Insurance Company in Rehabilitation. At the time the agreements were executed, both companies were under receivership with the Louisiana Department of Insurance. In total, SPLIC assumed approximately \$4.5 million in reserve liabilities and received approximately \$4.6 million in cash, with a minimal reinsurance ceding commission being paid. These transactions are accounted for under business combination accounting and are not deemed material.

#### Consolidated Results of Operations

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



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Revenues

Insurance revenues are primarily generated from premium revenues and investment income. In addition, realized gains and losses on investment holdings can significantly impact revenues from year to year.

|   | Years Ended December 31, |          |         |
|---|--------------------------|----------|---------|
|   | 2012                     | 2011     | 2010    |
|   | (In thousands)           |          |         |
| Revenues:   |                          |          |         |
| Premiums:   |                          |          |         |
| Life insurance  | \$163,170                | 154,778  | 145,665 |
| Accident and health insurance   | 1,635                    | 1,561    | 1,577   |
| Property insurance  | 5,068                    | 5,056    | 4,810   |
| Net investment income   | 31,725                   | 30,099   | 29,220  |
| Realized investment gains, net  | 196                      | 765      | 8,012   |
| Decrease in fair value of warrants                                      | 451                      | 1,136    | 232     |
| Other income  | 514                      | 761      | 808     |
| Total revenues  | 202,759                  | 194,156  | 190,324 |
| Exclude decrease in fair value of warrants                              | (451                     | ) (1,136 | ) (232  |
| Total revenues excluding fair value adjustments of warrants outstanding | \$202,308                | 193,020  | 190,092 |

**Premium Income.** Premium income derived from life, accident and health, and property insurance sales, increased 5.3% during 2012. The increase resulted primarily from renewal premiums, which totaled \$142.2 million, \$135.1 million and \$127.1 million in 2012, 2011 and 2010, respectively. New sales, termed as first year premiums, increased 6.1%, 6.6% and 2.1% in the life segment in 2012, 2011 and 2010. Endowment sales represent a significant portion of new business sales internationally with the 20 year endowment and endowment to age 65 as our top products. In addition, most of our life insurance policies contain a policy loan provision, which allows the policyholder to use cash value of a policy to pay premiums. The policy loan asset balance increased 10.0% and 9.8% in 2012 and 2011, year over year.

**Net Investment Income.** Net investment income increased to \$31.7 million in 2012 compared to \$30.1 million in 2011, despite a decline in the yield on investments as we experienced higher average invested assets as a result of investment of new premium revenue.

Net investment income performance is summarized as follows.

|  | Years Ended December 31,     |         |         |
|--|------------------------------|---------|---------|
|  | 2012                         | 2011    | 2010    |
|  | (In thousands, except for %) |         |         |
| Net investment income                      | \$31,725                     | 30,099  | 29,220  |
| Average invested assets, at amortized cost | 832,552                      | 767,079 | 696,134 |
| Yield on average invested assets           | 3.81                         | % 3.92  | % 4.20  |
|  |                              |         | %       |

Yields on invested assets vary between segment operations due to different portfolio mixes in the segments. The life segment has a higher concentration in U.S. government securities while the home service segment has a larger concentration in the corporate and municipal sectors.

We have traditionally invested in fixed maturity securities with a large percent held in callable issues. Over the past three years, we have experienced significant call activity related to fixed maturity security holdings due to the historically low interest rate environment. As these call proceeds were primarily invested into lower yielding securities, the yield on the portfolio has declined. The recent declines in yield rates has been leveling off in recent periods as the reinvestment of calls is resulting in a

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

lesser impact relative to yield changes. If market interest rates begin to rise, our call risk would diminish and our portfolio yield will rise over time, as new money investments would be made at higher rates.

Investment income from fixed maturity securities accounted for approximately 82.3% of total investment income for the year ended December 31, 2012. We have reduced investment holdings in bonds of U.S. Government-sponsored enterprises, such as Federal National Mortgage Association (“FNMA”) and Federal Home Loan Mortgage Corporation (“FHLMC”), which comprised 15.3% of the total fixed maturity portfolio based on amortized cost at December 31, 2012. We have increased our investment purchases of corporate and municipal securities over the past several years, focusing on utility service sectors in these security categories. In addition, we reinvested proceeds from bond calls totaling \$10.0 million into equity securities related to bond mutual funds in 2011 and continuing into 2012. These securities offer a competitive yield with a shorter duration.

|                           | Years Ended December 31, |          |          |
|---------------------------|--------------------------|----------|----------|
|                           | 2012                     | 2011     | 2010     |
|                           | (In thousands)           |          |          |
| Gross investment income:  |                          |          |          |
| Fixed maturity securities | \$27,470                 | 26,606   | 26,829   |
| Equity securities         | 2,158                    | 1,534    | 713      |
| Mortgage loans            | 104                      | 99       | 101      |
| Policy loans              | 3,332                    | 3,024    | 2,704    |
| Long-term investments     | 234                      | 225      | 246      |
| Other                     | 99                       | 122      | 207      |
| Total investment income   | 33,397                   | 31,610   | 30,800   |
| Less investment expenses  | (1,672                   | ) (1,511 | ) (1,580 |
| Net investment income     | \$31,725                 | 30,099   | 29,220   |

Investment income from fixed maturity investments increased for the year of 2012 due to a rise in investment holdings based upon amortized cost of \$28.8 million. The increase in earnings on asset balances of fixed maturity and equity securities from new money investments is offsetting the 11 basis point yield decline for the year. In addition, the increase in the policy loans asset balance, which represents policyholders utilizing their accumulated policy cash value, contributed to the increase to investment income.

Realized Gains (Losses) on Investments. In 2012, 2011 and 2010, the Company sold equity mutual funds, which were previously impaired, and realized gains of \$0.6 million, \$1.3 million and \$6.4 million, respectively.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Realized investment gains (losses) are as follows.

|  | Years Ended December 31, |        |       |
|--|--------------------------|--------|-------|
|  | 2012                     | 2011   | 2010  |
|  | (In thousands)           |        |       |
| Realized investment gains (losses):        |                          |        |       |
| Sales, calls and maturities                |                          |        |       |
| Fixed maturities                           | \$824                    | 119    | 753   |
| Equity securities                          | 636                      | 1,259  | 7,343 |
| Property and equipment                     | —                        | 2      | (8    |
| Other long-term investments                | 55                       | 16     | (49   |
| Net realized investment gains              | 1,515                    | 1,396  | 8,039 |
| Other-than-temporary impairments ("OTTI"): |                          |        |       |
| Fixed maturities                           | (1,319                   | ) (70  | ) (27 |
| Other long-term investments                | —                        | (561   | ) —   |
| Realized losses on OTTI                    | (1,319                   | ) (631 | ) (27 |
| Net realized investment gains (losses)     | \$196                    | 765    | 8,012 |

Included in net realized investment gains and losses are OTTI on investments. We recorded an OTTI write-down in 2012 of \$1,319,000 related to one coal powered energy issuer debt security holding which has a maturity date in 2017. In 2011 we recorded an OTTI of \$70,000 related to one American Airlines ("AMR") debt security holding that had a maturity date in 2012. AMR declared bankruptcy in November of 2011. We also recorded an impairment in 2011 of \$0.6 million related to an investment property that was acquired as part of the ONLIC acquisition in 2008. A current appraisal reflected a declining value of this Arkansas office building from the fair value at acquisition.

Decrease in Fair Value of Warrants. In 2012, all of the remaining warrants outstanding were either exercised or converted into our Class A common stock, due to an election by the warrant holders, or expiration. We recognized a gain on the decrease in fair value of warrants of \$0.5 million, \$1.1 million and \$0.2 million in 2012, 2011 and 2010, respectively. The 2012 and 2011 gain was the result of the significant decrease in the number of warrants outstanding due to expirations and exercises. The gain in 2010 was directly related to the decrease in the price of our Class A common stock. The warrant liability was calculated using the Black-Scholes option pricing model, which projects the future value of the warrants when they expire. Current accounting standards require the change in the value of the warrant liability be recorded as a component of revenues. When the liability increased we incurred a loss, and when the liability decreased we recognized income.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Benefits and Expenses

|   | Years Ended December 31, |                       |                       |
|---|--------------------------|-----------------------|-----------------------|
|   | 2012                     | 2011<br>(As adjusted) | 2010<br>(As adjusted) |
|   | (In thousands)           |                       |                       |
| Benefits and expenses:                                  |                          |                       |                       |
| Insurance benefits paid or provided:                    |                          |                       |                       |
| Claims and surrenders                                   | \$64,656                 | 60,056                | 61,038                |
| Increase in future policy benefit reserves              | 66,676                   | 58,264                | 46,420                |
| Policyholders' dividends                                | 9,091                    | 8,072                 | 7,485                 |
| Total insurance benefits paid or provided               | 140,423                  | 126,392               | 114,943               |
| Commissions   | 39,398                   | 38,374                | 36,585                |
| Other general expenses                                  | 25,664                   | 26,040                | 26,228                |
| Capitalization of deferred policy acquisition costs     | (29,074                  | ) (27,826             | ) (26,172             |
| Amortization of deferred policy acquisition costs       | 17,845                   | 16,848                | 17,293                |
| Amortization of cost of customer relationships acquired | 2,467                    | 2,998                 | 3,058                 |
| Total benefits and expenses                             | \$196,723                | 182,826               | 171,935               |

Claims and Surrenders. As noted in the table below, claims and surrenders increased from \$60.1 million in 2011 to \$64.7 million in 2012.

|                              | Years Ended December 31, |        |        |
|------------------------------|--------------------------|--------|--------|
|                              | 2012                     | 2011   | 2010   |
|                              | (In thousands)           |        |        |
| Death claims                 | \$22,730                 | 20,996 | 22,670 |
| Surrender expenses           | 21,217                   | 19,978 | 19,727 |
| Endowment benefits           | 15,814                   | 14,537 | 14,499 |
| Property claims              | 2,309                    | 1,986  | 1,578  |
| Accident and health benefits | 368                      | 449    | 608    |
| Other policy benefits        | 2,218                    | 2,110  | 1,956  |
| Total claims and surrenders  | \$64,656                 | 60,056 | 61,038 |

The Company monitors death claims based upon expectations. The claims experience was unfavorable in 2012, increasing by 8.3% from 2011 recorded amounts. These values may routinely fluctuate from year to year. Additionally, 2011 results include a \$0.8 million incurred but not reported release of liability related to our claim expense calculation.

Policy surrenders increased in 2012, 2011 and 2010, but remained at a level that represents approximately 0.5% of direct ordinary whole life insurance inforce. The increase in surrender expense is primarily related to our international business and is expected to increase over time due to the aging of this block of business. A significant portion of surrenders relates to policies that have been in force over fifteen years and no longer have a surrender charge associated with them. Total direct insurance inforce reported in 2012 and 2011 was \$4.6 billion compared to \$4.5 billion in 2010.

Endowment benefits increased in each of the last three years. We have a series of international policies that carry an immediate endowment benefit of an amount selected by the policy owner. These benefits have been popular in the

Pacific Rim and Latin America, where the Company has experienced increased interest in our guaranteed products in recent years. Like policy dividends, annual guaranteed endowments are factored into the premium and, as such, the increase has no impact on profitability. The Company expects these benefits to continue to increase as this block of business increases and persists.



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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Property claims increased 16% to approximately \$2.3 million in 2012 compared with the amount reported for 2011 due to Hurricane Issac claims experience in the current year with \$0.5 million uninsured losses. The 2010 reported property claim amounts were lower than historical experience.

Reserves. The change in future policy benefit reserves has increased 14.4% and 25.5% in 2012 and 2011 due primarily to the current low interest rate environment necessitating higher reserves for policies issued in the last few years due to lower long term yield projections compared to prior assumptions. In addition, we continue to experience growth in new sales of endowment products, which require higher initial reserve levels, than whole life products. Endowment sales totaled approximately \$14.3 million, \$12.3 million and \$9.4 million in 2012, 2011 and 2010, respectively.

Policyholder Dividends. Policyholder dividends have risen at a rate corresponding with the growth rate in new international life insurance premiums. The Company issues long duration participating policies to foreign residents that are expected to pay dividends to policyholders based upon actual experience. Policyholder dividends are factored into the premiums and have no impact on profitability.

Commissions. Commission expense fluctuates in a direct relationship to new and renewal insurance premiums and has increased 2.7% in 2012 compared to 2011 as premium revenues have increased.

Other General Expenses. Total general expenses decreased over the past several years on a consolidated basis as management has created efficiencies and improved processes. The decrease year to year was primarily related to lower audit, legal and consulting fees, as well as employee benefit cost reductions. We moved to a self insurance health plan for our employees in 2010 and have successfully decreased our overall benefit expenses.

We perform an expense study on an annual basis, utilizing an enterprise-wide time study, and we adjust cost allocations among entities as needed based upon this review. Any allocation changes are reflected in the segment operations, but do not impact total expenses.

Deferred Policy Acquisition Costs. Capitalized deferred policy acquisition costs ("DAC") were \$29.1 million, \$27.8 million and \$26.2 million in 2012, 2011 and 2010. These costs will vary based upon successful efforts related to newly issued policies and renewal business. Significantly lower amounts are capitalized related to renewal business in correlation with the lower commissions paid on that business compared to first year business which have higher commission rates.

Amortization of deferred policy acquisition costs is impacted by persistency and may fluctuate from year to year. Amortization costs increased in 2012 compared to 2011 as a result of the asset balance growth. Policy persistency was comparable in the life segment for the periods presented, but declined in the Home Service segment in 2012 and 2011, resulting in higher amortization. In addition, the prolonged low interest rate environment impacted the assumptions used in the development of the DAC asset for new policies issued in 2012 and 2011. This resulted in a lower DAC balance and increased amortization by approximately \$0.4 million and \$1.4 million in 2012 and 2011, respectively.

Cost of Customer Relationships Acquired and Other Intangibles. The higher amortization in 2010 and 2011 was related primarily to the ICC acquisition and greater amortization due to the increase in lapses on this new block of business. The current year amortization level recorded in 2012 is indicative of what we expect going forward or until we make additional acquisitions.

Federal Income Tax. Federal income tax expense was \$1.5 million, \$2.8 million and \$3.7 million in 2012, 2011 and 2010, respectively, resulting in effective tax rates of 25.0%, 25.1% and 20.0%, respectively. 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. In addition, the fair value change related to outstanding warrants of \$0.5 million, \$1.1 million, and \$0.2 million were reported as an increase in revenues in 2012, 2011 and 2010 respectively, which was not taxable and also impacted our corporate tax rate. Differences between our effective tax rate and the statutory tax rate result from income and expense items that are treated differently for financial reporting and tax purposes.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Segment Operations

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 segments generate the majority of our income. The amount of insurance, number of policies, and average face amounts of policies issued during the periods indicated are shown below.

|                 | Years Ended December 31,<br>2012 |                                 |   | 2011                             |                                 |   |
|-----------------|----------------------------------|---------------------------------|---|----------------------------------|---------------------------------|---|
|                 | Amount of<br>Insurance<br>Issued | Number of<br>Policies<br>Issued | Average Policy<br>Face Amount<br>Issued | Amount of<br>Insurance<br>Issued | Number of<br>Policies<br>Issued | Average Policy<br>Face Amount<br>Issued |
| Life            | 352,353,052                      | 5,745                           | 61,332                                  | 362,795,290                      | 5,921                           | 61,273                                  |
| Home<br>Service | 191,191,997                      | 28,402                          | 6,574                                   | 194,870,735                      | 27,289                          | 7,141                                   |

These segments are reported in accordance with U.S. GAAP. The Company evaluates profit and loss performance based on net income before federal income taxes.

|                                 | Income (Loss) Before Federal Income Taxes<br>Years Ended December 31, |                       |                       |
|---------------------------------|---|-----------------------|-----------------------|
|                                 | 2012  | 2011<br>(As adjusted) | 2010<br>(As adjusted) |
|                                 | (In thousands)  |                       |                       |
| Life Insurance                  | \$519   | 5,725                 | 12,552                |
| Home Service Insurance          | 6,365   | 5,926                 | 6,839                 |
| Other Non-Insurance Enterprises | (848  | ) (321                | ) (1,002              |
| Total                           | \$6,036   | 11,330                | 18,389                |

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Life Insurance

Our Life Insurance segment primarily issues ordinary whole life insurance in U.S. Dollar-denominated amounts to foreign residents in approximately 30 countries through approximately 1,500 independent marketing consultants, and domestically through over 400 independent marketing firms and consultants throughout the United States.

|   | Years Ended December 31, |               |               |
|---|--------------------------|---------------|---------------|
|   | 2012                     | 2011          | 2010          |
|   |                          | (As adjusted) | (As adjusted) |
|   | (In thousands)           |               |               |
| Revenue:  |                          |               |               |
| Premiums  | \$126,032                | 118,205       | 109,985       |
| Net investment income                                   | 17,828                   | 16,401        | 15,666        |
| Realized investment gains, net                          | 512                      | 1,347         | 6,590         |
| Other income  | 319                      | 526           | 650           |
| Total revenue   | 144,691                  | 136,479       | 132,891       |
| Benefits and expenses:                                  |                          |               |               |
| Insurance benefits paid or provided:                    |                          |               |               |
| Claims and surrenders                                   | 43,537                   | 40,525        | 41,040        |
| Increase in future policy benefit reserves              | 63,481                   | 54,310        | 42,619        |
| Policyholders' dividends                                | 8,846                    | 8,004         | 7,414         |
| Total insurance benefits paid or provided               | 115,864                  | 102,839       | 91,073        |
| Commissions   | 24,895                   | 23,482        | 21,899        |
| Other general expenses                                  | 10,961                   | 11,418        | 10,546        |
| Capitalization of deferred policy acquisition costs     | (23,371)                 | (21,675)      | (20,140)      |
| Amortization of deferred policy acquisition costs       | 15,077                   | 13,769        | 15,856        |
| Amortization of cost of customer relationships acquired | 746                      | 921           | 1,105         |
| Total benefits and expenses                             | 144,172                  | 130,754       | 120,339       |
| Income before federal income tax expense                | \$519                    | 5,725         | 12,552        |

Premiums. Premium revenues increased for 2012 compared to 2011 and 2010, due to higher international renewal premiums, which have experienced strong persistency as this block of insurance ages. First year premiums increased in the current year, reflecting improved new business production in all products internationally. Sales from Colombia, Ecuador, Taiwan and Venezuela represented the majority of the first year premium increase.

Endowment sales represent a significant portion of new business sales internationally, as these products continue to exceed our whole life sales in the current markets. In addition, most of our life insurance policies contain a policy loan provision, which allows the policyholder to use cash value of a policy to pay premiums. The policy loan asset balance increased 10.2% year over year.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Life Insurance premium breakout is detailed below.

|               | Years Ended December 31, |         |         |
|---------------|--------------------------|---------|---------|
|               | 2012                     | 2011    | 2010    |
|               | (In thousands)           |         |         |
| Premiums:     |                          |         |         |
| First year    | \$18,819                 | 17,735  | 16,630  |
| Renewal       | 107,213                  | 100,470 | 93,355  |
| Total premium | \$126,032                | 118,205 | 109,985 |

The following table sets forth, by country, our direct premiums from our international life insurance business for the periods indicated. Our international business and premium collections could be impacted by future changes relative to laws, regulations or economic events in the countries from which we accept applications.

| Country        | Years ended December 31, |                |   | 2011      |       | 2010 |           |       |   |
|----------------|--------------------------|----------------|---|-----------|-------|------|-----------|-------|---|
|                | 2012                     | (In thousands) |   |           |       |      |           |       |   |
| Venezuela      | \$27,295                 | 23.1           | % | \$21,154  | 19.2  | %    | \$16,757  | 16.4  | % |
| Colombia       | 25,088                   | 21.3           |   | 21,770    | 19.8  |      | 21,507    | 21.1  |   |
| Taiwan         | 16,223                   | 13.8           |   | 14,199    | 12.9  |      | 14,357    | 14.1  |   |
| Ecuador        | 15,333                   | 13.0           |   | 13,483    | 12.2  |      | 12,354    | 12.1  |   |
| Argentina      | 10,360                   | 8.8            |   | 9,355     | 8.5   |      | 9,190     | 9.0   |   |
| Other Non-U.S. | 23,684                   | 20.0           |   | 30,141    | 27.4  |      | 27,927    | 27.3  |   |
| Total          | \$117,983                | 100.0          | % | \$110,102 | 100.0 | %    | \$102,092 | 100.0 | % |

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

| State        | Years ended December 31, |                |   | 2011     |       | 2010 |          |       |   |
|--------------|--------------------------|----------------|---|----------|-------|------|----------|-------|---|
|              | 2012                     | (In thousands) |   |          |       |      |          |       |   |
| Texas        | \$5,318                  | 42.0           | % | \$5,240  | 41.5  | %    | \$5,670  | 41.1  | % |
| Indiana      | 1,726                    | 13.6           |   | 1,680    | 13.3  |      | 1,857    | 13.5  |   |
| Mississippi  | 1,033                    | 8.2            |   | 1,088    | 8.6   |      | 1,182    | 8.6   |   |
| Oklahoma     | 856                      | 6.8            |   | 946      | 7.5   |      | 1,132    | 8.2   |   |
| Missouri     | 735                      | 5.8            |   | 831      | 6.6   |      | 914      | 6.6   |   |
| Other States | 2,979                    | 23.6           |   | 2,848    | 22.5  |      | 3,050    | 22.0  |   |
| Total        | \$12,647                 | 100.0          | % | \$12,633 | 100.0 | %    | \$13,805 | 100.0 | % |

A number of domestic life insurance companies we acquired had blocks of accident and health insurance policies which we have ceded under a coinsurance agreement with an unaffiliated insurance company. Under the agreement, the other company assumes substantially all of our accident and health policies. The premium amounts ceded under the coinsurance agreement in the years ended December 31, 2012, 2011, and 2010 were \$3.9 million, \$4.5 million and \$5.3 million, respectively.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Net Investment Income. Net investment income has been negatively impacted by the low interest rate environment, which has resulted in declining portfolio yields, as discussed in the Consolidated Results of Operations above.

|   | For the Years Ended December 31, |         |         |   |
|---|----------------------------------|---------|---------|---|
|   | 2012                             | 2011    | 2010    |   |
|   | (In thousands, except for %)     |         |         |   |
| Net investment income                       | \$17,828                         | 16,401  | 15,666  |   |
| Average invested assets, at amortized cost  | 494,289                          | 443,707 | 396,360 |   |
| Annualized yield on average invested assets | 3.61                             | % 3.89  | % 4.17  | % |

Realized Investment Gains, Net. Realized gains of \$0.5 million, \$1.3 million and \$6.6 million were recognized in 2012, 2011 and 2010, due primarily to disposals of previously impaired equity mutual funds.

A breakout of claims and surrender benefits is detailed below.

|                              | For the Years Ended December 31, |        |        |
|------------------------------|----------------------------------|--------|--------|
|                              | 2012                             | 2011   | 2010   |
|                              | (In thousands)                   |        |        |
| Death claims                 | \$7,134                          | 6,775  | 7,278  |
| Surrender expenses           | 18,601                           | 17,244 | 17,354 |
| Endowment benefits           | 15,790                           | 14,524 | 14,473 |
| Accident and health benefits | 260                              | 308    | 443    |
| Other policy benefits        | 1,752                            | 1,674  | 1,492  |
| Total claims and surrenders  | \$43,537                         | 40,525 | 41,040 |

Death claims expense increased 5.3% in 2012 compared to 2011 due to more reported claims in the current year but were below the level experienced in 2010. In addition, 2011 results included a \$0.2 million release of incurred but not reported liability related to our claim experience calculation. Mortality experience is closely monitored by the Company as a key performance indicator and these amounts were within expected levels.

The increase in surrender expense is primarily related to our international business and is expected to increase over time due to the aging of this block of business. The majority of policy surrender benefits paid is attributable to our international business and was related to policies that have been in force over fifteen years, where surrender charges are no longer applicable.

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

Other policy benefits increased in the current year due primarily to interest paid on premium deposits and dividend accumulations, as these policyholder liability accounts have increased.

Increase in Future Policy Benefit Reserves. Policy benefit reserves in 2012 increased compared to the same periods in 2011, primarily from the effect of the current low interest rate environment on reserve development for policies issued in the last few years which have higher reserve build up compared to prior issue years. The accounting guidance of long duration contracts we sell requires the Company to “lock in” the original assumptions such as mortality, interest, surrenders and expenses at the time the initial policies are written, therefore gains or losses

attributable to actual experience that differs from the original assumptions flows through the income statement in the period where in the differences occur.

In addition, reserves have risen year over year for all periods presented due to the increased sales of endowment products, which build up reserve balances more quickly compared to other life product sales. Endowment sales totaled approximately \$14.3



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

million, \$12.3 million and \$9.4 million, representing approximately 81.9%, 69.4% and 56.5% of total new first year premium in 2012, 2011, and 2010, respectively.

**Policyholder Dividends.** Policyholder dividends have risen at a rate that corresponds with the growth rate in new international life insurance premiums. The Company issues long duration participating policies to foreign residents that are expected to pay dividends to policyholders based upon actual experience. Policyholder dividends are factored into the premiums and have no impact on profitability.

**Capitalization and Amortization of Deferred Policy Acquisition Costs.** Capitalized costs increased, as commission related costs have increased in the current year compared to 2011. Amortization of DAC increased in the current year by 9.5% from 2011 as the asset balance has increased. Amortization in 2010 was up compared to the two more recent years due to worse persistency experience in that particular year compared to both 2012 and 2011.

**Commissions.** Commission expense increase is directly related to the increase in premiums as noted above. First year policy premiums pay a higher commission rate than renewal policy premiums.

**Other General Expenses.** The expenses are allocated by segment, based upon an annual expense study performed by the Company, and were down due to lower audit and actuarial fees as well as employee benefit related costs.

## Home Service Insurance

Our Home Service Insurance segment provides pre-need and final expense ordinary life insurance and annuities to middle and lower income individuals primarily in Louisiana, Mississippi and Arkansas. Our policies in this segment are sold and serviced through funeral homes and a home service marketing distribution system utilizing over 550 employees and independent agents.

|   | Years Ended December 31, |               |               |
|---|--------------------------|---------------|---------------|
|   | 2012                     | 2011          | 2010          |
|   |                          | (As adjusted) | (As adjusted) |
|   | (In thousands)           |               |               |
| Revenue:  |                          |               |               |
| Premiums  | \$43,841                 | 43,190        | 42,067        |
| Net investment income                                   | 12,724                   | 12,861        | 13,008        |
| Realized investment gains (losses), net                 | (343                     | ) (601        | ) 1,475       |
| Other income  | 80                       | 112           | 82            |
| Total revenue   | 56,302                   | 55,562        | 56,632        |
| Benefits and expenses:                                  |                          |               |               |
| Insurance benefits paid or provided:                    |                          |               |               |
| Claims and surrenders                                   | 21,119                   | 19,531        | 19,998        |
| Increase in future policy benefit reserves              | 3,195                    | 3,954         | 3,801         |
| Policyholders' dividends                                | 245                      | 68            | 71            |
| Total insurance benefits paid or provided               | 24,559                   | 23,553        | 23,870        |
| Commissions   | 14,503                   | 14,892        | 14,686        |
| Other general expenses                                  | 12,089                   | 12,186        | 13,879        |
| Capitalization of deferred policy acquisition costs     | (5,703                   | ) (6,151      | ) (6,032      |
| Amortization of deferred policy acquisition costs       | 2,768                    | 3,079         | 1,437         |
| Amortization of cost of customer relationships acquired | 1,721                    | 2,077         | 1,953         |

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|  |         |        |        |
|--|---------|--------|--------|
| Total benefits and expenses              | 49,937  | 49,636 | 49,793 |
| Income before federal income tax expense | \$6,365 | 5,926  | 6,839  |

Premiums. The premium increases were due to the fact that this segment is continuing to report marginal growth primarily in Louisiana. Also, there is an increase of approximately \$180,000 of single premium due to a one time adjustment as noted below under Policyholders' dividends.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

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

| State        | Years ended December 31, |                | 2011       |       | 2010       |       |   |  |
|--------------|--------------------------|----------------|------------|-------|------------|-------|---|--|
|              | 2012                     | (In thousands) |            |       |            |       |   |  |
| Louisiana    | \$41,665                 | 92.8           | % \$41,134 | 92.7  | % \$39,973 | 92.5  | % |  |
| Arkansas     | 1,863                    | 4.1            | 1,869      | 4.2   | 1,837      | 4.3   |   |  |
| Mississippi  | 451                      | 1.0            | 370        | 0.8   | 334        | 0.8   |   |  |
| Other States | 937                      | 2.1            | 979        | 2.3   | 1,079      | 2.4   |   |  |
| Total        | \$44,916                 | 100.0          | % \$44,352 | 100.0 | % \$43,223 | 100.0 | % |  |

Net Investment Income. Net investment income has been negatively impacted by the low interest rate environment, which has resulted in declining portfolio yields as discussed in the Consolidated Results of Operations above.

Net investment income for our home service insurance segment is summarized as follows:

|   | For the Years Ended December 31, |         |         |   |
|---|----------------------------------|---------|---------|---|
|   | 2012                             | 2011    | 2010    |   |
|   | (In thousands, except for %)     |         |         |   |
| Net investment income                       | \$12,724                         | 12,861  | 13,008  |   |
| Average invested assets, at amortized cost  | 291,229                          | 287,833 | 279,682 |   |
| Annualized yield on average invested assets | 4.37                             | % 4.47  | % 4.65  | % |

Realized Investment Gains (Losses), Net. Net losses on investment of \$0.3 million in 2012 is related to an OTTI adjustment on one coal energy provider debt issuer. The operations of this energy provider have been negatively impacted by challenging environment in the coal-fired generation sector and overall decline in the price of power it can charge to customers. This fixed maturity security is scheduled to mature in 2017. Net realized losses of \$0.6 million in 2011 are due primarily from an OTTI on one American Airlines debt security that totaled \$70,000 due to the issuer filing bankruptcy, and a write-down of approximately \$0.5 million related to investment real estate for an office building in Arkansas. We obtained an appraisal in 2011 that reflected a loss in fair value. Gains of \$1.5 million in 2010 related primarily to sales of below investment grade securities that were added to the portfolio as part of an acquisition and had been previously impaired.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Claims and Surrenders. A breakout of claims and surrender benefits is detailed below.

|                              | For the Years Ended December 31, |        |        |
|------------------------------|----------------------------------|--------|--------|
|                              | 2012                             | 2011   | 2010   |
|                              | (In thousands)                   |        |        |
| Death claims                 | \$15,596                         | 14,221 | 15,392 |
| Surrender expenses           | 2,616                            | 2,734  | 2,374  |
| Endowment benefits           | 24                               | 13     | 26     |
| Property claims              | 2,309                            | 1,986  | 1,578  |
| Accident and health benefits | 108                              | 141    | 165    |
| Other policy benefits        | 466                              | 436    | 463    |
| Total claims and surrenders  | \$21,119                         | 19,531 | 19,998 |

Death claims expense was higher in 2012 compared to 2011 due to more reported claims in the current year. In addition, 2011 results include a \$0.6 million incurred but not reported release of liability related to our claim experience calculation. Mortality experience is closely monitored by the Company as a key performance indicator and these amounts were within expected levels.

Surrender benefits have increased in 2012 and 2011 compared to 2010, as the Home Service block grows, and is consistent with expectations for the current economic conditions.

Property claims increased in 2012 related to Hurricane Isaac. Gross Isaac losses recorded were approximately \$740,000 with reinsurance recoverable of \$240,000.

Increase in Future Policy Benefit Reserves. The current year change in reserves reflects increased lapse experience in 2012 compared to 2011 and 2010. We believe the increase in lapses are due to Hurricane Isaac and economic pressures from increased unemployment.

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

Commissions. Commission expense decreased in 2012 compared to 2011 and 2010 because agents are compensated based upon month-to-month route premium growth that has been impacted by increased policy lapses. This results in a lower commission to premium relationship as compensation is reduced. In addition, we have consolidated some collection routes, which resulted in elimination of one district office and its related staffing thereby also reducing the commission expense.

Other General Expenses. The expenses are allocated by segment based upon an annual expense study performed by the Company and were down in 2012 due to lower audit and actuarial fees as well as employee benefit related costs. Other general expenses decreased in 2011 compared to 2010, due to an overall decrease in expenses and a reallocation of expenses that became effective January 1, 2011, which reduced the home service segment allocation by \$1.5 million and increased the life segment allocation for that year.

Capitalization and Amortization of Deferred Policy Acquisition Costs ("DAC"). DAC capitalization is directly correlated to fluctuations in first year commissions. Amortization in 2012 and 2011 increased compared to 2010 primarily because we experienced a higher lapse rate in the two most recent years in this segment. We monitor lapse rates as a key component of our insurance operations. Amortization in 2011 includes an adjustment that resulted in an increase of \$0.3 million due to a refinement in an estimate using system generated information related to SPLIC assumptions. Amortization reported in 2010 is impacted by an adjustment that decreased amortization by \$0.3 million in that reporting period.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Other Non-Insurance Enterprises

Overall, other non-insurance operations are relatively immaterial to the consolidated results, except for the fair value adjustment related to the Company's warrants to purchase Class A common stock. These amounts have fluctuated due to the movement in our Class A common stock price and fair value calculation for warrants using the Black-Scholes valuation model. There are no warrants outstanding at the end of 2012.

## Investments

Financial stability and the prevention of capital erosion are important investment considerations for the Company. A primary investment goal is the conservation of assets due to the long-term nature of a significant portion of our liabilities. The administration of our investment portfolios is handled internally, pursuant to board-approved investment guidelines, with all trading activity approved by a committee of each entity's respective board of directors of our insurance company subsidiaries. The guidelines used require that bonds, both government and corporate, are of high quality, investment grade and comprise a majority of the investment portfolio. State insurance statutes prescribe the quality and percentage of the various types of investments that may be made by insurance companies and generally permit investment in qualified state, municipal, federal and foreign government obligations, high quality corporate bonds, preferred and common stock, mortgage loans and real estate within certain specified percentages. The assets selected are intended to mature in accordance with the average maturity of the insurance products and to provide the cash flow for our insurance company subsidiaries to meet their respective policyholder obligations.

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

|   | December 31, 2012                |                              | December 31, 2011                |                              |   |
|---|----------------------------------|------------------------------|----------------------------------|------------------------------|---|
|   | Carrying Value<br>(In thousands) | % of Total<br>Carrying Value | Carrying Value<br>(In thousands) | % of Total<br>Carrying Value |   |
| Fixed maturity securities:                              |                                  |                              |                                  |                              |   |
| U.S. Treasury and U.S. Government-sponsored enterprises | \$ 128,156                       | 13.4                         | % \$ 321,186                     | 36.8                         | % |
| Corporate   | 248,747                          | 26.0                         | 195,374                          | 22.4                         |   |
| Municipal bonds (2)                                     | 407,896                          | 42.5                         | 216,202                          | 24.8                         |   |
| Mortgage-backed (1)                                     | 6,588                            | 0.7                          | 8,849                            | 1.0                          |   |
| Foreign governments                                     | 141                              | —                            | 142                              | —                            |   |
| Total fixed maturity securities                         | 791,528                          | 82.6                         | 741,753                          | 85.0                         |   |
| Short-term investments                                  | 2,340                            | 0.2                          | 2,048                            | 0.2                          |   |
| Cash and cash equivalents                               | 56,299                           | 5.9                          | 33,255                           | 3.8                          |   |
| Other investments:                                      |                                  |                              |                                  |                              |   |
| Policy loans  | 42,993                           | 4.5                          | 39,090                           | 4.5                          |   |
| Equity securities                                       | 53,741                           | 5.6                          | 46,137                           | 5.3                          |   |
| Mortgage loans  | 1,509                            | 0.2                          | 1,557                            | 0.2                          |   |
| Real estate and other long-term investments             | 8,553                            | 0.9                          | 8,644                            | 1.0                          |   |
| Total cash, cash equivalents and investments            | \$ 956,963                       | 99.9                         | % \$ 872,484                     | 100.0                        | % |

(1) Includes \$6.1 million and \$8.1 million of U.S. Government agencies and government-sponsored enterprise for the years ended December 31, 2012 and 2011, respectively.

(2) Includes \$292.6 million and \$123.5 million of securities guaranteed by third parties for the years ended December 31, 2012 and 2011, respectively.

The current year decline in U.S. government-sponsored securities is due to call activity from this sector and reinvestment into fixed maturity corporate and municipal bond categories. The Company has increased investments in municipals primarily related to Build America taxable bonds, essential services and corporate issuer holdings in the utility sector.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

At December 31, 2012, investments in fixed maturity and equity securities were 88.2% of our total cash, and cash equivalents and investments. All of our fixed maturities were classified as either available-for-sale or held-to-maturity securities at December 31, 2012 and 2011. We had no fixed maturity or equity securities that were classified as trading securities at December 31, 2012 or 2011.

As previously discussed, our investment portfolios have been impacted significantly by the low interest rate environment over the past several years. The following table shows investment yields by segment operations as of December 31 for each year presented.

| Year | Business Segment |              | Consolidated |   |
|------|------------------|--------------|--------------|---|
|      | Life Insurance   | Home Service |              |   |
| 2012 | 3.61             | % 4.37       | % 3.81       | % |
| 2011 | 3.89             | % 4.47       | % 3.92       | % |
| 2010 | 4.17             | % 4.65       | % 4.20       | % |

Yields on investment assets vary between segment operations due to different portfolio mixes in the segments. The life segment invests more in U.S. Government securities while the home service segment has a larger concentration in the corporate and municipal sectors. The following table shows the breakdown between segments by investment bond category based on amortized cost.

| Fixed Maturity Category                     | December 31, 2012 |              |                                 | Consolidated |
|---|-------------------|--------------|---------------------------------|--------------|
|   | Life Insurance    | Home Service | Other Non-Insurance Enterprises |              |
|   | (In thousands)    |              |                                 |              |
| U.S. Treasury and U.S. Government-sponsored | \$86,762          | 32,805       | 1,023                           | 120,590      |
| Corporate                                   | 118,376           | 100,099      | 10,022                          | 228,497      |
| Municipal bonds                             | 227,945           | 131,515      | 31,986                          | 391,446      |
| Mortgage-backed                             | 633               | 5,473        | —                               | 6,106        |
| Foreign governments                         | 105               | —            | —                               | 105          |
| Total fixed maturity securities             | \$433,821         | 269,892      | 43,031                          | 746,744      |

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



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

The following table shows the distribution of the credit ratings of our portfolio of fixed maturity securities by carrying value.

|              | December 31, 2012                |                           | December 31, 2011                |                           |   |
|--------------|----------------------------------|---------------------------|----------------------------------|---------------------------|---|
|              | Carrying Value<br>(In thousands) | % of Total Carrying Value | Carrying Value<br>(In thousands) | % of Total Carrying Value |   |
| AAA          | \$60,752                         | 7.7                       | % \$46,663                       | 6.3                       | % |
| AA           | 375,926                          | 47.5                      | 482,869                          | 65.1                      |   |
| A            | 199,302                          | 25.2                      | 99,266                           | 13.4                      |   |
| BBB          | 134,119                          | 16.9                      | 95,558                           | 12.9                      |   |
| BB and other | 21,429                           | 2.7                       | 17,397                           | 2.3                       |   |
| Totals       | \$791,528                        | 100.0                     | % \$741,753                      | 100.0                     | % |

The Company made new investments in the A and BBB credit category of taxable municipals and corporate bonds, primarily public utility issuers with an average maturity of seven years. The increase in non-investment grade securities was due to downgrades of issuers in the current period, as the Company does not purchase below investment grade securities.

As of December 31, 2012, the Company held municipal securities that include third party guarantees. Detailed below is a presentation by NRSRO rating of our municipal holdings by funding type.

## Municipals shown including third party guarantees

|              | December 31, 2012   |                | Special Revenue |                | Other      |                | Total      |                | % Based on Amortized Cost |   |
|--------------|---|----------------|-----------------|----------------|------------|----------------|------------|----------------|---------------------------|---|
|              | General Obligation Fair Value<br>(In thousands, except percentages) | Amortized Cost | Fair Value      | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost |                           |   |
| AAA          | \$30,562  | 27,765         | 12,832          | 11,867         | —          | —              | 43,394     | 39,632         | 10.1                      | % |
| AA           | 83,220  | 77,762         | 142,112         | 131,788        | 5,196      | 5,168          | 230,528    | 214,718        | 54.9                      |   |
| A            | 28,082  | 27,860         | 89,335          | 87,527         | 2,828      | 2,841          | 120,245    | 118,228        | 30.2                      |   |
| BBB          | 539   | 514            | 12,288          | 12,124         | 1,031      | 1,042          | 13,858     | 13,680         | 3.5                       |   |
| BB and other | —   | —              | 4,928           | 5,188          | —          | —              | 4,928      | 5,188          | 1.3                       |   |
| Total        | \$142,403   | 133,901        | 261,495         | 248,494        | 9,055      | 9,051          | 412,953    | 391,446        | 100.0                     | % |

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Municipals shown excluding third party guarantees

|                 | December 31, 2012                   |                   | Special Revenue |                   | Other         |                   | Total         |                   | % Based on        |   |
|-----------------|-------------------------------------|-------------------|-----------------|-------------------|---------------|-------------------|---------------|-------------------|-------------------|---|
|                 | General Obligation<br>Fair<br>Value | Amortized<br>Cost | Fair<br>Value   | Amortized<br>Cost | Fair<br>Value | Amortized<br>Cost | Fair<br>Value | Amortized<br>Cost | Amortized<br>Cost |   |
|                 | (In thousands, except percentages)  |                   |                 |                   |               |                   |               |                   |                   |   |
| AAA             | \$7,000                             | 6,757             | 11,209          | 10,361            | —             | —                 | 18,209        | 17,118            | 4.4               | % |
| AA              | 95,836                              | 88,569            | 98,652          | 90,381            | 4,171         | 4,180             | 198,659       | 183,130           | 46.8              |   |
| A               | 39,029                              | 38,061            | 129,896         | 126,030           | 3,853         | 3,829             | 172,778       | 167,920           | 42.9              |   |
| BBB             | 538                                 | 514               | 16,810          | 16,534            | 1,031         | 1,042             | 18,379        | 18,090            | 4.6               |   |
| BB and<br>other | —                                   | —                 | 4,928           | 5,188             | —             | —                 | 4,928         | 5,188             | 1.3               |   |
| Total           | \$142,403                           | 133,901           | 261,495         | 248,494           | 9,055         | 9,051             | 412,953       | 391,446           | 100.0             | % |

The Company was not exposed to holding investments in any category under special revenue bond that were greater than 10% based upon activity as of December 31, 2012.

The tables below represent the Company's detailed exposure of municipal holdings in Louisiana and Texas, which exceed 10% of the total municipal portfolio as of December 31, 2012.

|   | General Obligation |                   | Special Revenue |                   | Other         |                   | Total         |                   |
|---|--------------------|-------------------|-----------------|-------------------|---------------|-------------------|---------------|-------------------|
|   | Fair<br>Value      | Amortized<br>Cost | Fair<br>Value   | Amortized<br>Cost | Fair<br>Value | Amortized<br>Cost | Fair<br>Value | Amortized<br>Cost |
|   | (In thousands)     |                   |                 |                   |               |                   |               |                   |
| Louisiana securities<br>including third party<br>guarantees |                    |                   |                 |                   |               |                   |               |                   |
| AA  | \$9,589            | 8,889             | 23,277          | 22,115            | —             | —                 | 32,866        | 31,004            |
| A   | 5,247              | 5,155             | 15,692          | 14,771            | —             | —                 | 20,939        | 19,926            |
| BBB   | 539                | 514               | 3,771           | 3,752             | 1,031         | 1,042             | 5,341         | 5,308             |
| BB and other  | —                  | —                 | 4,928           | 5,188             | —             | —                 | 4,928         | 5,188             |
| Total   | \$15,375           | 14,558            | 47,668          | 45,826            | 1,031         | 1,042             | 64,074        | 61,426            |
| Louisiana securities<br>excluding third party<br>guarantees |                    |                   |                 |                   |               |                   |               |                   |
| AA  | \$8,478            | 7,844             | 15,844          | 15,123            | —             | —                 | 24,322        | 22,967            |
| A   | 6,358              | 6,200             | 21,792          | 20,494            | —             | —                 | 28,150        | 26,694            |
| BBB   | 539                | 514               | 5,104           | 5,021             | 1,031         | 1,042             | 6,674         | 6,577             |
| BB and other  | —                  | —                 | 4,928           | 5,188             | —             | —                 | 4,928         | 5,188             |
| Total   | \$15,375           | 14,558            | 47,668          | 45,826            | 1,031         | 1,042             | 64,074        | 61,426            |

The Company invests in municipal securities of issuers in the state of Louisiana and receives a credit that reduces its premium tax liability in that state. At December 31, 2012, total holdings of municipal securities in Louisiana represented 15.5% of all municipal holdings based upon fair value. The Company also holds 20.3% of its municipal holdings in Texas issuers.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

|   | General Obligation |                | Special Revenue |                | Total      |                |
|---|--------------------|----------------|-----------------|----------------|------------|----------------|
|   | Fair Value         | Amortized Cost | Fair Value      | Amortized Cost | Fair Value | Amortized Cost |
|   | (In thousands)     |                |                 |                |            |                |
| Texas securities including third party guarantees |                    |                |                 |                |            |                |
| AAA   | \$30,563           | 27,765         | 7,005           | 6,365          | 37,568     | 34,130         |
| AA  | 15,400             | 14,781         | 13,035          | 12,529         | 28,435     | 27,310         |
| A   | 1,199              | 1,198          | 9,078           | 8,817          | 10,277     | 10,015         |
| BBB   | —                  | —              | 7,507           | 7,359          | 7,507      | 7,359          |
| Total   | \$47,162           | 43,744         | 36,625          | 35,070         | 83,787     | 78,814         |
| Texas securities excluding third party guarantees |                    |                |                 |                |            |                |
| AAA   | \$6,565            | 6,300          | 7,005           | 6,365          | 13,570     | 12,665         |
| AA  | 38,528             | 35,380         | 10,319          | 9,846          | 48,847     | 45,226         |
| A   | 2,069              | 2,064          | 11,794          | 11,500         | 13,863     | 13,564         |
| BBB   | —                  | —              | 7,507           | 7,359          | 7,507      | 7,359          |
| Total   | \$47,162           | 43,744         | 36,625          | 35,070         | 83,787     | 78,814         |

There were no other states or individual issuer holdings that represented or exceeded 10% of the total municipal portfolio as of December 31, 2012.

## Impairment Considerations Related to Investments in Fixed Maturity and Equity Securities

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

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

We recorded an OTTI write-down in 2012 of \$1,319,000 related to one coal powered energy issuer debt security holding which has a maturity date in 2017. The operations of this energy provider have been negatively impacted by the challenging environment in the coal-fired generation sector and overall decline in the price of power it can charge to customers. The Company recorded an OTTI of \$70,000 in 2011 related to one American Airlines bond holding, as

the issuer filed for bankruptcy. An additional impairment of \$27,000 was recorded in 2010 to write a security down to zero carrying value. Based upon our emphasis on investing in fixed maturity securities primarily composed of obligations of U.S. Government-sponsored corporations and our analysis of whether declines in fair value below cost are temporary or other-than-temporary, management believes that our investments in fixed maturity investments at December 31, 2012 were not impaired, and no additional other-than-temporary losses need to be recorded.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Gross unrealized losses on fixed maturities available-for-sale amounted to \$1.1 million as of December 31, 2012 and \$3.0 million as of December 31, 2011. This decrease in gross unrealized losses was due to a decrease in the interest rate environment. There were \$0.2 million and \$0.5 million of gross unrealized losses on equity securities as of December 31, 2012 and 2011. In 2012, 2011 and 2010, the Company sold equity mutual fund holdings from the Life and Home Service segments and recorded realized gains of \$0.6 million, \$1.3 million and \$6.4 million due to market recovery since impairment at December 31, 2008. Information on unrealized gains and losses by category is set forth in our consolidated financial statements, Note 2 - Investments, in the "Notes to the Consolidated Financial Statements."

## Reinsurance

As is customary among insurance companies, our insurance company subsidiaries reinsure with other companies portions of the life insurance risks they underwrite. A primary purpose of reinsurance agreements is to enable an insurance company to reduce the amount of risk on any particular life and, by reinsuring the amount exceeding the maximum amount the insurance company is willing to retain, to insure individuals in amounts larger than it could without such agreements. Even though a portion of the risk may be reinsured, our insurance company subsidiaries remain liable to perform all the obligations imposed by the policies issued by them and could be liable if their reinsurers were unable to meet their obligations under the reinsurance agreements.

We believe we have established appropriate reinsurance coverage based upon our net retained insured liabilities compared to our surplus.

The effect of reinsurance on premiums is as follows.

|                     | For the Years Ended December 31, |          |          |
|---------------------|----------------------------------|----------|----------|
|                     | 2012                             | 2011     | 2010     |
|                     | (In thousands)                   |          |          |
| Direct premiums     | \$175,546                        | 167,087  | 159,119  |
| Reinsurance assumed | 1,275                            | 1,874    | 1,553    |
| Reinsurance ceded   | (6,948                           | ) (7,566 | ) (8,620 |
| Net premiums        | \$169,873                        | 161,395  | 152,052  |

Our insurance subsidiaries monitor the solvency of their reinsurers in seeking to minimize the risk of loss in the event of default by a reinsurer. The primary reinsurers of our insurance subsidiaries are large, well-capitalized entities.

The effect of reinsurance on life insurance in force is as follows.

|                                       | For the Years Ended December 31, |        |        |
|---------------------------------------|----------------------------------|--------|--------|
|                                       | 2012                             | 2011   | 2010   |
|                                       | (In millions)                    |        |        |
| Direct written life insurance inforce | \$4,642                          | 4,559  | 4,452  |
| Reinsurance assumed                   | 801                              | 1,147  | 1,045  |
| Reinsurance ceded                     | (467                             | ) (462 | ) (381 |
| Net life insurance inforce            | \$4,976                          | 5,244  | 5,116  |

Virtually all of the Company's non-credit accident and health insurance has been reinsured and is administered by Puritan Life Insurance Company of America, an unaffiliated party. The reinsurance recoverables under this

agreement are collateralized by assets held in a trust for the benefit of the reinsured policies.

The Company monitors the credit ratings of our life and property reinsurers. The ratings by A.M. Best Company range from B+ (Good) to A+ (Superior).

SPFIC has first and second event catastrophe reinsurance coverage of \$10.0 million per event and a retention level of \$500,000 per event. Thus, the first \$500,000 of incurred claims and any claims in excess of \$10.0 million are SPFIC's responsibility. The

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reinsurance premium for first event catastrophe reinsurance was \$1,025,000, \$1,128,000 and \$1,130,000 in 2012, 2011 and 2010, respectively.

Liquidity and Capital Resources

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

Our liquidity requirements are met primarily by funds provided from operations. Premium deposits and revenues, investment income and investment maturities are the primary sources of funds, while investment purchases, policy benefits, and operating expenses are the primary uses of funds. We historically have not had to liquidate investments to provide cash flow, and there were no liquidity issues in 2012 or 2011. Our investments consist of 87.9% of marketable debt securities and 5.5% of equity securities classified as available-for-sale that could be readily converted to cash for liquidity needs.

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

Cash flows from our insurance operations historically have been sufficient to meet current needs. Cash flows from operating activities were \$69.3 million, \$64.3 million and \$60.5 million for the years ended December 31, 2012, 2011 and 2010, respectively. We have traditionally also had significant cash flows from both scheduled and unscheduled fixed maturity security calls, maturities, redemptions, and prepayments, which totaled \$326.7 million, \$283.3 million and \$387.4 million in 2012, 2011 and 2010. These cash flows, for the most part, are reinvested in fixed income securities. Net cash outflows from investment activity totaled \$50.0 million, \$85.1 million and \$62.1 million for the years ended December 31, 2012, 2011 and 2010, respectively. The outflows from investing activities for the year ended December 31, 2012, primarily related to the investment of excess cash and cash equivalents generated from operations during 2012. The Company's cash flows from financing activities were \$3.8 million in 2012, \$4.3 million in 2011 and \$2.6 million in 2010.

The NAIC has established minimum capital requirements in the form of RBC. RBC considers the type of business written by an insurance company, the quality of its assets, and various other aspects of an insurance company's business to develop a minimum level of capital called "Authorized Control Level Risk-based Capital" and compares this level to an adjusted statutory capital that includes capital and surplus as reported under statutory accounting principles, plus certain investment reserves. Should the ratio of adjusted statutory capital to control level risk-based capital fall below 200%, a series of remedial actions by the affected company would be required.

At December 31, 2012, all of our insurance subsidiaries were above the required minimum RBC levels.



December 31, 2012

|       |       |   |
|-------|-------|---|
| CICA  | 551   | % |
| CNLIC | 2,380 | % |
| SPFIC | 421   | % |
| SPLIC | 1,277 | % |

In 2011, CICA contributed 150,000 shares of Citizens, Inc. Class A common stock to CNLIC as a capital contribution due to minimum capital and surplus considerations. The contributed shares had a fair market contributed value of \$1.1 million. These shares were subsequently purchased by Citizens, Inc., the ultimate parent, for \$1.2 million cash in 2011. Citizens, Inc. also purchased

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Class A Common shares in 2012 from CTI with an approximate fair value of \$0.5 million. These transactions have been eliminated under consolidation accounting rules.

## Contractual Obligations and Off-balance Sheet Arrangements

We have committed to the following contractual obligations as of December 31, 2012 with the payments due by the period indicated below:

| Contractual Obligation               | Total          | Less than 1<br>Year | 1 to 3 Years | 3 to 5 Years | More than 5<br>Years |
|--------------------------------------|----------------|---------------------|--------------|--------------|----------------------|
|                                      | (In thousands) |                     |              |              |                      |
| Operating leases                     | \$810          | 378                 | 392          | 40           | —                    |
| Future policy benefit reserves:      |                |                     |              |              |                      |
| Life insurance                       | 762,319        | 282                 | 1,580        | 14,826       | 745,631              |
| Annuities                            | 51,750         | 26,642              | 11,941       | 5,148        | 8,019                |
| Accident and health                  | 5,491          | 5,491               | —            | —            | —                    |
| Total future policy benefit reserves | 819,560        | 32,415              | 13,521       | 19,974       | 753,650              |
| Policy claims payable:               |                |                     |              |              |                      |
| Life insurance                       | 9,659          | 9,659               |              |              |                      |
| Accident and health                  | 642            | 642                 |              |              |                      |
| Casualty                             | 714            | 714                 |              |              |                      |
| Total policy claims payable          | 11,015         | 11,015              | —            | —            | —                    |
| Total contractual obligations        | \$831,385      | 43,808              | 13,913       | 20,014       | 753,650              |

The payments related to the future policy benefits and policy claims payable reflected in the table above have been projected utilizing assumptions based upon our historical experience and anticipated future experience.

The Company does not have off-balance sheet arrangements at December 31, 2012 and, therefore, does not expect any future effects on the Company's financial condition related to any such arrangements. We do not utilize special purpose entities as investment vehicles, nor are there any such entities in which we have an investment that engages in speculative activities of any nature, and we do not use such investments to hedge our investment positions.

## Parent Company Liquidity and Capital Resources

Citizens is a holding company and has had minimal operations of its own. Our assets consist of the capital stock of our subsidiaries, cash, fixed income securities, mutual funds and investment real estate. Our cash flows depend primarily upon the availability of statutorily permissible payments, primarily payments under management agreements from our two primary life insurance subsidiaries, CICA and SPLIC. The ability to make payments is limited by applicable laws and regulations of Colorado, CICA's state of domicile, and Louisiana, SPLIC's state of domicile, which subject insurance operations to significant regulatory restrictions. These laws and regulations require, among other things, that these insurance subsidiaries maintain minimum solvency requirements and limit the amount of dividends these subsidiaries can pay to the holding company. We historically have not relied upon dividends from subsidiaries for our cash flow needs. However, CICA and SPLIC both dividend available funds from time to time in relation to new acquisition target strategies. CICA has contributed amounts in the form of dividends to Citizens totaling \$5.4 million, \$6.8 million and \$9.3 million in 2012, 2011 and 2010, respectively.

Additionally, a substantial portion of our international policyholders invest their policy cash dividends and benefits in our Class A common stock through our Stock Investment Plan (the “Plan”). Once a policyholder elects to participate in the Plan, their policy benefits can be used to purchase Citizens Class A common stock through the Plan in the open market. In addition, our existing holders of Class A common stock, our employees and our independent consultants are eligible to participate in the Plan. If fewer policyholders elect to participate in the Plan, or if our international premium collections were to decrease as a result of regulatory or marketing impediments, the trading volume of our Class A common stock may decline from its present levels.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Critical Accounting Estimates

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect reported amounts and related disclosures. Management considers an accounting estimate to be critical if: (1) it requires assumptions to be made that were uncertain at the time the estimate was made; and (2) changes in the estimate, or different estimates that could have been selected, could have a material effect on our consolidated results of operations or financial condition. While we believe that our estimates, assumptions, and judgments are reasonable, they are based on information presently available. Actual results may differ significantly. Additionally, changes in our assumptions, estimates or assessments as a result of unforeseen events or otherwise could have a material impact on our financial position or results of operations.

Management has discussed the development and selection of its critical accounting estimates with the Audit Committee of the Board of Directors, and the Audit Committee has reviewed the disclosure presented below relating to them. See Footnote No. 1, "Summary of Significant Accounting Policies," of the Notes to our Financial Statements for further information on our critical accounting policies.

Our critical accounting policies are as follows:

Policy Liabilities

Future policy benefit reserves have been computed by the net level premium method with assumptions as to investment yields, dividends on participating business, mortality and withdrawals based upon our experience. The preparation of financial statements requires management to make estimates and assumptions that affect the reported amount of policy liabilities and the increase in future policy benefit reserves. Management's judgments and estimates for future policy benefit reserves provide for possible unfavorable deviation.

We continue to use the original assumptions (including a provision for the risk of adverse deviation) in subsequent periods to determine the changes in the liability for future policy benefits (the "lock-in concept") unless a premium deficiency exists. Management monitors these assumptions and has determined that a premium deficiency did not exist as of December 31, 2012. Management believes that our policy liabilities and increase in future policy benefit reserves as of the years ended December 31, 2012, 2011 and 2010 are based upon assumptions, including a provision for the risk of adverse deviation, that do not warrant revision.

Deferred Policy Acquisition Costs

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

We utilize the factor method to determine the amount of costs to be capitalized and the ending asset balance. The factor method is based on the ratio of premium revenue recognized for the policies in force at the end of each reporting period compared to the premium revenue recognized for policies in force at the beginning of the reporting period. The factor method ensures that policies that lapsed or surrendered during the reporting period are no longer included in the deferred policy acquisition costs calculation. The factor method limits the amount of deferred costs to its estimated realizable value, provided actual experience is comparable to that contemplated in the factors.

Inherent in the capitalization and amortization of deferred policy acquisition costs are certain management judgments about what acquisition costs are deferred, the ending asset balance and the annual amortization. Approximately 90.0% of our capitalized deferred acquisition costs are attributed to first year excess commissions. The remaining 10.0% are attributed to costs that vary with and are directly related to the successful acquisition of new insurance business. Those costs generally include costs related to the production, underwriting and issuance of new business.

A recoverability test that considers, among other things, actual experience and projected future experience is performed at least annually. These annual recoverability tests initially calculate the available premium (gross premium less benefit and expense portion of premium) for the next 30 years. The available premium per policy and the deferred policy acquisition costs per policy are then calculated. The deferred policy acquisition costs are then evaluated over two methods utilizing reasonable assumptions and two other methods using pessimistic assumptions. The two methods using reasonable assumptions illustrate an early-deferred

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

policy acquisition recoverability period. The two methods utilizing pessimistic assumptions still support early recoverability of our aggregate deferred policy acquisition costs. Management believes that our deferred policy acquisition costs and related amortization for the years ended December 31, 2012, 2011 and 2010 limits the amount of deferred costs to its estimated realizable value. This belief is based upon the analysis performed on capitalized expenses that vary with and are primarily related to the acquisition of new and renewal insurance business, utilization of the factor method and annual recoverability testing.

Cost of Customer Relationships Acquired

Cost of Customer Relationships Acquired ("CCRA") is established when we purchase a block of insurance. CCRA is amortized primarily over the emerging profit of the related policies using the same assumptions as were used in computing liabilities for future policy benefits. We utilize various methods to determine the amount of the ending asset balance, including a static model and a dynamic model. Inherent in the amortization of CCRA are certain management judgments about the ending asset balance and the annual amortization. The assumptions used are based upon interest, mortality and lapses at the time of purchase.

A recoverability test that considers, among other things, actual experience and projected future experience is performed at least annually. These annual recoverability tests initially calculate the available premium (gross premium less benefit and expense portion of premium) for the next thirty years. The CCRA is then evaluated utilizing reasonable assumptions. Management believes our CCRA and related amortization is recoverable for the years ended December 31, 2012, 2011 and 2010. This belief is based upon the analysis performed on estimated future results of the block and our annual recoverability testing.

Goodwill

Current accounting guidance requires that goodwill balances be reviewed for impairment at least annually or more frequently if events occur or circumstances change that would indicate that a triggering event has occurred. A reporting unit is defined as an operating segment on one level below an operating segment. Most of the Company's reporting units, for which goodwill has been allocated, are equivalent to the Company's operating segment, as there is no discrete financial information available for the separate components of the segment or all of the components of the segment have similar economic characteristics.

The goodwill impairment test follows a multi step process as defined under current accounting guidance. An initial review may be performed whereby the assessment is based upon a qualitative factors before performing the first test step. In the first step, the fair value of a reporting unit is compared to its carrying value. If the carrying value of a reporting unit exceeds its fair value, the second step of the impairment test is performed for purposes of measuring the impairment. In the second step, the fair value of the reporting unit is allocated to all of the assets and liabilities of the reporting unit to determine an implied goodwill value. If the carrying amount of the reporting unit goodwill exceeds the implied goodwill value, an impairment loss is recognized in an amount equal to that excess.

Management's determination of the fair value of each reporting unit incorporates multiple inputs including discounted cash flow calculations, peer company price to earnings multiples, the level of the Company's Class A common stock price and assumptions that market participants would make in valuing the reporting unit. Other assumptions can include levels of economic capital, future business growth, and earnings projections.

Valuation of Investments in Fixed Maturity and Equity Securities

The evaluation of securities for impairments is a quantitative and qualitative process, which is subject to risks and uncertainties and is intended to determine whether declines in the fair value of investments should be recognized in current period earnings. The risks and uncertainties include changes in general economic conditions, the issuer's financial condition or future prospects, the effects of changes in interest rates or credit spreads and the expected recovery period.

Based upon current accounting guidance, investment securities must be classified as held-to-maturity, available-for-sale or trading. Management determines the appropriate classification at the time of purchase. The classification of securities is significant since it directly impacts the accounting for unrealized gains and losses on securities. Fixed maturity securities are classified as held-to-maturity and carried at amortized cost when management has the positive intent and the Company has the ability to hold the securities to maturity. Securities not classified as held-to-maturity are classified as available-for-sale and are carried at fair value, with the unrealized holding gains and losses, net of tax, reported in other comprehensive income and do not affect earnings until realized.

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### CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

The Company evaluates all securities on a quarterly basis, and more frequently when economic conditions warrant additional evaluations, for determining if an OTTI exists pursuant to the accounting guidelines. In evaluating the possible impairment of securities, consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial conditions and near-term prospects of the issuer, and the ability and intent of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. In analyzing an issuer's financial condition, the Company may consider whether the securities are issued by the Federal government or its agencies, by government-sponsored agencies, or whether downgrades by bond rating agencies have occurred, and reviews of the issuer's financial condition.

If management determines that an investment experienced an OTTI, management must then determine the amount of OTTI to be recognized in earnings. If management 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 less any current period loss, the OTTI will be separated into the amount representing the credit loss and the amount related to all other factors. The amount of OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of OTTI related to other factors will be recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings will become the new amortized cost basis of the investment. If management intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current period credit loss, the OTTI will be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. Any recoveries related to the value of these securities are recorded as an unrealized gain (as other comprehensive income (loss) in shareholders' equity) and not recognized in income until the security is ultimately sold.

The Company from time to time may dispose of an impaired security in response to asset/liability management decisions, future market movements, business plan changes, or if the net proceeds can be reinvested at a rate of return that is expected to recover the loss within a reasonable period of time.

### Premium Revenue and Related Expenses

Premiums on life and accident and health policies are reported as earned when due or, for short duration contracts, over the contract period on a pro rata basis. Benefits and expenses are associated with earned premiums so as to result in recognition of profits over the estimated life of the contracts. This matching is accomplished by means of provisions for future benefits and the capitalization and amortization of deferred policy acquisition costs.

Annuities are accounted for in a manner consistent with accounting for interest bearing financial instruments. Our primary annuity products do not include fees or other such charges.

### Tax Accounting

A deferred tax asset or deferred tax liability is recorded only if a determination is made that it is more-likely-than-not that the tax treatment on which the deferred tax item depends will be sustained in the event of an audit. These determinations inherently involve management's judgment. In addition, the Company must record a tax valuation allowance with respect to deferred tax assets if it is more-likely-than-not that the tax benefit will not be realized. This valuation allowance is in essence a contra account to the deferred tax asset. Management must determine the portion of the deferred tax asset and resulting tax benefit that may not be realized based upon judgment of expected outcomes. Due to significant estimates utilized in establishing the valuation allowance and the potential for changes in facts and circumstances, it is reasonably possible that we will be required to record a valuation allowance in future



reporting periods. Such a charge could have a material adverse effect on our results of operations, financial condition and capital position.

#### Recent Accounting Pronouncements

See Item 8. Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements, Note 1. Accounting Pronouncements.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

## General

The nature of our business exposes us to market risk relative to our invested assets and policy liabilities. Market risk is the risk of loss that may occur when changes in interest rates and public equity prices adversely affect the value of our invested assets. Interest rate risk is our primary market risk exposure. Substantial and sustained increases and decreases in market interest rates can affect the fair value of our investments. The fair value of our fixed maturity portfolio generally increases when interest rates decrease and decreases when interest rates increase.

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

|   | December 31, 2012 |               | Net<br>Unrealized<br>Gains<br>(Losses) | December 31, 2011 |               | Net<br>Unrealized<br>Gains<br>(Losses) |
|---|-------------------|---------------|--|-------------------|---------------|--|
|   | Amortized<br>Cost | Fair<br>Value |  | Amortized<br>Cost | Fair<br>Value |  |
|   | (In thousands)    |               |  |                   |               |  |
| Fixed maturities,<br>available-for-sale | \$559,736         | 604,520       | 44,784                                 | 484,809           | 514,253       | 29,444                                 |
| Fixed maturities, held-to-maturity      | 187,008           | 193,739       | 6,731                                  | 227,500           | 230,093       | 2,593                                  |
| Total fixed maturities                  | \$746,744         | 798,259       | 51,515                                 | 712,309           | 744,346       | 32,037                                 |
| Total equity securities                 | \$52,744          | 53,741        | 997                                    | 45,599            | 46,137        | 538                                    |

## Market Risk Related to Interest Rates

Our exposure to interest rate changes results from our significant holdings of fixed maturity investments, policy loans and mortgage loans on real estate, all of which comprised over 87.3% of our cash and investment portfolio as of December 31, 2012. These investments are mainly exposed to changes in U.S. Treasury rates. Our fixed maturities investments include U.S. Government-sponsored enterprises, U.S. Government bonds, securities issued by government agencies, state and municipal bonds, and corporate bonds. Approximately 16.9% of the fixed maturities we owned at market value on December 31, 2012 are instruments of U.S. Government-sponsored enterprises, or are backed by U.S. Government agencies.

To manage interest risk, we perform periodic projections of asset and liability cash flows to evaluate the potential sensitivity of our investments and liabilities. We assess interest rate sensitivity on an annual basis with respect to our fixed maturities investments using hypothetical test scenarios that assume either upward or downward shifts in the prevailing interest rates. The Company performed an analysis of fair values changes using assumed 100 basis point upward shifts in interest rates, noting that the fair value of our fixed maturity investment portfolio of \$798.3 million would decrease approximately \$58.1 million to a fair value of \$740.2 million upon a 100 basis point increase. The following table shows the effects on the fair values of our fixed maturity investments based upon these scenarios.

| Fair Values of Fixed Maturity Investments |      |      |      |
|---|------|------|------|
| Changes in Interest Rates in Basis Points |      |      |      |
| 0   | +100 | +200 | +300 |
| (In thousands)                            |      |      |      |

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|                    |           |         |         |         |
|--------------------|-----------|---------|---------|---------|
| Assumed fair value | \$798,259 | 740,174 | 704,701 | 658,217 |
|--------------------|-----------|---------|---------|---------|

While the test scenarios are for illustrative purposes only and do not reflect our expectations regarding future interest rates or the performance of fixed-income markets, it is a near-term change that illustrates the potential impact of such events. Due to the composition of our book of insurance business, we believe it is unlikely we would encounter large surrender activity due to an interest rate increase that would force us to dispose of our fixed maturities at a loss.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Our fixed maturity portfolio is exposed to call risk as a significant portion of the current holdings are callable. A decreasing interest rate environment can result in increased call activity as experienced over the past several years, and an increasing rate environment will likely result in securities being paid at their stated maturity.

There are no fixed maturities or other investments that we classify as trading instruments. Approximately 75.7% of fixed maturities were held in available-for-sale and 24.3% in held-to-maturity based upon fair value at December 31, 2012. At December 31, 2012 and 2011, we had no investments in derivative instruments, subprime loans or CDOs (collateralized debt obligations).

Market Risk Related to Equity Prices

Changes in the level or volatility of equity prices affect the value of equity securities we hold as investments. Our equity investments portfolio represented 5.6% of our total investments at December 31, 2012, with 95.7% invested in diversified equity and bond mutual funds.

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Reference is made to the financial statements, the notes thereto, and the report of our independent registered public accounting firm, as listed on the table of contents.

All other schedules have been omitted as the required information is inapplicable or the information required is presented in the financial statements or the notes thereto filed elsewhere herein.

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

Item 9A. CONTROLS AND PROCEDURES

(a) Disclosure Controls and Procedures

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

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

(b) Management Report on Internal Control over Financial Reporting

Management of our Company is responsible for establishing and maintaining adequate internal control over financial reporting. Management assessed internal control over financial reporting based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission

("COSO"). Based on this assessment, management has concluded that the Company maintained effective internal control over financial reporting as of December 31, 2012.

Our independent registered public accounting firm, Ernst & Young LLP, has issued an attestation report on our internal control over financial reporting. The report is included in item 9A(d) of this annual report.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

(c) Change in Internal Control over Financial Reporting

During 2012, there have been no changes in the Company's internal controls over financial reporting that materially affect or are reasonably likely to affect the Company's internal controls over financial reporting.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

(d) Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting

The Board of Directors and Shareholders of Citizens, Inc.:

We have audited Citizens, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Citizens, Inc. and subsidiaries' management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying "Management Report on Internal Control over Financial Reporting". Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Citizens, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial position as of December 31, 2012 and 2011, and the related consolidated statements of comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2012 of Citizens, Inc. and subsidiaries and our report dated March 11, 2013 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

San Antonio, Texas  
March 11, 2013

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Item 9B. OTHER INFORMATION

On March 11, 2013, the Company issued a news release (the "Release") reporting, among other things, results for its fourth quarter 2012 earnings. A copy of the Release is furnished as Exhibit 99.1 to this Annual Report on Form 10-K. Citizens also announced that it would hold a conference call to discuss its financial results at 10:00 a.m. Central Standard Time on Tuesday, March 12, 2013.

PART III

Items 10, 11, 12, 13 and 14 of this Report incorporate by reference the information in our definitive proxy material under the headings "Election of Directors and Executive Officers," "Executive Officer and Director Compensation," "Stock and Principal Stockholders," "Control of the Company," and "Principal Accounting Fees and Services," to be filed with the Securities and Exchange Commission within 120 days after December 31, 2012.

PART IV

Item 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a)(1) and (2) Filings as Part of this Report

The financial statements and schedules listed on the following index to financial statements and financial statement schedules are filed under Item 8 as part of this Form 10-K.

(b)(3) Exhibits – See the Exhibit Index

|  | Page<br>Reference |
|--|-------------------|
| Index to Consolidated Financial Statements and Financial Statement Schedules                   |                   |
| Report of independent registered public accounting firm  | <u>53</u>         |
| Consolidated statements of financial position at December 31, 2012 and 2011                    | <u>54</u>         |
| Consolidated statements of comprehensive income - years ended December 31, 2012, 2011 and 2010 | <u>56</u>         |
| Consolidated statements of stockholders' equity - years ended December 31, 2012, 2011 and 2010 | <u>57</u>         |
| Consolidated statements of cash flows - years ended December 31, 2012, 2011 and 2010           | <u>59</u>         |
| Notes to consolidated financial statements   | <u>61</u>         |
| Schedule II – Condensed Financial Information of Registrant                                    | <u>95</u>         |
| Schedule III – Supplementary Insurance Information   | <u>98</u>         |
| Schedule IV - Reinsurance  | <u>99</u>         |

All other schedules have been omitted because the required information is inapplicable or the information required is presented in the financial statements or the notes thereto filed elsewhere herein.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Citizens, Inc.:

We have audited the accompanying consolidated statements of financial position of Citizens, Inc. and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2012. Our audit also included the financial statement schedules II, III, and IV under Item 15 of the Index. These financial statements and schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Citizens, Inc. and subsidiaries at December 31, 2012 and 2011, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, in connection with implementing new accounting standards, the Company retrospectively changed its method of accounting for costs associated with issuing or renewing insurance contracts.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Citizens, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 11, 2013 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

San Antonio, Texas  
March 11, 2013

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Financial Position

December 31,

(In thousands)

| Assets  | 2012        | 2011<br>(As adjusted) |
|---|-------------|-----------------------|
| Investments:  |             |                       |
| Fixed maturities available-for-sale, at fair value (cost: \$559,736 and \$484,809 in 2012 and 2011, respectively)         | \$604,520   | 514,253               |
| Fixed maturities held-to-maturity, at amortized cost (fair value: \$193,739 and \$230,093 in 2012 and 2011, respectively) | 187,008     | 227,500               |
| Equity securities available-for-sale, at fair value (cost: \$52,744 and \$45,599 in 2012 and 2011, respectively)          | 53,741      | 46,137                |
| Mortgage loans on real estate   | 1,509       | 1,557                 |
| Policy loans  | 42,993      | 39,090                |
| Real estate held for investment (less \$1,287 and \$1,149 accumulated depreciation in 2012 and 2011, respectively)        | 8,496       | 8,539                 |
| Other long-term investments   | 57          | 105                   |
| Short-term investments  | 2,340       | 2,048                 |
| Total investments   | 900,664     | 839,229               |
| Cash and cash equivalents   | 56,299      | 33,255                |
| Accrued investment income   | 10,304      | 7,787                 |
| Reinsurance recoverable   | 9,651       | 9,562                 |
| Deferred policy acquisition costs   | 135,569     | 124,542               |
| Cost of customer relationships acquired   | 25,116      | 27,945                |
| Goodwill  | 17,160      | 17,160                |
| Other intangible assets   | 879         | 906                   |
| Federal income tax receivable   | 270         | 901                   |
| Property and equipment, net   | 7,383       | 7,860                 |
| Due premiums, net (less \$1,345 and \$1,698 allowance for doubtful accounts in 2012 and 2011, respectively)               | 10,527      | 9,169                 |
| Prepaid expenses  | 344         | 396                   |
| Other assets  | 782         | 800                   |
| Total assets  | \$1,174,948 | 1,079,512             |

See accompanying notes to consolidated financial statements.

(Continued)

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Financial Position

December 31,

(In thousands)

|   | 2012        | 2011<br>(As adjusted) |
|---|-------------|-----------------------|
| Liabilities and Stockholders' Equity  |             |                       |
| Liabilities:  |             |                       |
| Policy liabilities:   |             |                       |
| Future policy benefit reserves:   |             |                       |
| Life insurance  | \$762,319   | 697,502               |
| Annuities   | 51,750      | 47,060                |
| Accident and health   | 5,491       | 5,612                 |
| Dividend accumulations  | 11,962      | 10,601                |
| Premiums paid in advance  | 27,455      | 25,291                |
| Policy claims payable   | 11,015      | 10,020                |
| Other policyholders' funds  | 9,440       | 8,760                 |
| Total policy liabilities  | 879,432     | 804,846               |
| Commissions payable   | 2,606       | 2,851                 |
| Deferred federal income tax   | 17,301      | 13,940                |
| Payable for securities in process of settlement   | 2,358       | —                     |
| Warrants outstanding  | —           | 451                   |
| Other liabilities   | 10,143      | 9,382                 |
| Total liabilities   | 911,840     | 831,470               |
| Commitments and contingencies (Notes 5 and 8)   |             |                       |
| Stockholders' equity:   |             |                       |
| Common stock:   |             |                       |
| Class A, no par value, 100,000,000 shares authorized, 52,215,852 and 52,089,189 shares issued and outstanding 2012 and 2011, including shares in treasury of 3,135,738 in 2012 and 2011 | 259,383     | 258,548               |
| Class B, no par value, 2,000,000 shares authorized, 1,001,714 shares issued and outstanding in 2012 and 2011  | 3,184       | 3,184                 |
| Accumulated deficit   | (17,335)    | (21,851)              |
| Accumulated other comprehensive income:   |             |                       |
| Unrealized gains on securities, net of tax  | 28,887      | 19,172                |
| Treasury stock, at cost   | (11,011)    | (11,011)              |
| Total stockholders' equity  | 263,108     | 248,042               |
| Total liabilities and stockholders' equity  | \$1,174,948 | 1,079,512             |

See accompanying notes to consolidated financial statements.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Comprehensive Income

For the Years ended December 31,

(In thousands, except share amounts)

|   | 2012       | 2011<br>(As adjusted) | 2010<br>(As adjusted) |
|---|------------|-----------------------|-----------------------|
| Revenues:   |            |                       |                       |
| Premiums:   |            |                       |                       |
| Life insurance  | \$ 163,170 | 154,778               | 145,665               |
| Accident and health insurance   | 1,635      | 1,561                 | 1,577                 |
| Property insurance  | 5,068      | 5,056                 | 4,810                 |
| Net investment income   | 31,725     | 30,099                | 29,220                |
| Realized investment gains, net  | 196        | 765                   | 8,012                 |
| Decrease in fair value of warrants                                      | 451        | 1,136                 | 232                   |
| Other income  | 514        | 761                   | 808                   |
| Total revenues  | 202,759    | 194,156               | 190,324               |
| Benefits and expenses:  |            |                       |                       |
| Insurance benefits paid or provided:                                    |            |                       |                       |
| Claims and surrenders   | 64,656     | 60,056                | 61,038                |
| Increase in future policy benefit reserves                              | 66,676     | 58,264                | 46,420                |
| Policyholders' dividends  | 9,091      | 8,072                 | 7,485                 |
| Total insurance benefits paid or provided                               | 140,423    | 126,392               | 114,943               |
| Commissions   | 39,398     | 38,374                | 36,585                |
| Other general expenses  | 25,664     | 26,040                | 26,228                |
| Capitalization of deferred policy acquisition costs                     | (29,074 )  | (27,826 )             | (26,172 )             |
| Amortization of deferred policy acquisition costs                       | 17,845     | 16,848                | 17,293                |
| Amortization of cost of customer relationships acquired                 | 2,467      | 2,998                 | 3,058                 |
| Total benefits and expenses   | 196,723    | 182,826               | 171,935               |
| Income before federal income tax expense                                | 6,036      | 11,330                | 18,389                |
| Federal income tax expense  | 1,507      | 2,848                 | 3,685                 |
| Net income  | 4,529      | 8,482                 | 14,704                |
| Per Share Amounts:  |            |                       |                       |
| Basic and diluted earnings per share of Class A common stock            | \$0.09     | 0.17                  | 0.30                  |
| Basic and diluted earnings per share of Class B common stock            | 0.05       | 0.09                  | 0.15                  |
| Other comprehensive income:   |            |                       |                       |
| Unrealized gains on available-for-sale securities:                      |            |                       |                       |
| Unrealized holding gains arising during period                          | 15,130     | 29,589                | 4,846                 |
| Reclassification adjustment for gains included in net income            | 105        | (1,277 )              | (8,067 )              |
| Unrealized gains (losses) on available-for-sale securities, net         | 15,235     | 28,312                | (3,221 )              |
| Income tax expense on unrealized gains on available-for-sale securities | 5,520      | 10,479                | 731                   |
| Other comprehensive income (loss)                                       | 9,715      | 17,833                | (3,952 )              |

|                      |          |        |        |
|----------------------|----------|--------|--------|
| Comprehensive income | \$14,244 | 26,315 | 10,752 |
|----------------------|----------|--------|--------|

See accompanying notes to consolidated financial statements

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Stockholders' Equity  
For the Years Ended December 31, 2012, 2011, 2010  
(In thousands)

|  | Common Stock |         | Accumulated deficit | Accumulated other comprehensive income (loss) | Treasury stock | Total Stockholders' equity |   |
|--|--------------|---------|---------------------|---|----------------|----------------------------|---|
|  | Class A      | Class B |                     |   |                |                            |   |
| Balance at December 31, 2009   | \$256,703    | 3,184   | (38,092             | ) 5,291                                       | (11,011        | ) 216,075                  |   |
| Cumulative effect of change in accounting for deferred acquisition costs | —            | —       | (6,943              | ) —   | —              | (6,943                     | ) |
| Balance at January 1, 2010, as adjusted                                  | 256,703      | 3,184   | (45,035             | ) 5,291                                       | (11,011        | ) 209,132                  |   |
| Comprehensive income:  |              |         |                     |   |                |                            |   |
| Net income   | —            | —       | 14,704              | —   | —              | 14,704                     |   |
| Unrealized investment losses, net  | —            | —       | —                   | (3,952  | ) —            | (3,952                     | ) |
| Total comprehensive income   | —            | —       | 14,704              | (3,952  | ) —            | 10,752                     |   |
| Balance at December 31, 2010, as adjusted                                | 256,703      | 3,184   | (30,331             | ) 1,339                                       | (11,011        | ) 219,884                  |   |
| Comprehensive income:  |              |         |                     |   |                |                            |   |
| Net income   | —            | —       | 8,482               | —   | —              | 8,482                      |   |
| Unrealized investment gains, net   | —            | —       | —                   | 17,833  | —              | 17,833                     |   |
| Total comprehensive income   | —            | —       | 8,482               | 17,833  | —              | 26,315                     |   |
| Warrants Exercised   | 1,845        | —       | (2                  | ) —   | —              | 1,843                      |   |
| Balance at December 31, 2011, as adjusted                                | 258,548      | 3,184   | (21,851             | ) 19,172                                      | (11,011        | ) 248,042                  |   |
| Comprehensive income:  |              |         |                     |   |                |                            |   |
| Net income   | —            | —       | 4,529               | —   | —              | 4,529                      |   |
| Unrealized investment gains, net   | —            | —       | —                   | 9,715   | —              | 9,715                      |   |
| Total comprehensive income   | —            | —       | 4,529               | 9,715   | —              | 14,244                     |   |
| Warrants exercised   | 835          | —       | (13                 | ) —   | —              | 822                        |   |
| Balance at December 31, 2012   | \$259,383    | 3,184   | (17,335             | ) 28,887                                      | (11,011        | ) 263,108                  |   |

See accompanying notes to consolidated financial statements.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Stockholders' Equity, Continued  
 For the Years Ended December 31, 2012, 2011, 2010  
 (In thousands)

A summary of the number of shares of common stock of Class A, Class B and treasury stock issued is as follows:

|                              | Common Stock |         | Treasury<br>Stock |   |
|------------------------------|--------------|---------|-------------------|---|
|                              | Class A      | Class B |                   |   |
| Balance at January 1, 2010   | 51,822       | 1,002   | (3,136            | ) |
| Total stock issued in 2010   | —            | —       | —                 |   |
| Balance at December 31, 2010 | 51,822       | 1,002   | (3,136            | ) |
| Warrants exercised           | 267          | —       | —                 |   |
| Balance at December 31, 2011 | 52,089       | 1,002   | (3,136            | ) |
| Warrants exercised           | 127          | —       | —                 |   |
| Balance at December 31, 2012 | 52,216       | 1,002   | (3,136            | ) |

See accompanying notes to consolidated financial statements.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Cash Flows

For the Years Ended December 31

(In thousands)

|   | 2012       | 2011          | 2010       |
|---|------------|---------------|------------|
| Cash flows from operating activities:   |            | (As adjusted) |            |
| Net income  | \$4,529    | 8,482         | 14,704     |
| Adjustments to reconcile net income to net cash provided by operating activities: |            |               |            |
| Net realized gains on investments and other assets                                | (196 )     | (765 )        | (8,012 )   |
| Net deferred policy acquisition costs   | (11,229 )  | (10,978 )     | (8,879 )   |
| Amortization of cost of customer relationships acquired                           | 2,467      | 2,998         | 3,058      |
| Decrease in fair value of warrants  | (451 )     | (1,136 )      | (232 )     |
| Depreciation  | 1,233      | 1,057         | 1,048      |
| Amortization of premiums and discounts on investments                             | 6,082      | 4,207         | 4,381      |
| Deferred federal income tax expense (benefit)                                     | (2,159 )   | (1,776 )      | 193        |
| Change in:  |            |               |            |
| Accrued investment income   | (2,517 )   | (354 )        | 22         |
| Reinsurance recoverable   | (89 )      | 167           | 1,858      |
| Due premiums  | (1,358 )   | (632 )        | 423        |
| Future policy benefit reserves  | 66,394     | 57,999        | 45,896     |
| Other policyholders' liabilities  | 5,200      | 2,761         | 7,583      |
| Federal income tax receivable   | 631        | 1,013         | 2,109      |
| Commissions payable and other liabilities   | 516        | 1,408         | (3,594 )   |
| Other, net  | 217        | (170 )        | (19 )      |
| Net cash provided by operating activities   | 69,270     | 64,281        | 60,539     |
| Cash flows from investing activities:   |            |               |            |
| Sale of fixed maturities, available-for-sale                                      | 576        | —             | 8,029      |
| Maturities and calls of fixed maturities, available-for-sale                      | 156,863    | 199,730       | 189,826    |
| Maturities and calls of fixed maturities, held-to-maturity                        | 169,880    | 83,611        | 197,600    |
| Purchase of fixed maturities, available-for-sale                                  | (220,401 ) | (110,356 )    | (396,188 ) |
| Purchase of fixed maturities, held-to-maturity                                    | (145,770 ) | (230,985 )    | (71,452 )  |
| Sale of equity securities, available-for-sale                                     | 2,855      | 7,504         | 22,822     |
| Calls of equity securities, available-for-sale                                    | 920        | 682           | 243        |
| Purchase of equity securities, available-for-sale                                 | (10,000 )  | (32,504 )     | (9,668 )   |
| Principal payments on mortgage loans  | 48         | 48            | 45         |
| Increase in policy loans, net   | (3,903 )   | (3,480 )      | (3,489 )   |
| Sale of other long-term investments   | 5          | 5             | —          |
| Purchase of other long-term investments   | (116 )     | (33 )         | (302 )     |
| Purchase of property and equipment  | (619 )     | (1,800 )      | (2,064 )   |
| Sale of property and equipment  | —          | 2             | 46         |
| Maturity of short-term investments  | 2,000      | —             | 2,500      |
| Purchase of short-term investments  | (2,378 )   | (2,048 )      | —          |
| Proceeds from assumption reinsurance agreement                                    | —          | 4,550         | —          |
| Net cash used in investing activities   | (50,040 )  | (85,074 )     | (62,052 )  |



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Cash Flows  
For the Years Ended December 31  
(In thousands)

|  | 2012     | 2011          | 2010     |
|--|----------|---------------|----------|
|  |          | (As adjusted) |          |
| Cash flows from financing activities:                |          |               |          |
| Warrants exercised                                   | \$822    | 1,843         | —        |
| Annuity deposits                                     | 7,030    | 6,380         | 5,775    |
| Annuity withdrawals                                  | (4,038   | ) (3,898      | ) (3,164 |
| Net cash provided by financing activities            | 3,814    | 4,325         | 2,611    |
| Net increase (decrease) in cash and cash equivalents | 23,044   | (16,468       | ) 1,098  |
| Cash and cash equivalents at beginning of year       | 33,255   | 49,723        | 48,625   |
| Cash and cash equivalents at end of year             | \$56,299 | 33,255        | 49,723   |
| Supplemental Disclosure of Operating Activities:     |          |               |          |
| Cash paid during the year for income taxes           | \$3,036  | 3,612         | 1,382    |

See accompanying notes to consolidated financial statements.

## Supplemental Disclosure of Non-Cash Investing Activities:

In 2011, the Company sold a parcel of real estate and issued a mortgage loan for \$116,000.

In 2010, the Company sold a parcel of real estate and issued a mortgage loan for \$102,000. This same loan was foreclosed on and the real estate was transferred to the other long-term investments category in the amount of \$101,000.

## Supplemental Disclosures of Non-Cash Financing Activities:

In 2012, the Company made a cashless exercise of expiring warrants and issued Class A common shares totaling 13,606.

In 2011, the Company made a cashless exercise of expiring warrants and issued Class A common shares totaling 1,989.

See accompanying notes to consolidated financial statements.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 1: Summary of Significant Accounting Policies

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"), Citizens National Life Insurance Company ("CNLIC"), Security Plan Life Insurance Company ("SPLIC"), Security Plan Fire Insurance Company ("SPFIC"), Computing Technology, Inc. ("CTI"), and Insurance Investors, Inc. ("III"). All significant inter-company accounts and transactions have been eliminated. Citizens and its wholly-owned subsidiaries are collectively referred to as "the Company," "we," or "our."

We provide primarily life insurance, as well as a small amount of health insurance policies, through three of our subsidiaries - CICA, SPLIC, and CNLIC. CICA and CNLIC issue ordinary whole-life policies, 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.

Significant Accounting Policies

Investments

Investment securities are classified as held-to-maturity, available-for-sale or trading. Management determines the appropriate classification at the time of purchase. The classification of securities is significant since it directly impacts the accounting for unrealized gains and losses on securities. Fixed maturity securities are classified as held-to-maturity and carried at amortized cost when management has the positive intent and the Company has the ability to hold the securities to maturity. Securities not classified as held-to-maturity are classified as available-for-sale and are carried at fair value, with the unrealized holding gains and losses, net of tax, reported in other comprehensive income and do not affect earnings until realized. Fixed maturities consist primarily of bonds classified as available-for-sale or held-to-maturity. The Company does not classify any fixed maturities as trading. Equity securities (including non-redeemable preferred stock) are considered available-for-sale and are reported at fair value.

Unrealized appreciation (depreciation) of equity securities and fixed maturities held as available-for-sale is shown as a separate component of stockholders' equity, net of tax, and is a separate component of comprehensive income.

The Company evaluates all securities on a quarterly basis, and more frequently when economic conditions warrant additional evaluations, for determining if an other-than-temporary impairment ("OTTI") exists pursuant to the accounting guidelines. In evaluating the possible impairment of securities, consideration is given to the length of time

and the extent to which the fair value has been less than cost, the financial conditions and near-term prospects of the issuer, and the ability and intent of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. In analyzing an issuer's financial condition, the Company may consider whether the securities are issued by the Federal government or its agencies, by government-sponsored agencies, or whether downgrades by bond rating agencies have occurred, and reviews of the issuer's financial condition.

If management determines that an investment experienced an OTTI, management must then determine the amount of OTTI to be recognized in earnings. If management 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 less any current period loss, the OTTI will be separated into the amount representing the credit loss and the amount related to all other factors. The amount of OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of OTTI related to other factors will be recognized in other comprehensive

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings will become the new amortized cost basis of the investment. If management intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current period credit loss, the OTTI will be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. Any recoveries related to the value of these securities are recorded as an unrealized gain (as other comprehensive income (loss) in stockholders' equity) and not recognized in income until the security is ultimately sold.

The Company from time to time may dispose of an impaired security in response to asset/liability management decisions, future market movements, business plan changes, or if the net proceeds can be reinvested at a rate of return that is expected to recover the loss within a reasonable period of time.

Mortgage loans on real estate and policy loans are reported at unpaid principal balances.

Real estate and other long-term investments consist primarily of land and buildings that are recorded at depreciated cost. If the fair value of the real estate is less than the carrying value, an impairment loss is recognized and charged to earnings.

Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the effective interest method. Dividend and interest income is recognized when earned. Realized gains and losses are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

The Company had cash equivalents and fixed maturities with an aggregate fair value of \$10.2 million and \$10.5 million at December 31, 2012 and 2011, respectively, on deposit with various state regulatory authorities to fulfill statutory requirements.

#### Premium Revenue and Related Expenses

Premiums on life policies are recognized as earned when due. Due premiums on the balance sheet are net of allowances. Accident and health policies are recognized as revenue over the contract period on a pro rata basis. Benefits and expenses are associated with earned premiums so as to result in the recognition of profits over the estimated lives of the contracts. This matching is accomplished by means of a provision for future policy benefits and the capitalization and amortization of deferred policy acquisition costs.

Annuity policies, primarily flexible premium fixed annuity products, are accounted for in a manner consistent with accounting for interest bearing financial instruments. Premium receipts are not reported as revenue, rather as deposit liabilities to annuity contracts. The annuity products issued do not include fees or other such charges.

#### Deferred Policy Acquisition Costs and Cost of Customer Relationships Acquired

Acquisition costs, consisting of commissions and policy issuance, underwriting and agent convention expenses that are primarily related to and vary with the successful production of new and renewal business, have been deferred. These deferred amounts, referred to as deferred policy acquisition costs ("DAC"), are recorded as an asset on the balance sheet and amortized to income in a systematic manner, based on related contract revenues or gross

profits as appropriate.

Traditional life insurance and accident and health insurance acquisition costs are being amortized over the premium paying period of the related policies using assumptions consistent with those used in computing future policy benefit liabilities. For universal life type contracts and investment contracts that include significant surrender charges or that yield significant revenues from sources other than the investment contract holders' funds, the deferred contract acquisition cost amortization is matched to the recognition of gross profit. The effect on the DAC asset that would result from realization of unrealized gains or losses is recognized with an offset to accumulated other comprehensive income in consolidated stockholders' equity. If an internal replacement of insurance or investment contract modification substantially changes a contract as defined in current accounting guidance, then the DAC is written off immediately through income and any new deferrable costs associated with the new replacement are deferred. If a contract modification does not substantially change the contract, the DAC amortization on the original contract will continue and any acquisition costs associated with the related modification are immediately expensed.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

We utilize the factor method to determine the amount of costs to be capitalized and the ending asset balance. The factor method is based on the ratio of premium revenue recognized for the policies in force at the end of each reporting period compared to the premium revenue recognized for policies in force at the beginning of the reporting period. The factor method ensures that policies lapsed or surrendered during the reporting period are no longer included in the deferred policy acquisition costs calculation. The factor method limits the amount of deferred costs to its estimated realizable value, provided actual experience is comparable to that contemplated in the factors.

Inherent in the capitalization and amortization of deferred policy acquisition costs are certain management judgments about what acquisition costs are deferred, the ending asset balance and the annual amortization. Approximately 90% of our capitalized deferred acquisition costs are attributed to first year excess commissions. The remaining 10% are attributed to costs that vary with and are directly related to the acquisition of new insurance business. Those costs generally include costs related to the production, underwriting and issuance of new business.

A recoverability test that considers, among other things, actual experience and projected future experience is performed at least annually. These annual recoverability tests initially calculate the available premium (gross premium less the benefit and expense portion of premium) for the next 30 years. The available premium per policy and the deferred policy acquisition costs per policy are then calculated. The deferred policy acquisition costs are then evaluated over two methods utilizing reasonable assumptions and two other methods using pessimistic assumptions. Management believes that our deferred policy acquisition costs and related amortization for the years ended December 31, 2012, 2011 and 2010 limits the amount of deferred costs to its estimated realizable value. This belief is based upon the analysis performed on capitalized expenses that vary with and are primarily related to the acquisition of new and renewal insurance business, utilization of the factor method and annual recoverability testing.

The components of deferred acquisition costs from year to year are summarized as follows:

|                                      | For the Years Ended December 31, |               |               |
|--------------------------------------|----------------------------------|---------------|---------------|
|                                      | 2012                             | 2011          | 2010          |
|                                      |                                  | (As adjusted) | (As adjusted) |
|                                      | (In thousands)                   |               |               |
| Balance at beginning of period       | \$124,542                        | 113,761       | 104,888       |
| Capitalized                          | 29,074                           | 27,826        | 26,172        |
| Amortized                            | (17,845 )                        | (16,848 )     | (17,293 )     |
| Effects of unrealized gains (losses) | (202 )                           | (197 )        | (6 )          |
| Balance at end of period             | \$135,569                        | 124,542       | 113,761       |

Cost of customer relationships acquired ("CCRA") is established when we purchase a block of insurance. CCRA is amortized primarily over the emerging profit of the related policies using the same assumptions as were used in computing liabilities for future policy benefits. We utilize various methods to determine the amount of the ending asset balance, including a static model and a dynamic model. Inherent in the amortization of CCRA are certain management judgments about the ending asset balance and the annual amortization. The assumptions used are based upon interest, mortality and lapses at the time of purchase.

A recoverability test that considers, among other things, actual experience and projected future experience is performed at least annually. These annual recoverability tests initially calculate the available premium (gross premium less the benefit and expense portion of premium) for the next thirty years. The CCRA is then evaluated



utilizing reasonable assumptions. Management believes that our CCRA and related amortization is recoverable for the years ended December 31, 2012, 2011 and 2010. This belief is based upon the analysis performed on estimated future results of the block and our annual recoverability testing.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

Cost of customer relationships acquired relative to purchased blocks of insurance is summarized as follows:

|  | For the Years Ended December 31, |          |          |
|--|----------------------------------|----------|----------|
|  | 2012                             | 2011     | 2010     |
|  | (In thousands)                   |          |          |
| Balance at beginning of period                         | \$27,945                         | 31,631   | 34,728   |
| Acquisitions   | —                                | —        | —        |
| Amortization   | (2,467                           | ) (2,998 | ) (3,058 |
| Adjustment   |                                  | —        | —        |
| Change in effects of unrealized (gains) losses on CCRA | (362                             | ) (688   | ) (39    |
| Balance at end of period                               | \$25,116                         | 27,945   | 31,631   |

Estimated amortization of cost of customer relationship acquired in each of the next five years and thereafter is as follows. Actual future amortization will differ from these estimates due to variances from estimated future withdrawal assumptions.

|  | Amount         |
|--|----------------|
|  | (In thousands) |
| Year:  |                |
| 2013   | \$2,112        |
| 2014   | 1,933          |
| 2015   | 1,772          |
| 2016   | 1,658          |
| 2017   | 1,535          |
| Thereafter                                   | 17,172         |
|  | 26,182         |
| Effects of unrealized (gains) losses on CCRA | (1,066         |
| Total  | \$25,116       |

The value of CCRA in our various acquisitions, which is included in cost of customer relationships acquired in the accompanying consolidated financial statements, was determined based on the present value of future profits discounted at annual rates ranging from 4.5% to 8.5%.

#### Future Policy Benefits and Expenses

Future policy benefit reserves for traditional life insurance and accident and health insurance contract benefits and expenses are computed using a net level premium method, with assumptions as to investment yields, dividends on participating business, mortality and withdrawals based upon our experience, modified as necessary to reflect anticipated trends and to include provisions for possible unfavorable deviations.

The accrued account balance for non-traditional life insurance and investment contracts is computed as deposits net of withdrawals made by the contract holder, plus amounts credited based on contract specifications, less contract fees and charges assessed, plus any additional interest. Annuity interest crediting rates range from 3.0% to 5.5% annually. Benefits and expenses are charged against the account balance to recognize costs as incurred over the estimated lives of the contracts. Expenses include interest credited to contract account balances and benefits paid in

excess of contract account balances.

Unpaid claims on accident and health policies represent the estimated liability for benefit expenses, both reported but not paid and incurred but not reported to the Company. Liabilities for unpaid claims are estimated using individual case basis valuations and statistical analyses. Those estimates are subject to the effects of trends in claim severity and frequency.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

Anticipated investment income is not considered in determining whether a premium deficiency exists with respect to short-duration contracts. Premium deposits accrue interest at rates ranging from 4.0% to 8.25% per annum. The cost of insurance is included in the premium when collected and interest is credited annually to deposit accounts.

The development of liabilities for future policy benefits requires management to make estimates and assumptions regarding mortality, morbidity, lapse, expense, and investment experience. These estimates are based primarily on historical experience and future expectations of mortality, morbidity, expense, persistency, and investment assumptions. Actual results could differ materially from estimates. We monitor actual experience and revise assumptions as necessary.

## Goodwill and Other Intangible Assets

Goodwill is the difference between the purchase price in a business combination and the fair value of assets and liabilities acquired, and is not amortized. Other intangible assets include various state insurance licenses, which have been determined to have indefinite useful lives and, therefore, are not amortized. Both goodwill and other intangible assets with indefinite useful lives are subject to annual impairment analyses.

The goodwill impairment test uses a two step process as set forth under current accounting guidance. In the first step, the fair value of a reporting unit is compared to its carrying value. If the carrying value of a reporting unit exceeds its fair value, the second step of the impairment test is performed for purposes of measuring the impairment. In the second step, the fair value of the reporting unit is allocated to all of the assets and liabilities of the reporting unit to determine an implied goodwill value. If the carrying amount of the reporting unit goodwill exceeds the implied goodwill value, an impairment loss is recognized in an amount equal to that excess.

Management's determination of the fair value of each reporting unit incorporates multiple inputs including discounted cash flow calculations, peer company price to earnings multiples, the level of the Company's Class A common stock price and assumptions that market participants would make in valuing the reporting unit. Other assumptions can include levels of economic capital, future business growth, and earnings projections.

As of December 31, 2012, the Company had goodwill of \$12.6 million allocated to the Life Insurance segment and \$4.5 million allocated to the Home Service Insurance segment. The Company completes its annual goodwill assessment for the individual reporting units within the Life Insurance segment and Home Service Insurance segment as of December 31 each year. There was no impairment of goodwill in 2012, 2011 or 2010.

Goodwill is summarized as follows:

|   | Net Amount<br>(In thousands) |
|---|------------------------------|
| Balance at January 1, 2010                  | 17,160                       |
| Acquisition                                 | —                            |
| Adjustments                                 | —                            |
| Balance at December 31, 2010, 2011 and 2012 | 17,160                       |

## Participating Policies

At December 31, 2012 and 2011, participating business approximated 60.8% and 59.2%, respectively, of direct life insurance in force.

Future policy benefits on participating policies are estimated based on net level premium reserves for death and endowment policy benefits ranging from 3% to 8%, and the cash surrender values described in such contracts. The scaling rate used for the 2012 portfolio ranged between 3.2% up to 4.0% over 3 years and then going up to 5% at 15 years and remaining there for the duration. Earnings and dividends on participating policies are allocated based on policies in force.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

Policyholder dividends are determined based on the discretion of the Board of Directors of the policy issuing subsidiary. Policyholder dividends are accrued over the premium paying periods of the insurance contract.

## Earnings Per Share

Basic earnings per share are computed by dividing income available to common stockholders by the weighted average number of shares of common stock outstanding during each period. Diluted earnings per share are computed under the if-converted method for convertible securities and the treasury stock method for warrants, giving effect to all potential dilutive common stock, including options, warrants and convertible/redeemable preferred stock. The basic and diluted earnings per share of Class B common stock are one half the earnings per share of the Class A common stock.

During 2011, the warrants associated with the Series A-1 Preferred Stock were either exercised or expired on July 12, 2011. Shares issued from the exercise of warrants totaled 255,216, and 1,989 common Class A shares were issued under a cashless provision in the Preferred Stock contract. Additionally, 9,487 shares were issued from the exercise of warrants at various dates in 2011. During 2012, the warrants associated with the Series A-2 Preferred Stock were either exercised or expired. Shares issued from the exercise of warrants totaled 113,057 and 13,606 common Class A shares were issued under a cashless provision in the Preferred Stock contract.

The following table sets forth the computation of basic and diluted earnings per share.

|  | Years Ended December 31,                 |                       |                       |
|--|--|-----------------------|-----------------------|
|  | 2012                                     | 2011<br>(As adjusted) | 2010<br>(As adjusted) |
|  | (In thousands, except per share amounts) |                       |                       |
| Basic and diluted earnings per share:                              |  |                       |                       |
| Numerator:   |  |                       |                       |
| Net income   | \$4,529                                  | 8,482                 | 14,704                |
| Net income allocated to Class A common stock                       | \$4,483                                  | 8,397                 | 14,546                |
| Net income allocated to Class B common stock                       | 46                                       | 85                    | 158                   |
| Net income   | \$4,529                                  | 8,482                 | 14,704                |
| Denominator:   |  |                       |                       |
| Weighted average shares of Class A outstanding - basic             | 49,005                                   | 48,809                | 48,687                |
| Weighted average shares of Class B outstanding - basic and diluted | 1,002                                    | 1,002                 | 1,002                 |
| Total weighted average shares outstanding - basic                  | 50,007                                   | 49,811                | 49,689                |
| Basic and diluted earnings per share of Class A common stock       | \$0.09                                   | 0.17                  | 0.30                  |
| Basic and diluted earnings per share of Class B common stock       | 0.05                                     | 0.09                  | 0.15                  |

## Income Taxes

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered.

A deferred tax asset is recorded only if a determination is made that it is more-likely-than-not that the tax treatment on which the deferred tax asset depends will be sustained in the event of an audit. These determinations inherently involve management's judgment. In addition, the Company must record a tax valuation allowance with respect to deferred tax assets if it is more-likely-than-not that the tax benefit will not be realized. This valuation allowance is in essence a contra account to the deferred tax asset. Management must determine the portion of the deferred tax asset and resulting tax benefit that may not be realized based upon judgment of expected outcomes. Due to significant estimates utilized in establishing the valuation allowance and the potential for changes in facts and circumstances, it is reasonably possible that we will be required to record adjustments to the valuation allowance in future reporting periods. Such a charge could have a material adverse effect on our results of operations, financial condition and capital position.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

## Property and Equipment

Property and equipment, including leasehold improvements, are carried at cost less accumulated depreciation. Depreciation of property and equipment is computed using the straight-line method over the useful lives of the assets, ranging from three to thirty years. We amortize leasehold improvements over the shorter of the related lease term or the estimated life of the improvements. The Company has no capital leases.

The following is a summary of property and equipment.

|                                      | For the Years Ended December 31, |          |
|--------------------------------------|----------------------------------|----------|
|                                      | 2012                             | 2011     |
|                                      | (In thousands)                   |          |
| Property and equipment:              |                                  |          |
| Home office, land and buildings      | \$9,511                          | 9,309    |
| Furniture and equipment              | 2,464                            | 2,464    |
| Electronic data processing equipment | 4,083                            | 3,726    |
| Automobiles and marine assets        | 382                              | 382      |
| Airplane                             | 3,282                            | 3,282    |
| Total property and equipment         | 19,722                           | 19,163   |
| Accumulated depreciation             | (12,339)                         | (11,303) |
| Balance at end of period             | \$7,383                          | 7,860    |

## Reinsurance Recoverable

Reinsurance recoverable includes expected reimbursements for policyholder claim amounts in excess of the Company's retention, as well as profit sharing and experience refund accruals. Reinsurance recoverable is reduced for estimated uncollectible amounts, if any.

Reinsurance premiums, losses and adjustment expenses are accounted for on a basis consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. The cost of reinsurance related to long duration contracts is accounted for over the life of the underlying reinsured policies using assumptions consistent with those used to account for the underlying policies. The cost of reinsurance related to short duration contracts is accounted for over the coverage period. Profit-sharing and similar adjustable provisions are accrued based on the experience of the underlying policies.

## Cash Equivalents

The Company considers as cash equivalents all securities whose duration does not exceed 90 days at the date of acquisition.

## Short-term Investments

The Company considers investments maturing within one year at acquisition as short-term. These securities are carried at amortized cost, which approximates market value.



## Depreciation

Depreciation on most property and equipment is calculated on a straight-line basis using estimated useful lives ranging from three to ten years. Building improvements are depreciated over the estimated lives of thirty years.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

Commissions Payable

The Company recorded a reduction of approximately \$0.4 million in commission expense for the year ended 2012 due to balances that were held pending validation that are no longer considered payable.

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 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 materially from these estimates.

Reserving assumptions are reviewed to ensure our original assumptions at the time of policy issuance that related to interest, mortality, withdrawals, and settlement expenses are based upon management's best judgment. In 2012 and 2011, the Company revised assumptions used in the development of reserve and DAC balances to reflect the assumed decline in the long-term investment rate. The adjustment resulted in an increase to reserves of approximately \$0.2 million and \$0.8 million and a decrease in the DAC asset of approximately \$0.1 million and \$1.4 million, respectively.

Reclassifications

Certain amounts presented in prior years have been reclassified to conform to the current presentation. No individual amounts were material.

Accounting Pronouncements

Accounting Standards Recently Adopted

In June 2011, the FASB amended ASU No. 2011-05 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 was effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The adoption of this guidance did not have a material impact on our financial statements.

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 stockholders' equity balance as of January 1, 2010 by \$6.9 million.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

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

|   | As Previously<br>Reported             | Impact of<br>Change in<br>Accounting<br>Principle | As<br>Adjusted |   |
|---|---------------------------------------|---|----------------|---|
|   | (In thousands, except per share data) |   |                |   |
| Balance Sheet Accounts:                             |                                       |   |                |   |
| As of December 31, 2011:                            |                                       |   |                |   |
| Deferred acquisition costs                          | \$ 136,300                            | (11,758   | ) 124,542      |   |
| Deferred federal income taxes                       | 18,055                                | (4,115  | ) 13,940       |   |
| Accumulated deficit                                 | (14,208                               | ) (7,643  | ) (21,851      | ) |
| Statement of Operations:                            |                                       |   |                |   |
| Twelve months ended December 31, 2011:              |                                       |   |                |   |
| Capitalization of deferred policy acquisition costs | \$(29,433                             | ) 1,607   | (27,826        | ) |
| Amortization of deferred policy acquisition costs   | 18,620                                | (1,772  | ) 16,848       |   |
| Federal income tax expense                          | 2,790                                 | 58  | 2,848          |   |
| Net income  | 8,375                                 | 107   | 8,482          |   |
| Per share of Class A common stock:                  |                                       |   |                |   |
| Basic earnings per share                            | \$0.17                                | —   | 0.17           |   |
| Diluted earnings per share                          | \$0.17                                | —   | 0.17           |   |
| Twelve months ended December 31, 2010:              |                                       |   |                |   |
| Capitalization of deferred policy acquisition costs | \$(27,960                             | ) 1,788   | (26,172        | ) |
| Amortization of deferred policy acquisition costs   | 17,840                                | (547  | ) 17,293       |   |
| Federal income tax expense                          | 4,119                                 | (434  | ) 3,685        |   |
| Net income  | 15,511                                | (807  | ) 14,704       |   |
| Per share of Class A common stock:                  |                                       |   |                |   |
| Basic earnings per share                            | \$0.32                                | (0.02   | ) 0.30         |   |
| Diluted earnings per share                          | \$0.32                                | (0.02   | ) 0.30         |   |

## Accounting Standards Not Yet Adopted

In February 2013, the FASB issued ASU No. 2013-02, "Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income" ("ASU 2013-02"), which requires enhanced reporting of such amounts either on the face of the financial statements or in the notes to the financial statements. Under ASU 2013-02, the type of reclassification out of AOCI, as defined under current GAAP, will dictate whether the disclosure must provide the effect of the reclassification on the respective financial statement line items or whether cross-referencing to other disclosures that provide additional detail about the reclassification will be required. The amendments in ASU 2013-02 are effective prospectively for reporting periods beginning after December 15, 2012. We will adopt the requirements of ASU 2013-02 beginning with our financial statements for the quarterly period ending March 31, 2013, and will include the enhanced disclosures in the notes to our consolidated 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

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

2011-04 is effective for annual periods beginning after December 15, 2011, and did not have any impact on the Company's financial statements.

## Health Care Reform

The Affordable Care Act, as passed by the U.S. Congress in the first quarter of 2010. The Company has considered its medical and dental plans provided for employees and agents. While the Company will incur additional costs associated with the implementation of this Act, it does not believe these costs or ongoing costs associated with this Act will have a material impact to the consolidated financial statements. The Company does not provide a separate prescription drug plan to its retirees. In addition, the Company does not sell any medical insurance or prescription drug coverage. However, the Company does sell dental insurance but believes the impact of this Act is immaterial to these products. The Company will continue to assess the information contained in this Act as additional guidance becomes available and as additional implications are understood or clarified.

## Financial Reform

In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("the "Financial Reform Act") was enacted. The Financial Reform act includes a provision to establish a Federal Insurance Office with the primary purpose of collecting information to better understand insurance issues at the federal level and to monitor the extent to which traditional underserved communities and consumers, minorities and low and moderate income persons have access to affordable insurance products. The Financial Reform Act also contains provisions affecting financial institutions, credit rating agencies and other commercial and consumer businesses.

## Note 2: Investments

The Company invests primarily in fixed maturity securities, which totaled 82.7% of total investments and cash and cash equivalents at December 31, 2012. Holdings in high quality fixed maturity securities rated A or higher by Standard & Poor's, Inc. totaled 80.4% of investment holdings in this category, reflecting the conservative investment philosophy of the Company.

|  | December 31, 2012                |                           | December 31, 2011                |                           |
|--|----------------------------------|---------------------------|----------------------------------|---------------------------|
|  | Carrying Value<br>(In thousands) | % of Total Carrying Value | Carrying Value<br>(In thousands) | % of Total Carrying Value |
| Fixed maturity securities                    | \$791,528                        | 82.7                      | \$741,753                        | 85.0                      |
| Equity securities                            | 53,741                           | 5.6                       | 46,137                           | 5.3                       |
| Mortgage loans                               | 1,509                            | 0.2                       | 1,557                            | 0.2                       |
| Policy loans                                 | 42,993                           | 4.5                       | 39,090                           | 4.5                       |
| Real estate and other long-term investments  | 8,553                            | 0.9                       | 8,644                            | 1.0                       |
| Short-term investments                       | 2,340                            | 0.2                       | 2,048                            | 0.2                       |
| Cash and cash equivalents                    | 56,299                           | 5.9                       | 33,255                           | 3.8                       |
| Total cash, cash equivalents and investments | \$956,963                        | 100.0                     | \$872,484                        | 100.0                     |



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

The cost, gross unrealized gains and losses and fair value of investments in fixed maturities and equity securities, as of December 31, 2012 and 2011, are as follows.

|                                       | December 31, 2012 |            |            |         |
|---------------------------------------|-------------------|------------|------------|---------|
|                                       | Cost or           | Gross      | Gross      | Fair    |
|                                       | Amortized         | Unrealized | Unrealized | Value   |
|                                       | Cost              | Gains      | Losses     |         |
|                                       | (In thousands)    |            |            |         |
| Fixed maturities:                     |                   |            |            |         |
| Available-for-sale securities:        |                   |            |            |         |
| U.S. Treasury securities              | \$ 10,170         | 3,773      | —          | 13,943  |
| U.S. Government-sponsored enterprises | 81,788            | 3,815      | 22         | 85,581  |
| States and political subdivisions     | 265,812           | 17,227     | 777        | 282,262 |
| Foreign governments                   | 105               | 36         | —          | 141     |
| Corporate                             | 195,755           | 20,536     | 286        | 216,005 |
| Commercial mortgage-backed            | 481               | 17         | 2          | 496     |
| Residential mortgage-backed           | 5,625             | 469        | 2          | 6,092   |
| Total available-for-sale securities   | 559,736           | 45,873     | 1,089      | 604,520 |
| Held-to-maturity securities:          |                   |            |            |         |
| U.S. Government-sponsored enterprises | 28,632            | 514        | —          | 29,146  |
| States and political subdivisions     | 125,634           | 5,435      | 378        | 130,691 |
| Corporate                             | 32,742            | 1,160      | —          | 33,902  |
| Total held-to-maturity securities     | 187,008           | 7,109      | 378        | 193,739 |
| Total fixed maturity securities       | \$ 746,744        | 52,982     | 1,467      | 798,259 |
| Equity securities:                    |                   |            |            |         |
| Stock mutual funds                    | \$ 10,463         | 250        | 28         | 10,685  |
| Bond mutual funds                     | 41,504            | 541        | 129        | 41,916  |
| Common stock                          | 17                | —          | 2          | 15      |
| Preferred stock                       | 760               | 365        | —          | 1,125   |
| Total equity securities               | \$ 52,744         | 1,156      | 159        | 53,741  |

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

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



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

For investments of available-for-sale fixed maturities that have unrealized losses as of December 31, 2012, the cost, gross unrealized losses that have been in a continuous unrealized loss position for less than 12 months, gross unrealized losses that have been in a continuous unrealized loss position for 12 months or longer and fair value are as follows.

|  | December 31, 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           | \$10,603            | 22                | 9               | —                      | —                 | —               | 10,603     | 22                | 9               |
| States and political subdivisions          | 54,115              | 443               | 61              | 5,099                  | 334               | 2               | 59,214     | 777               | 63              |
| Corporate                                  | 22,316              | 286               | 16              | —                      | —                 | —               | 22,316     | 286               | 16              |
| Commercial mortgage-backed                 | 94                  | 2                 | 1               | —                      | —                 | —               | 94         | 2                 | 1               |
| Residential mortgage-backed                | —                   | —                 | —               | 52                     | 2                 | 1               | 52         | 2                 | 1               |
| Total available-for-sale securities        | 87,128              | 753               | 87              | 5,151                  | 336               | 3               | 92,279     | 1,089             | 90              |
| Held-to-maturity securities:               |                     |                   |                 |                        |                   |                 |            |                   |                 |
| States and political subdivisions          | 40,611              | 378               | 32              | —                      | —                 | —               | 40,611     | 378               | 32              |
| Total held-to-maturity securities          | 40,611              | 378               | 32              | —                      | —                 | —               | 40,611     | 378               | 32              |
| Total fixed maturities                     | \$127,739           | 1,131             | 119             | 5,151                  | 336               | 3               | 132,890    | 1,467             | 122             |
| Equity securities:                         |                     |                   |                 |                        |                   |                 |            |                   |                 |
| Stock mutual funds                         | \$—                 | —                 | —               | 972                    | 28                | 1               | 972        | 28                | 1               |
| Bond mutual funds                          | 3,335               | 88                | 1               | 2,959                  | 41                | 2               | 6,294      | 129               | 3               |
| Common stocks                              | 15                  | 2                 | 1               | —                      | —                 | —               | 15         | 2                 | 1               |
| Total equities                             | \$3,350             | 90                | 2               | 3,931                  | 69                | 3               | 7,281      | 159               | 5               |

As of December 31, 2012, there are 3 equity securities that had unrealized losses for greater than 12 months.

The largest group of available-for-sale fixed maturities in a gross unrealized loss position for more than 12 months is primarily the municipal bonds acquired in the acquisition of SPLIC in 2004, and under purchase GAAP accounting, have a higher cost basis than historical cost. These premiums are being amortized to net investment income. Management has completed its assessment of other-than-temporary impairment of these securities. Based on our evaluation of the credit worthiness of the issuers and because we do not intend to sell the investments, nor is it

likely that we would be required to sell these investments, before recovery of their amortized cost bases, which may be maturity, none of the unrealized losses are considered to be other-than-temporary.

We monitor 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. Our impairment review, in accordance with current guidance, is performed by the Company at each reporting date and management uses its best judgment to decide if impairment is other-than-temporary. We determine other-than-temporary impairment by reviewing relevant evidence related to the specific security issuer, as well as our intent to sell the security or whether we more likely than not will be required to sell the security before its anticipated recovery. All securities with a market price below par were segregated and reviewed as of December 31, 2012 based upon the items above for impairment.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

For investments of available-for-sale fixed maturities and equity securities that have unrealized losses as of December 31, 2011, the cost, gross unrealized losses that have been in a continuous unrealized loss position for less than 12 months, gross unrealized losses that have been in a continuous unrealized loss position for 12 months or longer and fair value are as follows.

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

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

The amortized cost and fair value of fixed maturities at December 31, 2012 by contractual maturity are shown 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.

|  | Cost or<br>Amortized Cost<br>(In thousands) | Fair Value |
|--|---|------------|
| Available-for-sale securities:               |   |            |
| Due in one year or less                      | \$ 15,092                                   | 15,159     |
| Due after one year through five years        | 79,760                                      | 85,074     |
| Due after five years through ten years       | 112,719                                     | 120,013    |
| Due after ten years                          | 346,059                                     | 377,686    |
| Securities not due at a single maturity date | 6,106                                       | 6,588      |
| Total available-for-sale securities          | 559,736                                     | 604,520    |
| Held-to-maturity securities:                 |   |            |
| Due in one year or less                      | 9,998                                       | 10,018     |
| Due after one year through five years        | 35,397                                      | 35,766     |
| Due after five years through ten years       | 47,093                                      | 50,225     |
| Due after ten years                          | 94,520                                      | 97,730     |
| Total held-to-maturity securities            | 187,008                                     | 193,739    |
| Total fixed maturities                       | \$ 746,744                                  | 798,259    |

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

The Company had no investments in any one entity, excluding U.S. Government agencies, which exceeded 10% of stockholders' equity at December 31, 2012. In addition, there were no investments that were non-income producing for the year ended December 31, 2012.

Major categories of net investment income are summarized as follows:

|                               | For the Years Ended December 31, |          |          |
|-------------------------------|----------------------------------|----------|----------|
|                               | 2012                             | 2011     | 2010     |
|                               | (In thousands)                   |          |          |
| Investment income on:         |                                  |          |          |
| Fixed maturities              | \$ 27,470                        | 26,606   | 26,829   |
| Equity securities             | 2,158                            | 1,534    | 713      |
| Mortgage loans on real estate | 104                              | 99       | 101      |
| Policy loans                  | 3,332                            | 3,024    | 2,704    |
| Long-term investments         | 234                              | 225      | 246      |
| Other                         | 99                               | 122      | 207      |
| Total investment income       | 33,397                           | 31,610   | 30,800   |
| Investment expenses           | (1,672                           | ) (1,511 | ) (1,580 |
| Net investment income         | \$ 31,725                        | 30,099   | 29,220   |



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

Proceeds and gross realized gains and losses from sales of fixed maturities available-for-sale for 2012, 2011 and 2010 are summarized as follows:

|                       | For the Years Ended December 31, |      |       |
|-----------------------|----------------------------------|------|-------|
|                       | 2012                             | 2011 | 2010  |
|                       | (In thousands)                   |      |       |
| Proceeds              | \$576                            | —    | 8,029 |
| Gross realized gains  | \$54                             | —    | 912   |
| Gross realized losses | \$3                              | —    | 25    |

Certain securities were sold during 2012 from a tax planning perspective and due to statutory reporting considerations related to non-rated securities. In 2010, the Company sold available-for-sale bonds to capture realized gains and reinvest in higher yielding securities of the same quality based upon market changes.

There were no securities sold from the held-to-maturity portfolio in 2012, 2011 or 2010.

Proceeds and gross realized gains and losses from sales of equity securities for 2012, 2011 and 2010 are summarized as follows:

|                       | For the Years Ended December 31, |       |        |
|-----------------------|----------------------------------|-------|--------|
|                       | 2012                             | 2011  | 2010   |
|                       | (In thousands)                   |       |        |
| Proceeds              | \$2,855                          | 7,504 | 22,822 |
| Gross realized gains  | \$632                            | 1,259 | 7,254  |
| Gross realized losses | \$—                              | —     | 11     |

In 2012, 2011 and 2010, the Company sold holdings of equity mutual funds that were previously impaired, generating realized capital gains for financial reporting purposes of \$0.6 million, \$1.3 million and \$6.4 million, respectively, but realized losses for tax purposes. The tax losses offset current year tax gains and were carried back to recover taxes paid on gains in prior years.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

Realized investment gains (losses) are as follows:

|   | For the Years Ended December 31, |        |       |
|---|----------------------------------|--------|-------|
|   | 2012                             | 2011   | 2010  |
|   | (In thousands)                   |        |       |
| Realized investment gains (losses):       |                                  |        |       |
| Sales, calls and maturities:              |                                  |        |       |
| Fixed maturities                          | \$824                            | 119    | 753   |
| Equity securities                         | 636                              | 1,259  | 7,343 |
| Property and equipment                    | —                                | 2      | (8 )  |
| Other long-term investments               | 55                               | 16     | (49 ) |
| Net realized gains                        | 1,515                            | 1,396  | 8,039 |
| Other-than-temporary impairments ("OTTI") |                                  |        |       |
| Fixed maturities                          | (1,319 )                         | (70 )  | (27 ) |
| Other long-term investments               | —                                | (561 ) | —     |
| Realized loss on OTTI                     | (1,319 )                         | (631 ) | (27 ) |
| Net realized investment gains             | \$196                            | 765    | 8,012 |

We recorded an OTTI write-down in 2012 of \$1,319,000 related to one coal powered energy issuer debt security holding which has a maturity date in 2017. We also recorded impairments in 2011 of \$70,000 related to a bond issuer that declared bankruptcy in 2011 and \$561,000 related to an investment property that was acquired as part of the Ozark acquisition in 2009. A current appraisal reflected a declining value of this Arkansas office building from the fair value at acquisition.

The Company had realized gains of \$246,000 from calls of held-to-maturity fixed maturities in 2012.

### Note 3: 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 fixed maturity and equity securities that are carried at fair value.

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

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

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

Level 3 - Instruments whose significant value drivers are unobservable.

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

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



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

the marketplace. Financial instruments in this category primarily include corporate fixed maturity 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 where we cannot corroborate the significant valuation inputs with market observable data.

The following table sets forth our assets and liabilities that are measured at fair value on a recurring basis as of the date indicated.

| Available-for-sale investments                             | December 31, 2012 |         |         | Total<br>Fair Value |
|--|-------------------|---------|---------|---------------------|
|  | Level 1           | Level 2 | Level 3 |                     |
|  | (In thousands)    |         |         |                     |
| Financial assets:  |                   |         |         |                     |
| Fixed maturities:  |                   |         |         |                     |
| U.S. Treasury and U.S.<br>Government-sponsored enterprises | \$ 13,943         | 85,581  | —       | 99,524              |
| States and political subdivisions                          | —                 | 282,262 | —       | 282,262             |
| Corporate  | —                 | 216,005 | —       | 216,005             |
| Commercial mortgage-backed                                 | —                 | 109     | 387     | 496                 |
| Residential mortgage-backed                                | —                 | 6,092   | —       | 6,092               |
| Foreign governments  | —                 | 141     | —       | 141                 |
| Total fixed maturities                                     | 13,943            | 590,190 | 387     | 604,520             |
| Equity securities:   |                   |         |         |                     |
| Stock mutual funds   | 10,685            | —       | —       | 10,685              |
| Bond mutual funds  | 41,916            | —       | —       | 41,916              |
| Common stock   | 15                | —       | —       | 15                  |
| Preferred stock  | 1,125             | —       | —       | 1,125               |
| Total equity securities                                    | 53,741            | —       | —       | 53,741              |
| Total financial assets                                     | \$ 67,684         | 590,190 | 387     | 658,261             |

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

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

## Financial Instruments Valuation

Fixed maturity securities, available-for-sale. At December 31, 2012, the fixed maturities, valued using a third-party pricing source, totaled \$590.2 million for Level 2 assets and comprised 89.7% of total reported fair value. Fair values for Level 3 assets are based upon unadjusted broker quotes that are non-binding. The Level 1 and Level 2 valuations are reviewed and validated 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. For the period ended December 31, 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. Fair values of these securities are based upon quoted market price and are classified as Level 1 assets.

Warrants outstanding. Fair value of our warrants are based upon industry standard models that consider various observable inputs and are classified as Level 2.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

The following table presents additional information about fixed maturity securities measured at fair value on a recurring basis and for which we have utilized significant unobservable (Level 3) inputs to determine fair value:

|  | December 31,   |       |
|--|----------------|-------|
|  | 2012           | 2011  |
|  | (In thousands) |       |
| Beginning Balance at January 1,              | \$459          | 519   |
| Total realized and unrealized gains (losses) |                |       |
| Included in net income                       | —              | —     |
| Included in other comprehensive income       | (6             | ) 6   |
| Principal paydowns                           | (66            | ) (66 |
| Transfer in and (out) of Level 3             | —              | —     |
| Ending Balance at December 31,               | \$387          | 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, if any, 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 instrument. 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 at each year-end were as follows:

|                                    | December 31, 2012 |               | December 31, 2011 |               |
|------------------------------------|-------------------|---------------|-------------------|---------------|
|                                    | Carrying<br>Value | Fair<br>Value | Carrying<br>Value | Fair<br>Value |
|                                    | (In thousands)    |               | (In thousands)    |               |
| Financial assets:                  |                   |               |                   |               |
| Fixed maturities, held-to-maturity | \$ 187,008        | 193,739       | 227,500           | 230,093       |
| Mortgage loans                     | 1,509             | 1,503         | 1,557             | 1,428         |
| Policy loans                       | 42,993            | 42,993        | 39,090            | 39,090        |
| Short-term investments             | 2,340             | 2,340         | 2,048             | 2,048         |
| Cash and cash equivalents          | 56,299            | 56,299        | 33,255            | 33,255        |
| Financial liabilities:             |                   |               |                   |               |
| Annuities                          | \$51,750          | 54,981        | 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 the discount rate and estimates of future cash flows.

Mortgage loans are secured principally by residential properties and commercial properties. Weighted average interest rates for these loans were approximately 6.6% and 6.6% per year, as of December 31, 2012 and 2011,

respectively, with maturities ranging from P2Y to P29Y years. Management estimated the fair value using an annual interest rate of 6.25% at December 31, 2012 and 2011. Our mortgage loans are considered Level 3 assets in the fair value hierarchy.

Policy loans have a weighted average annual interest rate of 7.7% as of December 31, 2012 and 2011, respectively, and have no specified maturity dates. The aggregate fair value of policy loans approximates the carrying value reflected on

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

the consolidated balance sheet. 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 that we have in force and cannot be valued separately and are not marketable. Therefore, the fair value 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 December 31, 2012 using discounted cash flows based upon a swap rate curve with interest rates ranging from 0.1% to 3.8% 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.

## Note 4: Policy Liabilities

Various assumptions used to determine the future policy benefit reserves of life insurance include the following: a) valuation interest rates from 4% to 9% per year; b) mortality assumptions are from the 1955 to 1960, 1965 to 1970, 1975 to 1980 and 2001 Select and Ultimate mortality tables; and c) withdrawals are based primarily on actual historical termination rates.

The following table presents information on changes in the liability for life, accident and health and property policy and contract claims for the years ended December 31, 2012, 2011 and 2010.

|                                    | For the Years Ended December 31, |          |          |
|------------------------------------|----------------------------------|----------|----------|
|                                    | 2012                             | 2011     | 2010     |
|                                    | (In thousands)                   |          |          |
| Policy claims payable at January 1 | \$10,020                         | 10,540   | 10,222   |
| Less: reinsurance recoverable      | 1,171                            | 1,188    | 2,455    |
| Net balance at January 1           | 8,849                            | 9,352    | 7,767    |
| Add claims incurred, related to:   |                                  |          |          |
| Current year                       | 26,094                           | 24,996   | 26,043   |
| Prior years                        | (687                             | ) (1,565 | ) (1,187 |
|                                    | 25,407                           | 23,431   | 24,856   |
| Deduct claims paid, related to:    |                                  |          |          |
| Current year                       | 18,302                           | 18,004   | 18,072   |
| Prior years                        | 6,127                            | 5,930    | 5,199    |
|                                    | 24,429                           | 23,934   | 23,271   |
| Net balance December 31            | 9,827                            | 8,849    | 9,352    |
| Plus: reinsurance recoverable      | 1,188                            | 1,171    | 1,188    |
| Policy claims payable, December 31 | \$11,015                         | 10,020   | 10,540   |

The Company experienced favorable development of \$0.7 million in 2012, primarily related to SPLIC. We have performed a review and have refined our incurred but not reported calculation in 2011 and 2012. This method is anticipated to provide us with a more refined view of the claims development process.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

The favorable development in 2011 of \$1,600,000 was primarily related the release of higher claim reserves in SPLIC due to longer claim reporting lags following Hurricane's Katrina and Rita and the relocation of insured lives. The claims related to these events have stabilized and the higher claim reserves are no longer deemed necessary.

## Note 5: Reinsurance

In the normal course of business, the Company reinsures portions of certain policies that we underwrite to limit disproportionate risks. During 2012 and 2011, we retained varying amounts of individual insurance up to a maximum retention of \$100,000 on any life. The Company also reinsures 100% of our accidental death benefit rider coverage. Catastrophe reinsurance is in place for our property policies. In 2012 and 2011, this reinsurance provided \$10,000,000 of coverage above a \$500,000 deductible. Our health insurance policies are substantially all reinsured on a 100% coinsurance basis. We remain contingently liable to the extent that the reinsuring companies cannot meet their obligations under these reinsurance treaties.

Our amounts recoverable from reinsurers represent receivables from and reserves ceded to reinsurers. We obtain reinsurance from multiple reinsurers, and we monitor concentration as well as financial strength ratings of our principal reinsurers. The ratings by A.M. Best Company range from B+ (Good) to A+ (Superior). To protect our position, we have established and funded a trust to cover the contingent liabilities related to accident and health reinsurance ceded to Puritan Life Insurance Company of America, which represents \$4.9 million of the \$9.7 million of reinsurance recoverable at December 31, 2012.

Assumed and ceded life reinsurance activity as of December 31, 2012 and 2011 is summarized as follows:

|   | At December 31, |           |
|---|-----------------|-----------|
|   | 2012            | 2011      |
|   | (In thousands)  |           |
| Aggregate assumed life insurance in force | \$801,261       | 1,147,222 |
| Aggregate ceded life insurance in force   | \$(466,898)     | (462,220) |
| Net life insurance in force               | \$4,976,157     | 5,244,200 |

The Company's reinsurance recoveries on ceded reinsurance were \$9.7 million in 2012 and \$9.6 million in 2011. Premiums, claims and surrenders assumed and ceded for all lines of business for these years are summarized as follows:

|   | For the Years Ended December 31, |         |         |
|---|----------------------------------|---------|---------|
|   | 2012                             | 2011    | 2010    |
|   | (In thousands)                   |         |         |
| Premiums from short-duration contracts: |                                  |         |         |
| Direct                                  | \$7,274                          | 7,227   | 6,994   |
| Assumed                                 | —                                | —       | —       |
| Ceded                                   | (1,034)                          | (1,128) | (1,131) |
| Net premiums earned                     | 6,240                            | 6,099   | 5,863   |
| Premiums from long-duration contracts:  |                                  |         |         |
| Direct                                  | 168,272                          | 159,860 | 152,125 |
| Assumed                                 | 1,275                            | 1,874   | 1,553   |

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|                               |           |          |          |   |
|-------------------------------|-----------|----------|----------|---|
| Ceded                         | (5,914    | ) (6,438 | ) (7,489 | ) |
| Net premiums earned           | 163,633   | 155,296  | 146,189  |   |
| Total premiums earned         | \$169,873 | 161,395  | 152,052  |   |
| Claims and surrenders assumed | \$1,313   | 1,865    | 1,549    |   |
| Claims and surrenders ceded   | \$(5,486  | ) (3,204 | ) (5,341 | ) |

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

SPFIC has catastrophe reinsurance that covers the first event in excess of a \$500,000 deductible up to \$10.0 million. In consideration for a reinstatement premium, second event coverage is provided in excess of a \$500,000 deductible up to \$10.0 million. The annual premium was approximately \$1.0 million in 2012, and \$1.1 million in 2011 and 2010.

## Note 6: Stockholders' Equity and Restrictions

The two classes of our common stock are equal in all respects, except (a) each Class A share receives twice the cash dividends paid on a per share basis to the Class B common stock; and (b) the Class B common stock elects a simple majority of the Board of Directors of Citizens and the Class A common stock elects the remaining directors.

The table below shows the combined total of all of our insurance subsidiaries' capital and surplus and net income (loss) for life insurance operations and property insurance operations, although these amounts are not all available as dividends to Citizens, Inc., because only CICA is directly owned by Citizens, Inc. All other subsidiaries are owned by CICA.

|   | For the Years Ended December 31, |         |        |
|---|----------------------------------|---------|--------|
|   | 2012                             | 2011    |        |
| Combined Statutory Stockholders' Equity | (In thousands)                   |         |        |
|   | (Unaudited)                      |         |        |
| Life insurance operations               | \$ 109,055                       | 114,314 |        |
| Property insurance operations           | 5,137                            | 5,113   |        |
| Total statutory equity                  | \$ 114,192                       | 119,427 |        |
|   | For the Years Ended December 31, |         |        |
|   | 2012                             | 2011    | 2010   |
| Combined Statutory Net Income           | (In thousands)                   |         |        |
|   | (Unaudited)                      |         |        |
| Life insurance operations               | \$ 4,055                         | 6,943   | 15,563 |
| Property insurance operations           | 28                               | 469     | (7)    |
| Total statutory net income              | \$ 4,083                         | 7,412   | 15,556 |

Generally, the net assets of the insurance subsidiaries available for transfer to their immediate parent are limited to the greater of the subsidiary net gain from operations during the preceding year or 10% of the subsidiary net statutory surplus as of the end of the preceding year as determined in accordance with accounting practices prescribed or permitted by insurance regulatory authorities. Under these practices, total surplus at December 31, 2012 was \$50.7 million and net gain from operations was \$2.9 million for CICA. Based upon statutory net gain from operations and surplus of CICA as of and for the year ended December 31, 2012, a dividend of approximately \$5.1 million could be paid to the Company without prior regulatory approval in 2013. Payments of dividends in excess of such amounts would generally require approval by regulatory authorities.

CICA, CNLIC, SPLIC and SPFIC have calculated their risk based capital ("RBC") in accordance with the National Association of Insurance Commissioners' Model Rule and the RBC rules as adopted by their respective states of domicile. All insurance subsidiaries exceeded RBC minimum levels at December 31, 2012.

Note 7: Convertible Preferred Stock

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. We also issued to the investors warrants to purchase shares of our Class A common stock, at an exercise price of \$6.95 per share, and unit warrants to purchase Series A-2 Convertible Preferred Stock (“Series A-2 Preferred”). 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 on December 30, 2005.

All outstanding warrants were exercised in 2011 and 2012 and none were remaining as of December 31, 2012.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

The fair value of the warrants was calculated using the Black-Scholes option pricing model and was classified as a liability on the balance sheet in the amount of \$0.5 million at December 31, 2011. The change in fair value of warrants was reported as a component of revenue in the income statement. The change in fair value of warrants for the year ended December 31, 2012, 2011 and 2010 caused an increase in revenues of \$0.5 million \$1.1 million and \$0.2 million, respectively.

Note 8: Commitments and Contingencies

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. 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.

The District Court has issued a case management order requiring the State to produce specific detail by property supporting its breach of contract allegations. Additionally, the case management order requires the State to deliver a settlement proposal to SPFIC and the other defendant insurance companies. Since, there are many potential individual claims at issue in this matter, each 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. SPFIC believes its claims 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. SPFIC intends to vigorously defend all claims asserted in any remaining proceedings. Therefore, in SPFIC's judgment given the issues discussed above, an estimate of probable loss cannot be made at this time.

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.

At this time we cannot estimate any possible loss or range of losses in regard to either Delia Bolanos Andrade, et al., Plaintiffs, v. Citizens Insurance Company of America, et al., Defendants or the Road Home Litigation.

We are defending these claims vigorously. However, in doing so, we continue to incur significant defense costs, including attorneys' fees, other direct litigation costs and the expenditure of substantial amounts of management time that otherwise would be devoted to our business. If we suffer an adverse judgment as a result of either of these claims, it could have a material adverse effect on our business, results of operations and financial condition.

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

We have the following lease commitments as of December 31, 2012 with the payments due by the periods indicated below.

|                    | Lease Commitments<br>(In thousands) |
|--------------------|-------------------------------------|
| Less than 1 year   | \$378                               |
| 1 year to 3 years  | 392                                 |
| 3 years to 5 years | 40                                  |
| More than 5 years  | —                                   |
| Total              | \$810                               |

Operating lease expense was \$0.6 million for the year ended December 31, 2012, and \$0.5 million for the same periods ended 2011 and 2010.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

## Note 9: Segment and Other Operating 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 described in the summary of significant account policies. We evaluate profit and loss performance based on U.S. GAAP net income before federal income taxes for our three reportable segments.

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

|   | December 31, 2012 |                 |                                       |              |
|---|-------------------|-----------------|---------------------------------------|--------------|
|   | Life<br>Insurance | Home<br>Service | Other<br>Non-Insurance<br>Enterprises | Consolidated |
|   | (In thousands)    |                 |                                       |              |
| Revenues:   |                   |                 |                                       |              |
| Premiums  | \$126,032         | 43,841          | —                                     | 169,873      |
| Net investment income                                   | 17,828            | 12,724          | 1,173                                 | 31,725       |
| Realized investment gains (losses), net                 | 512               | (343            | ) 27                                  | 196          |
| Decrease in fair value of warrants                      | —                 | —               | 451                                   | 451          |
| Other income  | 319               | 80              | 115                                   | 514          |
| Total revenue   | 144,691           | 56,302          | 1,766                                 | 202,759      |
| Benefits and expenses:                                  |                   |                 |                                       |              |
| Insurance benefits paid or provided:                    |                   |                 |                                       |              |
| Claims and surrenders                                   | 43,537            | 21,119          | —                                     | 64,656       |
| Increase in future policy benefit reserves              | 63,481            | 3,195           | —                                     | 66,676       |
| Policyholders' dividends                                | 8,846             | 245             | —                                     | 9,091        |
| Total insurance benefits paid or provided               | 115,864           | 24,559          | —                                     | 140,423      |
| Commissions   | 24,895            | 14,503          | —                                     | 39,398       |
| Other general expenses                                  | 10,961            | 12,089          | 2,614                                 | 25,664       |
| Capitalization of deferred policy acquisition costs     | (23,371           | ) (5,703        | ) —                                   | (29,074      |
| Amortization of deferred policy acquisition costs       | 15,077            | 2,768           | —                                     | 17,845       |
| Amortization of cost of customer relationships acquired | 746               | 1,721           | —                                     | 2,467        |
| Total benefits and expenses                             | 144,172           | 49,937          | 2,614                                 | 196,723      |
| Income (loss) before income tax expense                 | \$519             | 6,365           | (848                                  | ) 6,036      |

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

|   | December 31, 2011<br>(As adjusted) |                 |                                       |              |
|---|------------------------------------|-----------------|---------------------------------------|--------------|
|   | Life<br>Insurance                  | Home<br>Service | Other<br>Non-Insurance<br>Enterprises | Consolidated |
|   | (In thousands)                     |                 |                                       |              |
| Revenues:   |                                    |                 |                                       |              |
| Premiums  | \$ 118,205                         | 43,190          | —                                     | 161,395      |
| Net investment income                                   | 16,401                             | 12,861          | 837                                   | 30,099       |
| Realized investment gains (losses), net                 | 1,347                              | (601            | ) 19                                  | 765          |
| Decrease in fair value of warrants                      | —                                  | —               | 1,136                                 | 1,136        |
| Other income  | 526                                | 112             | 123                                   | 761          |
| Total revenue   | 136,479                            | 55,562          | 2,115                                 | 194,156      |
| Benefits and expenses:                                  |                                    |                 |                                       |              |
| Insurance benefits paid or provided:                    |                                    |                 |                                       |              |
| Claims and surrenders                                   | 40,525                             | 19,531          | —                                     | 60,056       |
| Increase in future policy benefit reserves              | 54,310                             | 3,954           | —                                     | 58,264       |
| Policyholders' dividends                                | 8,004                              | 68              | —                                     | 8,072        |
| Total insurance benefits paid or provided               | 102,839                            | 23,553          | —                                     | 126,392      |
| Commissions   | 23,482                             | 14,892          | —                                     | 38,374       |
| Other general expenses                                  | 11,418                             | 12,186          | 2,436                                 | 26,040       |
| Capitalization of deferred policy acquisition costs     | (21,675                            | ) (6,151        | ) —                                   | (27,826      |
| Amortization of deferred policy acquisition costs       | 13,769                             | 3,079           | —                                     | 16,848       |
| Amortization of cost of customer relationships acquired | 921                                | 2,077           | —                                     | 2,998        |
| Total benefits and expenses                             | 130,754                            | 49,636          | 2,436                                 | 182,826      |
| Income (loss) before income tax expense                 | \$ 5,725                           | 5,926           | (321                                  | ) 11,330     |

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

|   | December 31, 2010<br>(As adjusted) |                 |                                       |              |
|---|------------------------------------|-----------------|---------------------------------------|--------------|
|   | Life<br>Insurance                  | Home<br>Service | Other<br>Non-Insurance<br>Enterprises | Consolidated |
|   | (In thousands)                     |                 |                                       |              |
| Revenues:   |                                    |                 |                                       |              |
| Premiums  | \$ 109,985                         | 42,067          | —                                     | 152,052      |
| Net investment income                                   | 15,666                             | 13,008          | 546                                   | 29,220       |
| Realized investment gains, net                          | 6,590                              | 1,475           | (53                                   | ) 8,012      |
| Decrease in fair value of warrants                      | —                                  | —               | 232                                   | 232          |
| Other income  | 650                                | 82              | 76                                    | 808          |
| Total revenue   | 132,891                            | 56,632          | 801                                   | 190,324      |
| Benefits and expenses:                                  |                                    |                 |                                       |              |
| Insurance benefits paid or provided:                    |                                    |                 |                                       |              |
| Claims and surrenders                                   | 41,040                             | 19,998          | —                                     | 61,038       |
| Increase in future policy benefit reserves              | 42,619                             | 3,801           | —                                     | 46,420       |
| Policyholders' dividends                                | 7,414                              | 71              | —                                     | 7,485        |
| Total insurance benefits paid or provided               | 91,073                             | 23,870          | —                                     | 114,943      |
| Commissions   | 21,899                             | 14,686          | —                                     | 36,585       |
| Other general expenses                                  | 10,546                             | 13,879          | 1,803                                 | 26,228       |
| Capitalization of deferred policy acquisition costs     | (20,140                            | ) (6,032        | ) —                                   | (26,172      |
| Amortization of deferred policy acquisition costs       | 15,856                             | 1,437           | —                                     | 17,293       |
| Amortization of cost of customer relationships acquired | 1,105                              | 1,953           | —                                     | 3,058        |
| Total benefits and expenses                             | 120,339                            | 49,793          | 1,803                                 | 171,935      |
| Income before income tax expense                        | \$ 12,552                          | 6,839           | (1,002                                | ) 18,389     |

The table below summarizes assets by segment.

|                                 | For the Years Ended December<br>31, |                       |
|---------------------------------|-------------------------------------|-----------------------|
|                                 | 2012                                | 2011<br>(As adjusted) |
|                                 | (In thousands)                      |                       |
| Assets:                         |                                     |                       |
| Life Insurance                  | \$ 717,967                          | 644,645               |
| Home Service Insurance          | 385,046                             | 371,636               |
| Other Non-Insurance Enterprises | 71,935                              | 63,231                |
| Total assets                    | \$ 1,174,948                        | 1,079,512             |





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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

Major categories of earned premiums are summarized as follows:

|                      | For the Years Ended December 31, |         |         |
|----------------------|----------------------------------|---------|---------|
|                      | 2012                             | 2011    | 2010    |
|                      | (In thousands)                   |         |         |
| Premium income:      |                                  |         |         |
| Ordinary life        | \$ 162,070                       | 153,118 | 144,350 |
| Group life           | 1,100                            | 1,660   | 1,315   |
| Accident and health  | 1,635                            | 1,561   | 1,577   |
| Property             | 5,068                            | 5,056   | 4,810   |
| Total premium income | \$ 169,873                       | 161,395 | 152,052 |

## Geographic Information

The following table sets forth the Company's annual total of earned premiums from geographic area for the years indicated:

|                         | For the Years Ended December 31, |          |          |
|-------------------------|----------------------------------|----------|----------|
|                         | 2012                             | 2011     | 2010     |
|                         | (In thousands)                   |          |          |
| Area:                   |                                  |          |          |
| United States           | \$ 67,332                        | 51,126   | 53,189   |
| Venezuela               | 25,035                           | 21,150   | 16,655   |
| Colombia                | 23,010                           | 21,765   | 21,377   |
| Taiwan                  | 14,879                           | 14,196   | 14,270   |
| Ecuador                 | 14,064                           | 13,481   | 12,278   |
| Argentina               | 9,502                            | 9,353    | 9,134    |
| Other foreign countries | 21,724                           | 36,016   | 32,216   |
| Net reinsurance         | (5,673                           | ) (5,692 | ) (7,067 |
| Total                   | \$ 169,873                       | 161,395  | 152,052  |

## Note 10: Income Taxes

Our federal income tax expense was \$1.5 million, \$2.8 million and \$3.7 million in 2012, 2011 and 2010, respectively. This represents effective tax rates of 25.0%, 25.1% and 20.0%, respectively. The Company previously had a valuation allowance related to OTTI writedowns on stocks and stock mutual funds in 2008. Due to the sale of these mutual funds in 2009 and 2010, the valuation allowance was released in its entirety in 2009 and 2010. Part of this valuation allowance was released to other comprehensive income ("OCI") in 2009 due to the increase in fair value of mutual funds and stocks still owned. As the stocks and mutual funds have been disposed of since 2009, this valuation allowance has been released as reductions of tax expense. During 2010, 2011 and 2012 \$1.9 million, \$570,000 and \$188,000 has been released as a reduction of tax expense, respectively.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

The table below summarizes the changes in the valuation allowance.

|  | Deferred Tax<br>Liability | Other<br>Comprehensive<br>Income | Goodwill | Income Tax<br>Expense<br>(Benefit) |
|--|---------------------------|----------------------------------|----------|------------------------------------|
|  | (In thousands)            |                                  |          |                                    |
| Balance at December 31, 2009           | (2,462                    | ) (2,701                         | ) 1,058  | 4,105                              |
| Release of valuation allowance in 2010 | 2,462                     | 1,858                            | —        | (4,320                             |
| Balance at December 31, 2010           | —                         | (843                             | ) 1,058  | (215                               |
| Release of valuation allowance in 2011 | —                         | 570                              | —        | (570                               |
| Balance at December 31, 2011           | —                         | (273                             | ) 1,058  | (785                               |
| Release of valuation allowance in 2012 | —                         | 188                              | —        | (188                               |
| Balance at December 31, 2012           | \$—                       | (85                              | ) 1,058  | (973                               |

A reconciliation of federal income tax expense computed by applying the federal income tax rate of 35% in 2012, 2011 and 2010 to income (loss) before federal income tax expense is as follows:

|  | Years Ended December 31, |               |               |
|--|--------------------------|---------------|---------------|
|  | 2012                     | 2011          | 2010          |
|  |                          | (As adjusted) | (As adjusted) |
|  | (In thousands)           |               |               |
| Expected tax expense   | \$2,113                  | 3,966         | 6,436         |
| Change in valuation allowance  | —                        | —             | (2,462        |
| Release of valuation allowance previously held in other comprehensive income | (188                     | ) (570        | ) (1,858      |
| Taxable intercompany stock sales   | 182                      | 405           | 1,369         |
| Tax-exempt interest and dividends-received deduction                         | (364                     | ) (251        | ) (203        |
| Change in fair value of options and warrants                                 | (158                     | ) (398        | ) (81         |
| Adjustment of prior year taxes   | —                        | (280          | ) 566         |
| Effect of graduated rates  | (100                     | ) —           | —             |
| Other  | 22                       | (24           | ) (82         |
| Total income tax expense   | \$1,507                  | 2,848         | 3,685         |

Income tax expense (benefit) consists of:

|                          | Years Ended December 31, |               |               |
|--------------------------|--------------------------|---------------|---------------|
|                          | 2012                     | 2011          | 2010          |
|                          |                          | (As adjusted) | (As adjusted) |
|                          | (In thousands)           |               |               |
| Current                  | \$3,666                  | 4,624         | 3,492         |
| Deferred                 | (2,159                   | ) (1,776      | ) 193         |
| Total income tax expense | \$1,507                  | 2,848         | 3,685         |

Deferred tax expense is comprised of \$1,971,000 deferred tax benefit and \$188,000 tax benefit released from OCI.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

The components of deferred federal income taxes are as follows:

|  | Years Ended December 31, |           |
|--|--------------------------|-----------|
|  | 2012                     | 2011      |
|  | (As adjusted)            |           |
|  | (In thousands)           |           |
| Deferred tax assets:   |                          |           |
| Future policy benefit reserves   | \$34,785                 | 30,842    |
| Net operating and capital loss carryforwards   | 3,098                    | 3,751     |
| Due and accrued dividends and expenses   | 1,324                    | 1,274     |
| Investments  | 308                      | 433       |
| State income tax credits   | 131                      | 135       |
| Other  | 542                      | 190       |
| Total gross deferred tax assets  | 40,188                   | 36,625    |
| Valuation allowance  | —                        | —         |
| Total gross deferred tax assets net of valuation allowance                                       | 40,188                   | 36,625    |
| Deferred tax liabilities:  |                          |           |
| Deferred policy acquisition costs, cost of customer relationships acquired and intangible assets | (40,844                  | ) (39,279 |
| Unrealized gains on investments available-for-sale   | (16,023                  | ) (10,494 |
| Other  | (622                     | ) (792    |
| Total gross deferred tax liabilities   | (57,489                  | ) (50,565 |
| Net deferred tax liability   | \$(17,301                | ) (13,940 |

A summary of the changes in the components of deferred federal and state income taxes is as follows:

|   | At December 31, |           |
|---|-----------------|-----------|
|   | 2012            | 2011      |
|   | (As adjusted)   |           |
|   | (In thousands)  |           |
| Deferred federal and state income taxes:    |                 |           |
| Balance January 1,                          | \$(13,940       | ) (5,237  |
| Deferred tax benefit (expense)              | 1,971           | 1,206     |
| Investments available-for-sale              | (5,529          | ) (10,219 |
| Effects of unrealized gains on CCRA and DAC | 197             | 310       |
| Balance December 31,                        | \$(17,301       | ) (13,940 |

The Company and our subsidiaries had net operating losses at December 31, 2012 available to offset future taxable income of approximately \$8,851,000, expiring at various times through 2029. A portion of the net operating loss carryforward is subject to limitations under Section 382 of the Internal Revenue Code. At December 31, 2012 and 2011, we determined that as a result of our historical income, projected future income, tax planning strategies, and the nature of the items from which the deferred tax assets are derived, other than assets for which OTTI was recorded, it was more likely than not that the deferred tax assets would be realized. The Company has sufficient unrealized gains in its available-for-sale portfolio so as not to need a valuation allowance for OTTI writedowns.

The Company and our subsidiaries had no capital loss carry-forwards at December 31, 2012.

At December 31, 2012, the Company had accumulated approximately \$3,291,000 in our "policyholders' surplus account." This is a special memorandum tax account into which certain amounts not previously taxed, under prior tax

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CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

laws, were accumulated. No new additions are expected to be made to this account. Federal income taxes will become payable thereon at the then current tax rate (a) when and if distributions to shareholders, other than stock dividends and other limited exceptions, are made in excess of the accumulated previously taxed income; or (b) when a company ceases to be a life insurance company as defined by the Internal Revenue Code and such termination is not due to another life insurance company acquiring its assets in a nontaxable transaction. We do not anticipate any transactions that would cause any part of this amount to become taxable. However, should the balance at December 31, 2012 become taxable, the tax computed at present rates would be approximately \$1,152,000.

There are no uncertain tax positions for the year ended December 31, 2012; therefore, we did not accrue any interest or penalties related to these items.

The Company's Federal income tax return is filed on a consolidated basis with the following entities:

Citizens, Inc.  
CICA Life Insurance Company of America  
Security Plan Life Insurance Company  
Security Plan Fire Insurance Company  
Computing Technology, Inc.  
Insurance Investors, Inc.  
Citizens National Life Insurance Company

The method of allocation among companies is subject to a written tax sharing agreement, approved by the Board of Directors, whereby allocation is made primarily on a separate return basis with current credit for any net operating losses or other items utilized in the consolidated tax return. Intercompany tax balances are settled quarterly.

The Company and our subsidiaries file income tax returns in the U.S. federal jurisdiction and various U.S. states. Most of our subsidiaries are not subject to examination by U.S. tax authorities for years prior to 2009. Some of our subsidiaries have open tax years going back as far as 1996 due to net operating loss carry-forwards.



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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

## Note 11: Other Comprehensive Income (Loss)

The changes in the components of other comprehensive income (loss) are reported net of the effects of income taxes of 35% in 2012, 2011 and 2010, as indicated below.

|   | Amount<br>(In thousands) | Tax Effect | Amount     |
|---|--------------------------|------------|------------|
| Year ended December 31, 2012  |                          |            |            |
| Unrealized gains (losses) on securities:                              |                          |            |            |
| Unrealized holding gains (losses) arising during the period           | \$15,694                 | (5,493     | ) 10,201   |
| Reclassification adjustment for (gains) losses included in net income | 105                      | (36        | ) 69       |
| Effects on DAC and CCRA   | (564                     | ) 197      | (367 )     |
| Change in tax valuation allowance                                     | —                        | (188       | ) (188 )   |
| Other comprehensive income  | \$15,235                 | (5,520     | ) 9,715    |
| Year ended December 31, 2011  |                          |            |            |
| Unrealized gains (losses) on securities:                              |                          |            |            |
| Unrealized holding gains (losses) arising during the period           | \$30,474                 | (10,666    | ) 19,808   |
| Reclassification adjustment for (gains) losses included in net income | (1,277                   | ) 447      | (830 )     |
| Effects on DAC and CCRA   | (885                     | ) 310      | (575 )     |
| Change in tax valuation allowance                                     | —                        | (570       | ) (570 )   |
| Other comprehensive loss  | \$28,312                 | (10,479    | ) 17,833   |
| Year ended December 31, 2010  |                          |            |            |
| Unrealized gains (losses) on securities:                              |                          |            |            |
| Unrealized holding gains (losses) arising during the period           | \$4,891                  | (1,712     | ) 3,179    |
| Reclassification adjustment for (gains) losses included in net income | (8,067                   | ) 2,824    | (5,243 )   |
| Effects on DAC and CCRA   | (45                      | ) 15       | (30 )      |
| Change in tax valuation allowance                                     | —                        | (1,858     | ) (1,858 ) |
| Other comprehensive income  | \$(3,221                 | ) (731     | ) (3,952 ) |

## Note 12: Benefit Plans

The Company sponsors a defined contribution profit-sharing plan. Employees with one year of service can participate. Contributions are made at the discretion of the Board of Directors and are subject to a tiered vesting schedule. Employer contributions to the plan were \$0.8 million in 2012 and \$1.0 million in 2011 and 2010. The plan does not permit employee contributions.

The Company is primarily self-insured for employee health benefits. The Company records its self-insurance liability based on claims filed and an estimate of claims incurred but not yet reported. There is stop-loss coverage for amounts in excess of \$100,000 per individual per year. If more claims are made than were estimated or if the costs of actual claims increase beyond what was anticipated, reserves recorded may not be sufficient and additional accruals may be required in future periods.

## Note 13: Related Party Transactions

The Company sponsors the Citizens, Inc. Stock Investment Plan (the "Plan"), which is administered by an independent third party. The Plan is a means for new and existing investors in our Class A Common Stock to purchase and sell shares at market prices. Each share purchased through the Plan is registered in the name of the investing shareholder. The Company offers the Plan to our policyholders for automatic investment of policy benefits, including policyholder dividends and annual endowment benefits. We do not have possession of, or control over, any amounts invested through the Plan.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

Citizens, Inc. purchased Class A common shares during 2012 and 2011 that were held by subsidiaries at market value as of the transaction dates, which approximated \$0.6 million and \$1.2 million, respectively. These transactions were eliminated for financial reporting purposes in accordance with consolidation accounting, but generated a tax expense for the year ended December 31, 2012 and 2011 totaling approximately \$0.2 million and \$0.4 million.

In 2012 and 2011, CICA made a return of capital of \$5.4 million and \$6.8 million, respectively, to Citizens, Inc. and SPLIC paid a dividend to CICA in the amount of \$2.3 million and \$0.6 million, respectively.

## Note 14: Quarterly Financial Information (Unaudited)

The following table contains selected unaudited financial data for each quarter.

|  | Fourth<br>Quarter<br>(In thousands, except per share amounts)                  | Third<br>Quarter                  | Second<br>Quarter                  | First<br>Quarter                  |
|--|--|-----------------------------------|------------------------------------|-----------------------------------|
| 2012   |  |                                   |                                    |                                   |
| Revenues   | \$54,070   | 52,182                            | 49,602                             | 46,905                            |
| Benefits and expenses                              | 54,511   | 48,137                            | 49,263                             | 44,812                            |
| Federal income tax (benefit) expense               | (144)  | ) 1,134                           | (64)                               | ) 581                             |
| Net income (loss)                                  | (297)  | ) 2,911                           | 403                                | 1,512                             |
| Net income (loss) available to common shareholders | (297)  | ) 2,911                           | 403                                | 1,512                             |
| Basic earnings per share of Class A common stock   | (0.01)   | ) 0.06                            | 0.01                               | 0.03                              |
| Basic earnings per share of Class B common stock   | —  | 0.03                              | —                                  | 0.02                              |
| Diluted earnings per share of Class A common stock | (0.01)   | ) 0.06                            | 0.01                               | 0.03                              |
| Diluted earnings per share of Class B common stock | —  | 0.03                              | —                                  | 0.02                              |
|  | Fourth<br>Quarter<br>(As adjusted)<br>(In thousands, except per share amounts) | Third<br>Quarter<br>(As adjusted) | Second<br>Quarter<br>(As adjusted) | First<br>Quarter<br>(As adjusted) |
| 2011   |  |                                   |                                    |                                   |
| Revenues   | \$52,458   | 48,333                            | 48,296                             | 45,069                            |
| Benefits and expenses                              | 50,779   | 45,551                            | 43,918                             | 42,578                            |
| Federal income tax expense (benefit)               | (119)  | ) 729                             | 1,369                              | 869                               |
| Net income   | 1,798  | 2,053                             | 3,009                              | 1,622                             |
| Net income available to common shareholders        | 1,798  | 2,053                             | 3,009                              | 1,622                             |
| Basic earnings per share of Class A common stock   | 0.04   | 0.04                              | 0.06                               | 0.03                              |
| Basic earnings per share of Class B common stock   | 0.02   | 0.02                              | 0.03                               | 0.02                              |
| Diluted earnings per share of Class A common stock | 0.04   | 0.04                              | 0.04                               | 0.03                              |
| Diluted earnings per share of Class B common stock | 0.02   | 0.02                              | 0.03                               | 0.01                              |

## Note 15: Subsequent Events

We have evaluated for subsequent events as defined by the accounting guidance through the date of financial statement issuance. No items were identified in this period subsequent to the financial statement date that required

adjustment or disclosure.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Financial Schedules

## Schedule II

## Condensed Financial Information of Registrant

## CITIZENS, INC. (Parent Company)

## Balance Sheets

|   | At December 31, |               |
|---|-----------------|---------------|
|   | 2012            | 2011          |
|   |                 | (As adjusted) |
|   | (In thousands)  |               |
| Assets  |                 |               |
| Investment in subsidiaries <sup>(1)</sup>   | \$ 197,059      | 190,003       |
| Fixed maturities available-for-sale, at fair value                                    | 43,946          | 35,299        |
| Fixed maturities held-to-maturity, at amortized cost                                  | 151             | 151           |
| Equity securities available-for-sale, at fair value                                   | 972             | 926           |
| Mortgage loans on real estate   | 479             | 485           |
| Real estate and other long-term investments   | 6,365           | 6,468         |
| Cash  | 16,489          | 16,494        |
| Accrued investment income   | 598             | 384           |
| Accounts receivable from subsidiaries <sup>(1)</sup>                                  | 2,212           | 2,517         |
| Other assets  | 526             | 763           |
| Total assets  | \$ 268,797      | 253,490       |
| Liabilities and Stockholders' Equity  |                 |               |
| Liabilities:  |                 |               |
| Accrued expense and other liabilities   | \$ 5,689        | 4,997         |
| Liabilities for options and warrants  | —               | 451           |
| Total liabilities   | \$ 5,689        | 5,448         |
| Stockholders' equity:   |                 |               |
| Common stock:   |                 |               |
| Class A   | \$ 259,383      | 258,548       |
| Class B   | 3,184           | 3,184         |
| Accumulated retained deficit  | (17,335         | ) (21,851     |
| Unrealized investment gains on securities held by parent and subsidiaries, net of tax | 28,887          | 19,172        |
| Treasury stock  | (11,011         | ) (11,011     |
| Total stockholders' equity  | 263,108         | 248,042       |
| Total liabilities and stockholders' equity  | \$ 268,797      | 253,490       |

<sup>(1)</sup> Eliminated in consolidation.

See accompanying report of independent registered public accounting firm.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Financial Schedules

## Schedule II, Continued

## Condensed Financial Information of Registrant

## CITIZENS, INC. (Parent Company)

## Statements of Operations

|   | Years Ended December 31, |                       |                       |
|---|--------------------------|-----------------------|-----------------------|
|   | 2012                     | 2011<br>(As adjusted) | 2010<br>(As adjusted) |
|   | (In thousands)           |                       |                       |
| Revenues:   |                          |                       |                       |
| Management service fees <sup>(1)</sup>                      | \$27,930                 | 28,560                | 29,153                |
| Investment income   | 1,157                    | 822                   | 423                   |
| Decrease in fair value of warrants                          | 451                      | 1,136                 | 232                   |
| Other   | —                        | —                     | —                     |
| Realized investment gains (losses), net                     | 27                       | 18                    | (53)                  |
| Total revenues  | 29,565                   | 30,536                | 29,755                |
| Expenses:   |                          |                       |                       |
| General   | 26,280                   | 26,418                | 26,529                |
| Taxes, licenses and fees                                    | 870                      | 962                   | 821                   |
| Federal income tax expense                                  | 708                      | 709                   | 787                   |
| Total expenses  | 27,858                   | 28,089                | 28,137                |
| Income before equity in income of consolidated subsidiaries | 1,707                    | 2,447                 | 1,618                 |
| Equity in income of consolidated subsidiaries               | 2,822                    | 6,035                 | 13,086                |
| Net income  | \$4,529                  | 8,482                 | 14,704                |

<sup>(1)</sup> Eliminated in consolidation.

See accompanying report of independent registered public accounting firm.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Financial Schedules

## Schedule II, Continued

## Condensed Financial Information of Registrant

## CITIZENS, INC. (Parent Company)

## Statements of Cash Flows

|   | Years Ended December 31, |               |               |
|---|--------------------------|---------------|---------------|
|   | 2012                     | 2011          | 2010          |
|   |                          | (As adjusted) | (As adjusted) |
|   | (In thousands)           |               |               |
| Cash flows from operating activities:   |                          |               |               |
| Net income  | \$4,529                  | 8,482         | 14,704        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |               |               |
| Realized investment losses (gains), net   | (27                      | ) (18         | ) 53          |
| Equity in income of consolidated subsidiaries                                     | (2,822                   | ) (6,035      | ) (13,086     |
| Decrease in fair value of warrants  | (451                     | ) (1,136      | ) (232        |
| Accrued expenses and other liabilities  | 692                      | 1,762         | 845           |
| Amortization of premiums and discounts on investments                             | 492                      | 165           | 96            |
| Depreciation  | 263                      | 249           | 227           |
| Accrued investment income   | (213                     | ) (210        | ) (164        |
| Decrease (increase) in receivable from subsidiaries                               | 305                      | (81           | ) 1,552       |
| Other, net  | (266                     | ) (246        | ) (295        |
| Net cash provided by operating activities   | 2,502                    | 2,932         | 3,700         |
| Cash flows from investing activities:   |                          |               |               |
| Purchase of fixed maturities, held-to-maturity                                    | —                        | (1,156        | ) —           |
| Calls of fixed maturities, held-to-maturity                                       | —                        | 1,000         | —             |
| Purchase of fixed maturities, available-for-sale                                  | (16,199                  | ) (24,794     | ) (18,254     |
| Maturities of fixed maturities, available-for-sale                                | 8,017                    | 8,725         | 1,750         |
| Purchase of equity securities, available-for-sale                                 | —                        | (1,000        | ) —           |
| Sale of real estate and other long-term investments                               | 11                       | 16            | 61            |
| Purchase of other long-term investments and property and equipment                | (5                       | ) (154        | ) (437        |
| Maturity of short-term investments  | —                        | —             | —             |
| Capital contribution to subsidiary  | —                        | —             | —             |
| Net cash used by investment activities  | (8,176                   | ) (17,363     | ) (16,880     |
| Cash flows from financing activities:   |                          |               |               |
| Dividend from subsidiary  | 5,400                    | 6,800         | 19,800        |
| Warrants exercised  | 822                      | 1,843         | —             |
| Purchase of the Company's stock from affiliates                                   | (553                     | ) (1,226      | ) (4,314      |
| Net cash provided by financing activities   | 5,669                    | 7,417         | 15,486        |
| Net increase (decrease) in cash   | (5                       | ) (7,014      | ) 2,306       |
| Cash at beginning of year   | 16,494                   | 23,508        | 21,202        |
| Cash at end of year   | \$16,489                 | 16,494        | 23,508        |

See accompanying report of independent registered public accounting firm.





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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Financial Schedules

## Schedule III

## Supplementary Insurance Information

|   | At December 31, |         |
|---|-----------------|---------|
|   | 2012            | 2011    |
|   | (As adjusted)   |         |
|   | (In thousands)  |         |
| Deferred policy acquisition cost:   |                 |         |
| Life Insurance  | \$110,144       | 101,850 |
| Home Service Insurance  | 25,425          | 22,692  |
| Other Non-Insurance Enterprises   | —               | —       |
| Total consolidated deferred policy acquisition costs                        | \$135,569       | 124,542 |
| Future policy benefit reserves and policy claims payable:                   |                 |         |
| Life Insurance  | \$583,553       | 517,869 |
| Home Service Insurance  | 247,022         | 242,325 |
| Other Non-Insurance Enterprises   | —               | —       |
| Total consolidated future policy benefit reserves and policy claims payable | \$830,575       | 760,194 |
| Unearned premiums:  |                 |         |
| Life Insurance  | \$791           | 693     |
| Home Service Insurance  | 206             | 214     |
| Other Non-Insurance Enterprises   | —               | —       |
| Total consolidated unearned premiums  | \$997           | 907     |
| Other policy claims and benefits payable:                                   |                 |         |
| Life Insurance  | \$43,063        | 38,929  |
| Home Service Insurance  | 4,797           | 4,816   |
| Other Non-Insurance Enterprises   | —               | —       |
| Total consolidated other policy claims and benefits payable                 | \$47,860        | 43,745  |

See accompanying report of independent registered public accounting firm.

For the Company's short duration premiums (property), written premium is not materially different from earned premium, therefore only earned premiums are detailed in Schedule IV.

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## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Financial Schedules

For the Company's short duration premiums (property), written premium is not materially different from earned premium, therefore only earned premiums are detailed in Schedule IV.

## Schedule IV

## Reinsurance

|                               | Direct<br>Amount | Ceded to<br>Other<br>Companies | Assumed<br>From Other<br>Companies | Net Amount | % of<br>Amount<br>Assumed to<br>Net |   |
|-------------------------------|------------------|--------------------------------|------------------------------------|------------|-------------------------------------|---|
|                               | (In thousands)   |                                |                                    |            |                                     |   |
| Year ended December 31, 2012  |                  |                                |                                    |            |                                     |   |
| Life insurance in force       | \$4,641,794      | 466,898                        | 801,261                            | 4,976,157  | 16.1                                | % |
| Premiums:                     |                  |                                |                                    |            |                                     |   |
| Life insurance                | 163,935          | 2,040                          | 1,275                              | 163,170    |                                     |   |
| Accident and health insurance | 5,510            | 3,874                          | —                                  | 1,636      |                                     |   |
| Property insurance            | 6,102            | 1,034                          | —                                  | 5,068      |                                     |   |
| Total premiums                | \$175,547        | 6,948                          | 1,275                              | 169,874    | 0.8                                 | % |
| Year ended December 31, 2011  |                  |                                |                                    |            |                                     |   |
| Life insurance in force       | \$4,559,198      | 462,220                        | 1,147,222                          | 5,244,200  | 21.9                                | % |
| Premiums:                     |                  |                                |                                    |            |                                     |   |
| Life insurance                | 154,812          | 1,908                          | 1,874                              | 154,778    |                                     |   |
| Accident and health insurance | 6,091            | 4,530                          | —                                  | 1,561      |                                     |   |
| Property insurance            | 6,184            | 1,128                          | —                                  | 5,056      |                                     |   |
| Total premiums                | \$167,087        | 7,566                          | 1,874                              | 161,395    | 1.2                                 | % |
| Year ended December 31, 2010  |                  |                                |                                    |            |                                     |   |
| Life insurance in force       | \$4,451,979      | 381,076                        | 1,044,759                          | 5,115,662  | 20.4                                | % |
| Premiums:                     |                  |                                |                                    |            |                                     |   |
| Life insurance                | 146,331          | 2,219                          | 1,553                              | 145,665    |                                     |   |
| Accident and health insurance | 6,847            | 5,270                          | —                                  | 1,577      |                                     |   |
| Property insurance            | 5,941            | 1,131                          | —                                  | 4,810      |                                     |   |
| Total premiums                | \$159,119        | 8,620                          | 1,553                              | 152,052    | 1.0                                 | % |

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, hereunto duly authorized.

CITIZENS, INC.

Date: March 11, 2013

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

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

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below hereby constitutes and appoints Rick D. Riley and Geoffrey M. Kolander or any one of them, as his or her attorney-in-fact and agent, with full power of substitution, for him or her in any and all capacities, hereby giving and granting to said attorney-in-fact and agent full power and authority to do and perform all and every act and thing whatsoever requisite and necessary to be done in and about the premises as fully, to all intents and purposes, as he might or could do if personally present at the doing thereof, hereby ratifying and confirming all that said attorney-in-fact and agent may or shall lawfully do, or cause to be done, in connection with the proposed filing by Citizens, Inc., with the Securities and Exchange Commission, under the provisions of the Securities Exchange Act of 1934, as amended, of an annual report on Form 10-K for the fiscal year ended December 31, 2012, including but not limited to, such full power and authority to do the following: (i) execute and file such annual report; (ii) execute and file any amendment or amendments thereto; (iii) receive and respond to comments from the Securities and Exchange Commission related in any way to such annual report or any amendment or amendments thereto; and (iv) execute and deliver any and all certificates, instruments or other documents related to the matters enumerated above, as the attorney-in-fact in his sole discretion deems appropriate.

Dated: March 11, 2013

/s/ Harold E. Riley  
Harold E. Riley, Chairman of the Board and  
Chief Executive Officer

/s/ E. Dean Gage  
Dr. E. Dean Gage, Director

/s/ Terry S. Maness  
Dr. Terry S. Maness, Director

/s/ Dottie S. Riley

/s/ Rick D. Riley  
Rick D. Riley, Vice Chairman, President and  
Chief Corporate Officer

/s/ Robert B. Sloan, Jr.  
Dr. Robert B. Sloan, Jr., Director

/s/ Grant G. Teaff  
Grant G. Teaff, Director

/s/ Timothy T. Timmerman

Dottie S. Riley, Director

Timothy T. Timmerman, Director

/s/ Steven F. Shelton  
Steven F. Shelton, Director

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EXHIBITS

Exhibit No. The following exhibits are filed herewith:

- 3.1 Restated and Amended Articles of Incorporation (a)
- 3.2 Amended and Restated Bylaws dated March 1, 2013
- 4.1 Amendment to State Series A-1 and A-2 Senior Convertible Preferred Stock (b)
- 11 Statement re: Computation of per share earnings (see financial statements)
- 21 Subsidiaries of the Registrant\*
- 23 Consent of Independent Registered Public Accounting Firm - Ernst & Young LLP\*
- 24 Power of Attorney (c)
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act\*
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act\*
- 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act\*
- 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act\*
- 99.1 News Release reporting the fourth quarter and year ended 2012 results issued on March 11, 2013 (furnished herewith.)
- 101.INS XBRL Instance Document (furnished herewith)
- 101.SCH XBRL Taxonomy Extension Schema (furnished herewith)
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase (furnished herewith)
- 101.DEF XBRL Taxonomy Extension Definition Linkbase (furnished herewith)
- 101.LAB XBRL Taxonomy Extension Label Linkbase (furnished herewith)
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase (furnished herewith)

\* Filed herewith.

(a) Filed on March 15, 2004 with the Registrant's Annual Report on Form 10-K for the Year Ended December 31, 2003 as Exhibit 3.1, and incorporated herein by reference.

(b) Filed on July 15, 2004, with the Registrant's Current Report on Form 8-K as Exhibit 4.1, and incorporated herein by reference.

(c) The Power of Attorney is incorporated in the signature page enclosed herein.