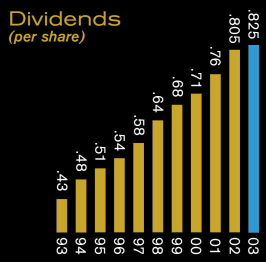
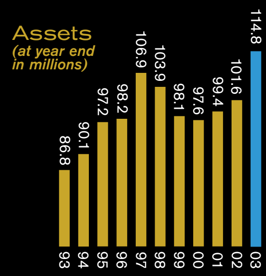
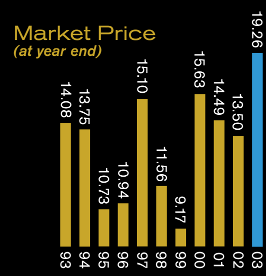
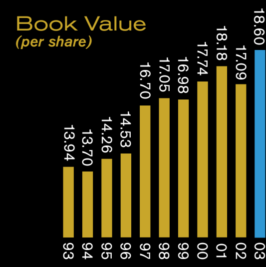
2003

the national security group, inc. annual report to shareholders









a company must have vision to prosp

Contents

Performance Highlights

Vision – where a dream and a plan join hands to inspire success.

A team of individuals, a group of companies – all with the same vision of what an insurance company ought to be for the people it serves. At National Security, our vision is clear: look for the needs and meet them in the most effective way possible. Learning from the success and challenges of the past and keeping a watchful eye on the market, we have enhanced our performance, improved our processes and prepared our people for success. And in 2003, the vision became a reality.

The National Security Group, Inc., is composed of three insurance companies: National Security Insurance Company (Life Company), National Security Fire and Casualty Company (Fire Company) and Omega One Insurance Company, a wholly owned subsidiary of the Fire Company. These companies provide a diversified line of insurance coverage in communities primarily in the South. Natsco, Inc., is a wholly owned subsidiary formed in 1984.

er, and 2003 was a prosperous year.

(In thousands except per share data)

For the Year	2003	2002	Percent of Change
Earnings Per Share	1.66	0.37	348.6%
Earnings ..Ä	4,090	908	350.4%
Net Premium Income	47,536	32,631	45.7%
Net Investment Income	4,394	4,235	3.8%
Return on Average Equity	9.3%	2.1%	342.8%
Average Shares Outstanding	2,467	2,467	
At Year End			
Shareholders' Equity Per Share	18.60	17.09	8.8%
Shareholders' Equity	45,872	42,159	8.8%
Total Assets	114,802	101,602	13.0%
Shares Outstanding	2,467	2,467	

	Stock Bid Prices High	Stock Bid Prices Low	Dividends Per Share
2003			
First Quarter	14.50	13.35	0.205
Second Quarter	14.75	11.95	0.205
Third Quarter	17.00	14.03	0.205
Fourth Quarter	20.50	15.75	0.210
2002			
First Quarter	16.00	13.90	0.200
Second Quarter	15.60	13.70	0.200
Third Quarter	15.80	13.00	0.200
Fourth Quarter	14.90	13.00	0.205

by carefully observing the direction of the indu

The Executive Management Team for The National Security Group, Inc., from left to right: Jack E. Brunson, President, National Security Fire and Casualty; William L. Brunson President and Chief Executive Officer, The National Security Group, Inc.; J. Douglas Martin, Jr., Vice President, National Security Insurance Company; Brian McLeod, Chief Financial Officer and Treasurer, The National Security Group, Inc.; Mickey L. Murdock, Chief Operating Officer and Senior Vice President, The National Security Group, Inc.

Letter To Shareholders

stry, we have been able to grow and expand.

The highest premium income in the Company's history and significantly improved earnings are two of the highlights of 2003. Unlike 2002, when we experienced a good bit of growth but achieved unsatisfactory underwriting results, the past year proved successful in both areas, with premium income increased over 45% and profitable underwriting results. 2003 also entailed other major accomplishments in areas that, although less evident on financial statements, are extremely important in our plans for long-term growth and progress. We consider 2003 to have been a successful year, but we also fully recognize that we still have many areas in which improvement is needed.

Earnings in 2003 of approximately $4.1 million or $1.66 per share were a big improvement over 2002's results. Improved underwriting results in our property and casualty operations were the primary factor. Net investment income was increased only slightly for the year compared to last year, even with the additional cash due to our premium growth. Reinvestment rates on current maturities are at multi-decade lows, which is the primary cause for the marginal increase in investment income.

Shareholders' Equity was $45.9 million at year-end, or a book value per share of $18.60, an increase of approximately 9% from our equity one year ago. Equity growth was helped by a recovery in the Company's common stock portfolio, and increased cash from operations. Our earnings constituted an approximate 9.1% Return on Average Shareholders' Equity, an improvement over the previous year but below our target.

Continued improvements in infrastructure were a major component of 2003 accomplishments, including systems implementation affecting our primary operating systems, additional web site development, telephone system modifications, and further development of our document management system. These improvements are expected to greatly enhance our ability to provide efficient and effective support to our agents and policyholders while improving access to information and enhancing productivity of our home office staff. While development in these areas will always be ongoing and essential, we do anticipate less time being devoted in these areas in the next few years than in the past few years. This will allow for a reallocation of resources to areas that have a more direct impact on top line growth and bottom line profitability including implementation of more efficient business processes, home office staff education and professional development, and business retention.

We remain excited about the prospects of The Mobile Attic, Inc., the Company's 50% owned affiliate. Portable storage is a relatively young and growing industry. The Mobile

Attic, in its third full year of operation, produced essentially break-even results in 2003 on revenues of over $1.5 million. The business model has been changed from a dealer network to a franchise-format and the sale of franchises has commenced. This change will reduce the capital requirements of growing the business and facilitate expansion at a faster pace. We expect The Mobile Attic to begin making positive contributions to our bottom line results in 2004. Information on this business is available at www.mobileattic.com or by contacting us directly.

We do not anticipate any material changes in our business strategy in the year ahead. We will continue to emphasize internally generated growth in our core insurance lines, maintaining discipline in our underwriting , and continuing to develop our workforce and operating procedures with an emphasis on service and ease of doing business. Emphasis in property and casualty operations will be placed on maintaining acceptable underwriting results in a growing book of business, and continuing to develop a more geographically diverse business to reduce the potential adverse affects of catastrophes. With life insurance production, emphasis will continue to be placed on developing a network of independent agents and offering life and supplemental health products through established property and casualty producers. Focus will continue to be placed on work-site product offerings and offering of specialty products through groups and associations.

While 2003 results were among the best in recent Company history, we will not become complacent. We have higher expectations of Company performance in the future. While our improved performance has been recognized in a 43% increase in Company stock price during 2003, we recognize the fact that we still have much room for improvement and we will continue to build our business for the long-term, focusing on our core strategies, our customers, and our agents, employees and shareholders. We appreciate your support.

William L. Brunson, Jr.
President and CEO

success can be gained by focusing on

Having Vision and Applying it to Business

National Security's plan to prosper is now paying off with positive results in every area of our business. In 2003, we reaped the benefits of several years of careful planning and preparation, and we enjoyed one of the best profit years in company history. The fundamental changes implemented in recent years have greatly enhanced the performance of our people and processes, resulting in one of our best years ever. From upgrading our technology to increasing premium revenues, National Security is looking up and looking ahead.

Our policyholders needed easy access to our wide range of insurance plans, and we have provided that access through agents trained and qualified to sell our products. Many of our agents needed more opportunities for income, and we have cross-trained them to increase their income potential. Our personnel needed a more streamlined approach to processing applications and claims, and we have upgraded our computer technology to reduce the time and labor involved in paperwork.

For convenience and cost-effectiveness, we are continuing the transition to a paperless workplace as we begin imaging all policies and other paperwork. Our computer upgrades continued as we completed the installation of the Life Company's Future First System.

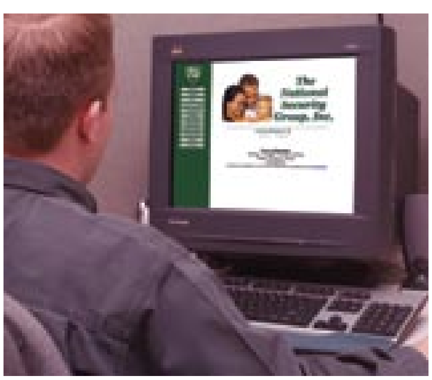
Overall, expenses were lower in 2003, due in part to careful examination of operating expenses and risk assessment. We are continuing to grow our policyholder base in non-coastal areas to evenly distribute risk. Dealing directly with more of our agents has reduced the expense of using third-party general agencies and has made the application process easier for the company and our agents. National Security's marketing representatives travel extensively, seeking opportunities to recruit and train agents who can share our vision and help grow our business.

markets and their changing needs.

we never lose sight of our priority for deve

loping new and existing niche markets.

We have found our niche in speciality markets. Our priority continues to be developing new and existing markets, specializing in meeting needs unique to the markets we serve. Never satisfied with the status quo, we take our cues from the needs of the policyholders, not just what other companies are doing. Observing shifts in target market demographics, we respond to their changing needs with niche insurance products and a high level of service to meet those needs.



We have continued to improve our offering of group products by adding critical illness coverage.

Where others see obstacles, we see opportunities. As some of our competitors pulled out of Tennessee, Mississippi and South Carolina, we took over existing books of insurance business to improve our market share. The Fire Company assumed a $4 million book of business from a company in Birmingham. Because of increased sales and the addition of these existing blocks of business, our premium revenues are up 45 percent and at an all-time high. National Security stock also reached a milestone in 2003 when prices broke the $20 barrier for the first time and shareholders' equity increased almost 9%.

In 2002, National Security formed a joint venture in the off site storage industry with Cash Brothers' Leasing, Inc., known as The Mobile Attic™. With a variety of styles and options for residential storage, construction applications and records storage, these mobile storage units are delivered to the customer's site. The customer can use the units for temporary office space or records storage or load the unit for pick-up by the dealer or franchisee. The joint venture has proven successful, and The Mobile Attic has stepped up to the next level of franchising for a promising future.

Success is a process in itself and should never be taken for granted. We will diligently continue this process we have begun, and we will share the vision with our policyholders, our agents, our employees and our shareholders. Together, we will share the vision and share the success.

(Dollars in thousands-except per share figures)

Per share figures for 1994 and prior years are restated for a three-for-two stock split issued in 1994. Per share figures for 2000 and prior years are resta

	2003	2002	2001	2000	1999	1998	1997
Earnings Per Share:							
From Operations	**1.66**	0.37	1.67	1.53	1.52	0.35	1.07
Extraordinary Items	**.00**	.00	.00	.00	.00	.00	.00
Total	**1.66**	0.37	1.67	1.53	1.52	0.35	1.07
Book Value Per Share	**18.60**	17.09	18.18	17.74	16.98	17.05	16.70
Total Shareholders' Equity	**45,872**	42,159	44,884	43,780	41,888	41,968	46,352
Assets	**114,802**	101,602	99,484	97,563	98,105	103,973	106,958
Earnings	**4,090**	908	4,130	3,776	3,756	930	2,998
Investment Income	**4,394**	4,325	4,506	4,434	4,354	4,351	4,204
Return of Equity (Percent)	**9.3**	2.1	9.3	8.8	8.9	2.1	6.9
Premiums	**47,536**	32,631	25,357	22,921	25,936	28,451	31,156
Shares Outstanding (Year-end)	**2,467**	2,467	2,467	2,056	2,056	2,051	2,313

Combined Ratio-Property & Casualty Companies							
Loss	**60.0**	75.5	54.3	61.7	70.9	87.0	79.3
Expense	**30.8**	31.9	36.1	34.8	35.8	40.3	31.0
Combined	**90.8**	107.4	90.4	96.5	106.7	127.3	110.3
Common Stock Data							
Dividends Paid Per Share	**.825**	0.805	0.76	0.71	0.68	0.64	0.58
Price at Year End	**19.26**	13.5	14.49	15.63	9.17	11.56	15.10
Price Range	**20.50-11.95**	16.00-13.00	15.63-10.21	16.04-9.17	12.50-7.71	17.71-8.75	20.00-10.63
P&C Co. Premiums/Surplus Ratio	**1.5**	1.2	0.7	0.6	0.8	0.9	0.9
Life Co. Insurance in Force (Millions)	**179**	176	176	151	141	132	132
BEST's Rating							
P&C Company	**B++**	B++	B++	B++	B++	B++	A-
Life Company	**B**	B	B	B	B	B	B
Debt (Thousands)	**3,059**	3,380	2,108	2,401	2,672	3,004	133

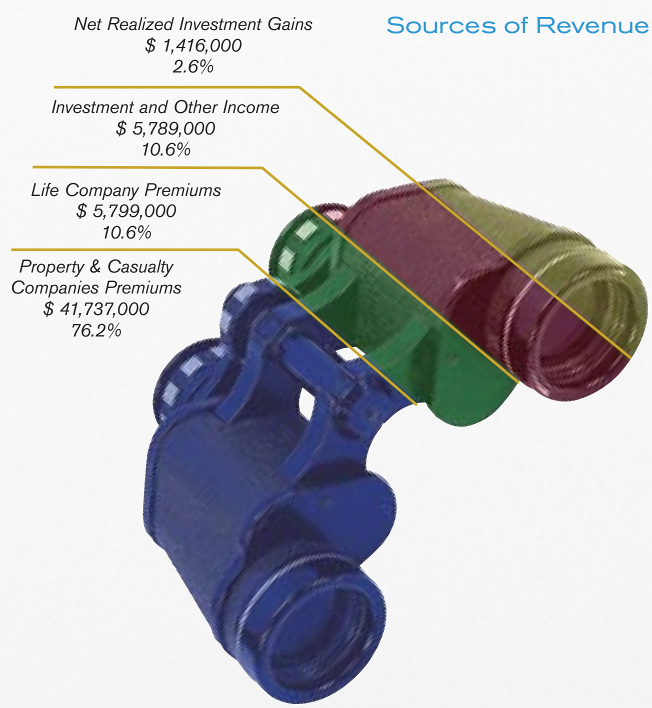
ated for a 20% stock dividend issued in 2001.

1996	1995	1994	1993
0.48	0.08	1.31	1.23
.00	.00	.00	.09
0.48	0.08	1.31	1.32
14.53	14.26	13.70	13.94
40,519	39,774	38,482	39,140
98,219	97,266	90,116	86,875
1,356	214	3,674	3,701
3,935	4,311	4,001	3,894
3.4	0.5	9.5	9.2
26,654	24,372	26,289	29,240
2,320	2,325	2,340	2,340
79.8	82.7	64.2	65.6
30.9	29.4	28.0	25.5
110.7	112.1	92.2	91.1
0.54	0.51	0.48	0.43
10.94	10.73	13.75	14.08
11.88-9.69	15.00-10.21	15.13-13.47	14.67-11.39
0.8	0.7	0.9	1.2
138	142	149	152
A-	A	A	A
B	B	B	B
182	224	0	0

(In thousands except per share figures)

	Premiums	Investment & Other Income	Realized Investment Gains or (losses)	Benefits	Operating Net Income	Operating Net Income Per Share
2003						
1st QTR	$ 9,927	$ 1,392	$ 66	$ 6,052	$ 770	$ 0.31
2nd QTR	12,025	1,516	595	7,531	1,326	0.54
3rd QTR	12,397	1,445	54	6,960	912	0.37
4th QTR	13,187	1,436	701	7,002	1,082	0.44
Total	$47,536	$ 5,789	$ 1,416	$27,545	$ 4,090	$ 1.66
2002						
1st QTR	$ 7,243	$ 1,308	$ 224	$ 4,824	$ 344	$ 0.14
2nd QTR	8,063	1,424	454	6,180	98	0.04
3rd QTR	8,281	1,454	(313)	5,421	174	0.07
4th QTR	9,044	1,100	803	6,338	292	0.12
Total	$32,631	$ 5,286	$ 1,168	$22,763	$ 908	$ 0.37

Sources of Revenue



Consolidated Statements of Income

Dollars In thousands except per share amounts	Year ended December 31,		
	2003	2002	2001
Revenues			
Net premiums earned..........................Ä	**$ 47,536**	$ 32,631	$ 25,357
Net investment income ....Ä	**4,137**	4,235	4,506
Net realized investment gains...........Ä	**1,416**	1,168	1,640
Other income...Ä	**1,395**	1,051	1,280
	54,484	39,085	32,783
Benefits and Expenses			
Policyholder benefits paid or provided	**27,545**	22,763	13,516
Amortization of deferred policy acquisition costs	**1,825**	1,406	1,778
Commissions ....Ä	**8,901**	6,222	4,338
General insurance expenses ....Ä	**8,623**	5,943	6,223
Insurance taxes, licenses and fees...Ä	**1,718**	1,311	1,215
Interest expense ....Ä	**203**	246	243
	48,815	37,891	27,313
Income Before Income Taxes and Equity in (Loss) Income of Affiliate	**5,669**	1,194	5,470
Income Tax Expense (Benefit)			
Current...Ä	**1,823**	316	1,051
Deferred ....Ä	**(273)**	106	341
	1,550	422	1,392
Income Before Equity in (Loss) Income of Affiliate	**4,119**	772	4,078
Equity in (Loss) Income of Affiliate	**(29)**	136	52
Net Income	**$ 4,090**	$ 908	$ 4,130
Earnings per Common Share			
Net Income	**$ 1.66**	$ 0.37	$ 1.67

See accompanying notes to consolidated financial statements.

The National Security Group, Inc.
Consolidated Balance Sheets

Dollars In thousands	December 31, 2003	2002
Assets		
Investments		
Fixed Maturities held-to-maturity, at amortized cost (estimated fair value: 2003 - $18,198; 2002 - $20,267)	**$ 18,631**	$ 19,380
Fixed Maturities available-for-sale, at estimated fair value (cost: 2003 - $53,300; 2002 - $41,219)	**55,015**	43,013
Equity securities available-for-sale at estimated fair value (cost: 2003 - $10,205; 2002 - $11,091)	**20,730**	18,681
Notes receivable from affiliate	**–**	625
Mortgage loans on real estate, at cost	**245**	281
Investment real estate, at book value (accumulated depreciation: 2003 - $17; 2002 - $17)	**1,564**	1,581
Policy loans	**730**	710
Investment in affiliate	**885**	914
Short-term investments	**2,190**	2,998
Total Investments	**99,992**	88,183
Cash	**782**	805
Accrued investment income	**930**	1,010
Receivable from agents, less allowance for credit losses (2003 - $140; 2002 - $176)	**2,602**	2,273
Reinsurance recoverable	**1,799**	1,699
Deferred policy acquisition costs	**5,817**	5,243
Prepaid reinsurance premiums	**496**	343
Property and equipment, net	**2,230**	1,798
Other assets	**154**	248
Total Assets	**$114,802**	$101,602
Liabilities and Shareholders' Equity		
Policy and claim reserves	**$ 49,311**	$ 45,054
Checks outstanding in excess of bank balance	**3,051**	2,445
Other policyholder funds	**1,416**	1,527
Long-term debt	**3,059**	3,380
Accrued income taxes	**1,486**	233
Other liabilities	**7,519**	4,303
Deferred income tax	**3,088**	2,501
Total Liabilities	**68,930**	59,443
Contingencies	**–**	–
Shareholders' Equity		
Preferred stock, $1 par value, 500,000 shares authorized, none issued or outstanding	**–**	–
Class A common stock, $1 par value, 2,500,000 shares authorized, none issued or outstanding.	**–**	–
Common stock, $1 par value, 2,500,000 shares authorized, 2,466,600 shares issued and outstanding	**2,467**	2,467
Additional paid-in capital	**4,951**	4,951
Accumulated other comprehensive income	**8,629**	6,971
Retained earnings	**29,825**	27,770
Total Shareholders' Equity	**45,872**	42,159
Total Liabilities and Shareholders' Equity	**$114,802**	$101,602

See accompanying notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity

Dollars in thousands

	Total	Comprehensive Income (Loss)	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Paid-in Capital	Treasury Stock
Balance at December 31, 2000	$ 43,780		$ 35,225	$ 9,779	$ 2,340	$ 17	$(3,581)
Comprehensive income:							
Net Income for 2001	4,130	$ 4,130	4,130	–	–	–	–
Other comprehensive loss, net of tax							
Unrealized loss on securities, net of reclassification adjustment	(1,161)	(1,161)	–	(1,161)	–	–	–
Comprehensive Income		$ 2,969					
Retirement of treasury stock	–		(3,297)	–	(284)		3,581
Stock dividend (20%)	–		(5,345)	–	411	4,934	–
Cash dividends	(1,865)		(1,865)	–	–	–	–
Balance at December 31, 2001	44,884		28,848	8,618	2,467	4,951	–
Comprehensive loss:							
Net Income for 2002	908	$ 908	908	–	–	–	–
Other comprehensive loss, net of tax							
Unrealized loss on securities, net of reclassification adjustment	(1,647)	(1,647)	–	(1,647)	–	–	–
Comprehensive loss		$(739)					
Cash dividends	(1,986)		(1,986)	–	–	–	–
Balance at December 31, 2002	42,159		27,770	6,971	2,467	4,951	–
Comprehensive Income:							
Net Income for 2003	4,090	$ 4,090	4,090	–	–	–	–
Other comprehensive income, net of tax							
Unrealized loss on securities, net of reclassification adjustment	1,658	1,658	–	1,658	–	–	–
Comprehensive Income		$ 5,748					
Cash dividends	(2,035)		(2,035)	–	–	–	–
Balance at December 31, 2003	$ 45,872		$ 29,825	$ 8,629	$ 2,467	$ 4,951	$ –

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Dollars In thousands

	Year ended December 31,		
	2003	2002	2001
Cash flows from operating activities:			
Net income	**$ 4,090**	$ 908	$ 4,130
Adjustments to reconcile net income to net cash provided by operating activities:			
Change in accrued investment income	**80**	(72)	(57)
Change in reinsurance recoverable	**(100)**	1,825	10
Amortization of deferred policy acquisition costs	**1,825**	1,406	1,778
Change in receivable for securities	**–**	50	93
Net realized gains on investments	**(1,416)**	(1,163)	(1,640)
Policy acquisition costs deferred	**(2,399)**	(2,034)	(1,924)
Change in prepaid reinsurance premiums	**(153)**	(52)	2
Depreciation expense and amortization/accretion	**541**	195	(42)
Change in policy liabilities and claims	**4,257**	3,315	(179)
Change in income tax payable	**1,253**	(360)	257
Change in deferred income taxes	**(275)**	266	169
Change in other liabilities	**3,216**	634	555
Equity in loss (earnings) of investee	**29**	(136)	(52)
Other, net	**(235)**	(461)	(187)
Net cash provided by operating activities	**10,713**	4,321	2,913
Cash flows from investing activities:			
Purchases of held-to-maturity securities	**(17,694)**	(1,777)	(982)
Purchases of available-for-sale securities	**(22,455)**	(19,600)	(16,575)
Proceeds from maturities of held-to-maturity securities	**13,271**	5,564	6,926
Proceeds from sales of available-for-sale securities	**17,379**	14,141	10,508
Proceeds from sale of real estate held for investment	**24**	95	38
Purchases of real estate held for investment	**–**	(53)	–
Net proceeds from sale (purchases) of short-term investments	**808**	(1,202)	(121)
Repayment of (advances on) loans, net	**641**	(1,090)	(443)
Purchase of property and equipment	**(852)**	(1,039)	(335)
Proceeds from sale of property and equipment	**3**	–	57
Net cash used in investing activities	**(8,875)**	(4,961)	(927)
Cash flows from financing activities:			
Proceeds from notes payable	**–**	1,477	–
Payments on long-term debt	**(321)**	(205)	(293)
Change in other policyholder funds	**(111)**	24	15
Dividends paid	**(2,035)**	(1,986)	(1,865)
Change in checks outstanding in excess of bank balances	**606**	540	798
Net cash used in financing activities	**(1,861)**	(150)	(1,345)
Net (decrease) increase in cash	**(23)**	(790)	641
Cash at beginning of year	**805**	1,595	954
Cash at end of year	**$ 782**	$ 805	$ 1,595

See accompanying notes to consolidated financial statements.

NOTE A - SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary - Omega One Insurance Company (Omega). Omega included a wholly-owned subsidiary - Liberty Southern Insurance Company (LSIC) through September 30, 2001. LSIC was liquidated on September 30, 2001. All significant intercompany transactions and accounts have been eliminated.

Investment in Affiliate

The Company's investment in affiliate consists of a 50% interest in Mobile Attic, Inc., a portable storage leasing company. The Company accounts for this investment using the equity method (see Notes B, O and Q).

Description of Major Products

NSIC is licensed in the states of Alabama, Georgia, Mississippi, Texas, South Carolina and Florida and was organized in 1947 to provide life and burial insurance policies to the home service market. Premiums sold and serviced by company agents primarily include industrial life, ordinary life, accident and health, limited hospital, and cancer. NSFC operates in various property and casualty lines, the most significant of which are low valued dwelling property, home service fire, nonstandard automobile physical damage and liability, nonstandard commercial, ocean marine. Omega operates in property and casualty lines, the most significant of which is commercial auto liability.

Basis of Presentation

The significant accounting policies followed by The National Security Group, Inc. and subsidiaries that materially affect financial reporting are summarized below. The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles (GAAP) which, as to the subsidiary insurance companies, differ from statutory accounting practices permitted by regulatory authorities.

Investments

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

- *Securities Held-to-Maturity.* Bonds, notes and redeemable preferred stock for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts which are recognized in interest income using methods which approximate level yields over the period to maturity.
- *Securities Available-for-Sale.* Bonds, notes, common stock and non-redeemable preferred stock not classified as either held-to-maturity, or trading are reported at fair value, adjusted for other-than-temporary declines in fair value.

The Company and its subsidiaries have no trading securities.

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

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

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

Receivable from Agents

Agent balances are reported at unpaid balances, less a provision for credit losses.

Property and Equipment

Property and equipment is carried at cost less accumulated depreciation and includes expenditures that substantially increase the useful lives of existing property and equipment. Maintenance, repairs, and minor renovations are charged to expense as incurred. Upon sale or retirement of property and equipment, the cost and related accumulated depreciation are eliminated from the respective account and the resulting gain or loss is included in the results of operations. The Company provides for depreciation of property and equipment using the straight-line method designed to amortize costs over estimated useful lives. Estimated useful lives range up to 40 years for buildings and from 3-20 years for electronic data processing equipment and furniture and fixtures.

Fair Value of Financial Instruments

The following table presents the carrying value and fair value of the Company's financial instruments, as defined in accordance with applicable requirements. Fair values of the Company's financial instruments are estimated by reference to quoted prices from market sources and financial institutions, as well as other valuation techniques. In cases where quoted market prices are not available, fair values are estimated using present value or other valuation techniques. The fair value estimates are made at a specific point in time, based on available market information and judgments about the financial instrument, such as estimates of timing and amount of expected future cash flows. Such estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument, nor do they consider the tax impact of the realization of unrealized gains or losses. In many cases, the fair value estimates cannot be substantiated by comparison to independent markets, nor can the disclosed value be realized in immediate settlement of the instrument.

Certain financial instruments, particularly insurance liabilities other than financial guarantees and investment contracts, leases and affiliate investments, are excluded from the disclosures. In evaluating the Company's management of interest rate and liquidity risk, the fair values of all assets and liabilities should be taken into consideration.

The fair values of cash, cash equivalents, short-term investments and balances due on accounts from agents, reinsurers and others approximate their carrying amounts as reflected in the consolidated balance sheets due to their short-term availability or maturity.

NOTE A - SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

Dollars in thousands	December 31, 2003		2002	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets and related Instruments				
Debt and equity securities	$ 94,378	$ 93,945	$ 81,074	$ 81,961
Mortgage loans	245	245	281	281
Policy loans	730	730	710	710
Liabilities and related Instruments				
Other policyholder funds	1,416	1,416	1,527	1,527
Long-term debt	3,059	3,059	3,380	3,380

Statement of Cash Flows

For purposes of reporting cash flows, cash includes cash-on-hand and demand deposits with banks.

Premium Revenues

Life insurance premiums are recognized as revenues when due. Property and casualty insurance premiums, less amounts ceded to reinsurers, are recognized on a pro rata basis over the terms of the policies. Reinsurance premiums assumed are recognized as reported by the ceding company.

Deferred Policy Acquisition Costs

The costs of acquiring new insurance business are deferred and amortized over the lives of the policies. Deferred costs include commissions, other agency compensation and expenses, and other underwriting expenses directly related to the level of new business produced.

Acquisition costs relating to life contracts are amortized over the premium paying period of the contracts, or the first renewal period of term policies, if earlier. Assumptions utilized in amortization are consistent with those utilized in computing policy liabilities.

The method of computing the deferred policy acquisition costs for property and casualty policies limits the amount deferred to a percentage of related unearned premiums.

Policy Liabilities

The liability for future life insurance policy benefits is computed using a net level premium method including the following assumptions:

Years of Issue	Interest rate
1947 - 1968	4%
1969 - 1978	6% graded to 5%
1979 - 2003	7% graded to 6%

Mortality assumptions include various percentages of the 1955-60 and 1965-70 Select and Ultimate Basic Male Mortality Table. Withdrawal assumptions are based on the Company's experience.

Claim Liabilities

The liability for unpaid claims represents the estimated liability for claims reported to the Company and its subsidiaries plus claims incurred but not yet reported and the related adjustment expenses. The liabilities for claims and related adjustment expenses are determined using case-basis evaluations and statistical analyses and represent estimates of the ultimate net cost of all losses incurred through December 31 of each year. Although considerable variability is inherent in such estimates, management believes that the liabilities for unpaid claims and related adjustment expenses are adequate. The estimates are continually reviewed and adjusted as necessary; such adjustments are included in current operations.

Earnings Per Share

Earnings per share of common stock is based on the weighted average number of shares outstanding during each year. The adjusted weighted average shares outstanding were 2,466,600 (2,466,600 in 2002 and 2001).

Reinsurance

In the normal course of business, NSFC seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policy. Amounts paid for prospective reinsurance contracts are reported as prepaid reinsurance premiums and amortized over the remaining contract period.

In the normal course of business, NSIC seeks to limit its exposure to loss on any single insured and to recover a portion of benefits paid by ceding reinsurance to other insurance enterprises or reinsurers under excess coverage contracts. NSIC retains a maximum of $30,000 of coverage per individual life. The cost of reinsurance is amortized over the contract period of the reinsurance.

Reclassifications

Certain reclassifications have been made in the previously reported financial statements to make the prior year amounts comparable to those of the current year. Such reclassifications had no effect on the previously reported net income or shareholders' equity.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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 from those estimates.

Advertising

The Company expenses advertising costs as incurred. Advertising costs were $89,000 for the year ended December 31, 2003 ($101,000 and $110,000 for the years ended December 31, 2002 and 2001, respectively).

NOTE A - SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

Concentration of Credit Risk

The Company maintains cash depository accounts which, at times, may exceed federally insured limits. These amounts represent actual account balances held by financial institutions at the end of the period, and unlike the balance reported in the financial statements, the account balances do not reflect timing delays inherent in reconciling items such as outstanding checks and deposits in transit. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents. At December 31, 2003, the Company's uninsured cash balances totaled $289,000.

Recently Issued Accounting Standards

In July 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, which addresses financial accounting and reporting for costs associated with exit or disposal activities, and must be applied prospectively to exit or disposal activities initiated after December 31, 2002. The adoption of this statement did not have a material impact on the Company's financial position or results of operations.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. SFAS No. 149 amends and clarifies certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. SFAS No. 149 was effective for certain contracts entered into or modified by the company after June 30, 2003. The Company adopted SFAS No. 149 effective July 1, 2003 with no material impact on its financial condition or results of operations.

In May 2003, the FASB issued SFAS 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. Financial instruments that are within the scope of the statement, which previously were often classified as equity, must now be classified as liabilities. This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise generally effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of this statement did not have a material effect on the Company's results of operations or financial position.

In November 2002, the FASB issued FASB Interpretation ("FIN") 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN 45 expands the disclosures required by guarantors for obligations under certain types of guarantees. It also requires initial recognition at fair value of a liability for such guarantees. The Company adopted the disclosure requirements of FIN 45 for the quarter ended December 31, 2002 and the liability recognition requirements to all guarantees issued or modified after December 31, 2002. The adoption of these requirements did not have a material impact on the Company's results of operations or financial position.

In January 2003, the FASB issued FIN 46, *Consolidation of Variable Interest Entities–an Interpretation of Accounting Research Bulletin No. 51*. FIN No. 46 addresses consolidation by business enterprises where equity investors do not bear the residual economic risks and rewards. The underlying principle behind FIN 46 is that if a business enterprise has the majority financial interest in an entity, which is defined in FIN 46 as a variable interest entity, the assets, liabilities and results of the activities of the variable interest entity should be included in consolidated financial statements with those of the business enterprise. In December 2003, the FASB issued Revised FIN 46 (FIN 46R) to clarify certain aspects of FIN 46 including the determination of who is the primary beneficiary of a variable interest entity. FIN 46R postponed the effective date as to when companies are required to apply the provisions prospectively for all variable interest entities in existence prior to January 31, 2003 until the first financial reporting period that ends after March 15, 2004. However, for entities that are considered to be special purpose entities, the effective date of FIN 46R is financial reporting periods after December 15, 2003. The Company does not have an interest in any special purpose entities. The Company expects to consolidate its affiliate, Mobile Attic, Inc., upon adoption of FIN 46R in the first quarter 2004. The consolidation of Mobile Attic is expected to increase total assets by approximately $15 million and total liabilities by approximately $14 million. The consolidation of Mobile Attic is not expected to have a material impact on the results of operations as the Company is currently accounting for the investment under the equity method.

NOTE B - INVESTMENT IN AFFILIATE

Summarized financial information for the Company's investment in Mobile Attic, Inc., accounted for by the equity method, follows:

Dollars in thousands	2003	2002
Current assets	$ 758	$ 435
Noncurrent assets	$ 14,331	$ 7,325
Current liabilities	$ 5,306	$ 571
Noncurrent liabilities	$ 7,997	$ 5,346

Dollars in thousands	Year ended December 31,		
	2003	2002	2001
Gross revenue	$ 1,432	$ 964	$ 259
Operating expenses	$ 1,457	$ 615	$ 110
Net (loss) income	$(57)	$ 272	$ 120

NOTE C - STATUTORY ACCOUNTING PRACTICES

The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) which vary in certain respects from reporting practices prescribed or permitted by insurance regulatory authorities. The significant differences for statutory reporting include: (a) acquisition costs of acquiring new business are charged to operations as incurred, (b) life policy liabilities are established utilizing interest and mortality factors specified by regulatory authorities, (c) the Asset Valuation Reserve (AVR) and the Interest Maintenance Reserve (IMR) are recorded as liabilities, and (d) non-admitted assets (furniture and equipment, agents' debit balances and prepaid expenses) are charged directly to surplus.

Statutory net gains from operations and capital and surplus, excluding intercompany transactions, are summarized as follows:

Dollars in thousands	Year ended December 31,		
	2003	2002	2001
NSIC - including realized capital gains of $287, $356 and $652, respectively	$ 7	$ 729	$ 709
NSFC - including realized capital gains of $203, $622 and $875, respectively	$ 2,526	$ 789	$ 2,720
OMEGA - including realized capital gains of $257, $150, and $152, respectively	$ 779	$ 702	$ 1,047
Statutory Capital and Surplus:			
NSIC - including AVR of $1,180, $580, and $1,586, respectively	$ 10,195	$ 10,895	$ 11,416
NSFC	$ 23,104	$ 20,201	$ 23,572
OMEGA	$ 6,691	$ 5,656	$ 5,000

The above amounts exclude allocation of overhead from the Company. NSIC, NSFC and Omega are in compliance with statutory restrictions with regard to minimum amounts of surplus and capital.

NOTE D - INVESTMENT SECURITIES

The amortized cost and aggregate fair values of investments in securities are as follows:

Dollars in thousands	December 31, 2003			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
Corporate debt securities	$18,286	$ 1,331	$ 27	$19,590
Obligations of states and political subdivisions	13,366	506	181	13,691
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	21,648	292	206	21,734
Total fixed maturities	53,300	2,129	414	55,015
Equity securities	10,205	11,011	484	20,732
Total	$63,505	$13,140	$ 898	$75,747
Held-to-maturity securities:				
Obligations of states and political subdivisions	$ 4,635	$ 37	$ 136	$ 4,536
U.S. Treasury securities and obligations of U.S. government corporations and agencies	13,996	48	382	13,662
Total	$18,631	$ 85	$ 518	$18,198

NOTE D - INVESTMENT SECURITIES - CONTINUED

Dollars in thousands	December 31, 2002			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
Corporate debt securities	$ 21,781	$ 1,189	$ 186	$22,784
Obligations of states and political subdivisions	3,215	212	1	3,426
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	16,223	580	–	16,803
Total fixed maturities	41,219	1,981	187	43,013
Equity securities	11,091	9,272	1,682	18,681
Total	$ 52,310	$ 11,253	$ 1,869	$61,694
Held-to-maturity securities:				
Corporate debt securities	$ 8,253	$ 428	$ 38	$ 8,643
Obligations of states and political subdivisions	4,799	393	5	5,187
U.S. Treasury securities and obligations of U.S. government corporations and agencies	6,328	118	9	6,437
Total	$ 19,380	$ 939	$ 52	$20,267

The amortized cost and aggregate fair value of debt securities at December 31, 2003, by contractual maturity, are as follows. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Dollars in thousands	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	$ 1,895	$ 1,929
Due after one year through five years	16,792	17,977
Due after five years through ten years	19,533	20,008
Due after ten years	15,080	15,101
Total	$ 53,300	$ 55,015
Held-to-maturity securities:		
Due in one year or less	$ –	$ –
Due after one year through five years	1,301	1,330
Due after five years through ten years	3,614	3,484
Due after ten years	13,716	13,384
Total	$ 18,631	$ 18,198

For 2003, gross gains of $2,266,000 ($1,412,000 for 2002 and $1,785,000 for 2001) and gross losses of $858,000 ($318,000 for 2002 and $324,000 for 2001) were realized on sales of available-for-sale-securities.

During the first quarter of 2003, the Company transferred certain corporate bonds from SFAS No. 115 classification of held-to-maturity to available-for-sale. This decision was made due to circumstances considered by the Company to be both unusual and nonrecurring, which could not have been reasonably anticipated. With interest rates at four decade lows and corporate bond spreads extremely tight relative to U.S. Treasury securities, the Company intends to sell certain (primarily corporate) bonds which were previously held in the SFAS 115 classification of held-to-maturity. The proceeds of these bonds will be reinvested primarily in agency securities and in the process raise the overall credit quality of the portfolio. The net carrying amount of the securities transferred was $9,833,000 and unrealized gains (net of tax) on these securities totaled $467,000 at the transfer date.

The gross realized investment losses and related fair value for securities available for sale at December 31, 2003 were as follows:

Dollars in thousands	Less than 12 months		12 months or longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Fixed maturities						
Corporate	$ 543	$ 14	$ 751	$ 13	$ 1,294	$ 27
Obligations of state and political subdivisions	2,755	121	69	3	2,824	124
U.S. Treasury securities and obligations of U.S. Goverment corporations and agencies	11,301	264	498	–	11,799	251
Equity securities	363	15	1,848	468	2,211	483
	$14,962	$ 414	$ 3,166	$ 484	$18,128	$ 885

NOTE D - INVESTMENT SECURITIES - CONTINUED

All unrealized losses are reviewed to determine whether the losses are other than temporary. Factors considered include whether the securities are backed by the U.S. Government or its agencies and concerns surrounding the recovery of full principle. Management believes the unrealized losses are market driven and no ultimate loss will occur.

NOTE E - NET INVESTMENT INCOME

Major categories of investment income are summarized as follows:

Dollars in thousands	Year ended December 31, 2003	2002	2001
Fixed maturities	$ 3,618	$ 3,722	$ 3,819
Equity securities	528	539	544
Mortgage loans on real estate	19	25	16
Investment real estate	160	24	138
Policy loans	32	37	35
Other, principally short-term investments	41	108	88
	4,398	4,455	4,640
Less: Investment expenses	(261)	(220)	(134)
Net investment income	$ 4,137	$ 4,235	$ 4,506

An analysis of investment gains follows:

Dollars in thousands	Year ended December 31, 2003	2002	2001
Net realized investment gains (losses):			
Fixed maturities	$ 627	$(6)	$ 149
Other, principally equity securities	789	1,174	1,491
	$ 1,416	$ 1,168	$ 1,640

An analysis of the net increase (decrease) in unrealized appreciation on available-for-sale securities follows:

Dollars in thousands	Year ended December 31, 2003	2002	2001
Net increase (decrease) in unrealized appreciation on available-for-sale securities before deferred income tax	$ 2,520	$(2,495)	$(1,366)
Deferred income tax	(862)	848	205
Net decrease in unrealized appreciation on available-for-sale securities	$ 1,658	$(1,647)	$(1,161)

NOTE F - PROPERTY AND EQUIPMENT

At December 31, property and equipment consisted of the following:

Dollars in thousands	2003	2002
Building and Improvements	$ 1,660	$ 1,358
Electronic data processing equipment	2,223	1,748
Furniture and fixtures	838	749
	4,721	3,855
Less accumulated depreciation	2,491	2,057
	$ 2,230	$ 1,798

Depreciation expense for the year ended December 31, 2003 was $419,000 ($206,000 for the year ended December 31, 2002 and $197,000 for the year ended December 31, 2001).

NOTE G - INCOME TAXES

Total income tax expense varies from amounts computed by applying current federal income tax rates to income before income taxes. The reason for these differences and the approximate tax effects are as follows:

Dollars in thousands	Year ended December 31, 2003	2002	2001
Federal income tax rate applied to pre-tax income	$ 1,927	$ 406	$ 1,860
Dividends received deduction and tax-exempt interest	(176)	(184)	(182)
Small life insurance company deduction	(18)	(230)	(122)
Other, net	(183)	430	(164)
Federal income tax expense	$ 1,550	$ 422	$ 1,392

NOTE G - INCOME TAXES - CONTINUED

Net deferred tax liabilities are determined based on the estimated future tax effects of differences between the financial statement and tax basis of assets and liabilities given the provisions of the enacted tax laws.

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

Dollars in thousands	December 31, 2003	December 31, 2002
Deferred policy acquisition costs	$(1,978)	$(1,782)
Policy liabilities	209	279
Unearned premiums	908	645
Claim liabilities	279	309
General insurance expenses	1,107	799
Unrealized gains on securities available-for-sale	(3,613)	(2,751)
Net deferred tax liabilities	$(3,088)	$(2,501)

The appropriate income tax effects of changes in temporary differences are as follows:

Dollars in thousands	Year ended December 31, 2003	2002	2001
Deferred policy acquisition costs	$ 196	$ 213	$ 49
Policy liabilities	70	70	70
Unearned premiums	(263)	(181)	(81)
General insurance expenses	(306)	(42)	(62)
Alternative minimum tax credit carryforwards	–	45	243
Claim liabilities	30	1	122
	$(273)	$ 106	$ 341

Under pre-1984 life insurance company tax laws, a portion of NSIC's gain from operations was not subject to current income taxation, but was accumulated for tax purposes in a memorandum account designated "policyholders' surplus". The aggregate balance in this account, $3,720,000 at December 31, 2003, would be taxed at current rates only if distributed to shareholders or if the account exceeded a prescribed minimum. The Deficit Reduction Act of 1984 eliminated additions to policyholders' surplus for 1984 and thereafter. Deferred taxes have not been provided on amounts designated as policyholders' surplus. The deferred income tax liability not recognized is approximately $1,270,000 at December 31, 2003.

NOTE H - LONG-TERM DEBT

Long-term debt consisted of the following as of December 31:

Dollars in thousands	2003	2002
Note payable to bank with an interest rate based on LIBOR (3.87% at December 31, 2003 and 4.18% at December 31, 2002) dated March, 2002; maturity March, 2007. Payments due quarterly with balloon payment at maturity. Unsecured	$ 3,059	$ 3,380

Aggregate maturities of long-term debt for each of the four years subsequent to December 31, 2003 are as follows: 2004-$339,000; 2005-$351,000; 2006-$365,000; 2007-$2,004,000.

NOTE I - POLICY AND CLAIM RESERVES

At December 31, policy and claim reserves consisted of the following:

Dollars in thousands	2003	2002
Benefit and loss reserves		
Property and casualty	$ 11,343	$ 11,513
Accident and Health	411	352
Life and Annuity	23,331	22,858
Unearned premiums	13,750	9,827
Policy and contract claims	476	504
	$ 49,311	$ 45,054

NOTE I - POLICY AND CLAIM RESERVES - CONTINUED

The following table is a reconciliation of beginning and ending property and casualty reserve balances for claims and claim adjustment expense for the years ended December 31:

Dollars in thousands	2003	2002	2001
Claims and claim adjustment expense reserves at beginning of year	$ 11,513	$ 11,489	$ 15,409
Less reinsurance recoverables on unpaid losses	1,555	2,396	3,092
Net balances at beginning of year	9,958	9,093	12,317
Provisions for claims and claim adjustment expenses for claims arising in current year	27,066	22,111	14,045
Estimated claims and claim adjustment expenses for claims arising in prior years	(1,928)	(1,547)	(3,089)
Total increases	25,138	20,564	10,956
Claims and claim adjustment expense payments for claims arising in:			
Current year	19,892	15,594	9,891
Prior years	5,093	4,105	4,289
Total payments	24,985	19,699	14,180
Net balance at end of year	10,111	9,958	9,093
Plus reinsurance recoverables on unpaid losses	1,232	1,555	2,396
Claims and claim adjustment expense reserves at end of year	$ 11,343	$ 11,513	$ 11,489

As a result of changes in estimates of insured events in prior years, the provision for claims and claim adjustment expenses (net of reinsurance recoveries) decreased in 2003, 2002 and 2001 because of lower-than-anticipated losses in commercial and private passenger automobile lines of business.

The Company has a geographic exposure to catastrophe losses in certain areas of the country. Catastrophes can be caused by various events including hurricanes, windstorms, earthquakes, hail, severe winter weather, explosions and fires, and the incidence and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Most catastrophe losses are restricted to small geographic areas; however, hurricanes and earthquakes may produce significant damage in large, heavily populated areas. The Company generally seeks to reduce its exposure to catastrophes through individual risk selection and the purchase of catastrophe reinsurance.

NOTE J - REINSURANCE

The Company's insurance operations participate in reinsurance in order to limit losses, minimize exposure to large risks, provide additional capacity for future growth and effect business-sharing arrangements. Life reinsurance is accomplished through yearly renewable term. Property and casualty reinsurance is placed on both a quota-share and excess of loss basis. Reinsurance ceded arrangements do not discharge the insurance subsidiaries as the primary insurer, except for cases involving a novation. Failure of reinsurers to honor their obligations could result in losses to the insurance subsidiaries. The insurance subsidiaries evaluate the financial conditions of their reinsurers and monitor concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize their exposure to significant losses from reinsurance insolvencies. At December 31, 2003, reinsurance receivables with a carrying value of $765,000 ($220,000 at December 31, 2002) and prepaid reinsurance premiums of $496,000 ($343,000 at December 31, 2002) were associated with a single reinsurer. The amounts of recoveries pertaining to reinsurance contracts that were deducted from losses incurred during 2003, 2002 and 2001 were approximately $580,000, $374,000, and $989,000, respectively.

The effect of reinsurance on premiums written and earned was as follows:

Dollars in thousands	2003			
	Life		Property & Casualty	
	Written	Earned	Written	Earned
Direct	$ 5,719	$ 5,843	$45,507	$44,666
Assumed	–	–	500	500
Ceded	(44)	(44)	(3,276)	(3,429)
Net	$ 5,675	$ 5,799	$42,731	$ 41,737

Dollars in thousands	2002			
	Life		Property & Casualty	
	Written	Earned	Written	Earned
Direct	$ 5,526	$ 5,441	$31,959	$29,350
Assumed	–	–	–	–
Ceded	(45)	(45)	(2,063)	(2,115)
Net	$ 5,481	$ 5,396	$29,896	$27,235

NOTE J - REINSURANCE - CONTINUED

Dollars in thousands	2001			
	Life		Property & Casualty	
	Written	Earned	Written	Earned
Direct	$ 5,047	$ 5,206	$ 22,528	$ 21,777
Assumed	–	–	–	–
Ceded	(45)	(45)	(1,579)	(1,581)
Net	$ 5,002	$ 5,161	$ 20,949	$ 20,196

NOTE K - EMPLOYEE BENEFIT PLAN

In 1989, the Company and its subsidiaries established a retirement savings plan and transferred the assets from the defined contribution profit sharing plan into the new plan. All full-time employees who have completed one year of service at January 1 or July 1 are eligible to participate and all employee contributions are fully vested for employees who have completed 1,000 hours of service in the year of contribution. Contributions for 2003, 2002, and 2001 amounted to $228,000, $177,000, and $130,000, respectively. Contributions are at the Board of Directors' discretion subject to governmental limitations.

In 1987, the Company established a deferred compensation plan for its Board of Directors. The Board members have an option of deferring their fees to a cash account or to a stock account and all share deferrals are recorded at the fair market value on the date of the award. Costs of the deferred compensation plan for 2003, 2002, and 2001 amounted to approximately $421,000, $19,000, and $35,000, respectively.

NOTE L - REGULATORY REQUIREMENTS AND DIVIDEND RESTRICTIONS

The amount of dividends paid from NSIC to the Company in any year may not exceed, without prior approval of regulatory authorities, the greater of 10% of statutory surplus as of the end of the preceding year, or the statutory net gain from operations for the preceding year. At December 31, 2003, NSIC's retained earnings unrestricted for the payment of dividends in 2004 amounted to $1,019,000. Under applicable Alabama insurance laws and regulations, NSIC is required to maintain a minimum total surplus (to include both paid-in and contributed and unassigned surplus) of $200,000.

NSFC is similarly restricted in the amount of dividends payable to the Company; dividends may not exceed the greater of 10% of statutory surplus as of the end of the preceding year, or net income for the preceding year. As a result, dividends from NSFC to the Company are limited to $2,526,000 in 2004. Under applicable Alabama insurance laws and regulations, NSFC is required to maintain a minimum total surplus (to include both paid-in and contributed and unassigned surplus) of $100,000.

Under applicable Alabama insurance laws and regulations, Omega is required to maintain a minimum total surplus (to include both paid-in and contributed and unassigned surplus) of $600,000.

At December 31, 2003, securities with market values of $3,606,000 ($3,564,000 at December 31, 2002) were deposited with various states pursuant to statutory requirements.

NOTE M - SHAREHOLDERS' EQUITY

Preferred Stock

The Preferred Stock may be issued in one or more series as shall from time to time be determined and authorized by the Board of Directors. The directors may make specific provisions regarding (a) the voting rights, if any (b) whether such dividends are to be cumulative or noncumulative (c) the redemption provisions, if any (d) participating rights, if any (e) any sinking fund or other retirement provisions (f) dividend rates (g) the number of shares of such series and (h) liquidation preference.

Common Stock

The holders of the Class A Common Stock will have one-twentieth of one vote per share, and the holders of the common stock will have one vote per share.

In the event of any liquidation, dissolution or distribution of the assets of the Company remaining after the payments to the holders of the Preferred Stock of the full preferential amounts to which they may be entitled as provided in the resolution or resolutions creating any series thereof, the remaining assets of the Company shall be divided and distributed among the holders of both classes of common stock, except as may otherwise be provided in any such resolution or resolutions.

NOTE N - INDUSTRY SEGMENTS

The Company and its subsidiaries operate primarily in the insurance industry. Premium revenues and operating income by industry segment for the years ended December 31, 2003, 2002 and 2001 are summarized below:

Dollars in thousands	2003	2002	2001
Premium revenues:			
Individual life and accident and health insurance	$ 5,799	$ 5,395	$ 5,161
Property and casualty insurance	41,737	27,236	20,196
	$ 47,536	$ 32,631	$ 25,357
Income (loss) before income taxes:			
Individual life and accident and health insurance	$ 563	$ 1,118	$ 586
Property and casualty insurance	5,720	518	5,440
Other	(411)	(196)	(313)
	5,872	1,440	5,713
Interest expense	(203)	(246)	(243)
	$ 5,669	$ 1,194	$ 5,470
Assets:			
Individual life and accident and health insurance	$ 45,796	$ 44,719	$ 44,513
Property and casualty insurance	66,906	54,186	54,962
Other	2,100	2,697	509
	$114,802	$101,602	$ 99,984
Amortization of deferred policy acquisition costs and depreciation expense:			
Individual life and accident and health insurance	$ 98	$ 98	$ 549
Property and casualty insurance	1,727	1,308	1,229
	$ 1,825	$ 1,406	$ 1,778

Capital expenditures during the year ended December 31, 2003, were $645,000 for the individual life and accident and health insurance segment, $118,000 for the property and casualty insurance segment and $88,000 for other segments.

NOTE O - CONTINGENCIES

Financial Guarantee

At December 31, 2003, the Company guaranteed the $13 million lines of credit of its affiliate, Mobile Attic, Inc. The Company is paid a guaranty fee based on the average balance of the line of credit. In 2003, the Company received $114,000 ($15,000 in 2002) in guaranty fees. The guaranties expire in April, 2004 and May, 2006. Credit risk represents the accounting loss that would be recognized at the reporting date if Mobile Attic, Inc. failed to perform completely as contracted. The credit risk of $13 million assumes that no amounts could be recovered from other parties. The book value of the mobile storage units, which serves as collateral on the lines of credit, was $14,175,000 at December 31, 2003.

Litigation

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

NSFC was named a defendant in a Washington County, Alabama action alleging fraud and bad faith in connection with a claim for wind damage to a mobile home. This action was settled in January, 2004 under terms which required that the amount be kept confidential. The amount of this settlement has been reflected in the financial statements for the period ending December 31, 2003.

In two separate actions, NSIC is named as a defendant in purported class actions relating to the past sale of industrial burial insurance. The actions address whether the premiums charged were "excessive" relative to the benefit provided and whether the premiums charged were in any manner discriminatory relative to the race of the person insured. In addition, several individual actions on behalf of specifically named persons have been filed with similar allegations. No class has been certified in either of the purported class actions although a Motion for Class Certification has been filed in one of the actions. While NSIC did at one time sell industrial burial insurance, no such plans have been sold for several decades.

The Company establishes and maintains reserves on contingent liabilities. In many instances, however, it is not feasible to predict the ultimate outcome with any degree of accuracy. While a resolution of these matters may significantly impact consolidated earnings and the Company's consolidated financial position, it remains management's opinion, based on information presently available, that the ultimate resolution of these matters will not have a material impact on the Company's consolidated financial position. However, it should be noted that instances of class action lawsuits against insurance companies appear to be increasing in several states in which insurance subsidiaries of the company operate.

NOTE P - SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during 2003 was $204,000 ($261,000 in 2002 and $241,000 in 2001). Cash paid for income taxes in 2003 was $400,000 ($76,000 in 2002 and $800,000 in 2001). In 2002, noncash investing activity consisted of the conversion of a $725,000 note receivable to an equity investment.

NOTE Q - RELATED PARTY TRANSACTIONS

At December 31, notes receivable from affiliate consisted of the following:

Dollars in thousands	2003	2002
5.25% short term note dated December 18, 2002; maturity February, 2003. Principle and interest due February, 2003, secured by portable storage units	$ –	$ 350
6.25% term note dated October 1, 2002; maturity October, 2007. Payments of $16,116 due quarterly, secured by portable storage units	$ –	$ 275
	$ –	$ 625

During 2003, the company advanced a total of $3,074,000 to its affiliate, Mobile Attic, Inc., under various short-term notes payable. All advances were fully repaid in 2003. The company received $25,000 in interest on the advances.

During 2002, the balance on the convertible line of credit was increased to $1 million and, under the terms of the line of credit, $725,000 of the balance was converted to common equity of the affiliate. The remaining $275,000 was converted to the long-term note described above.

To the Board of Directors
and Shareholders of
The National Security Group, Inc.
Elba, Alabama

We have audited the accompanying consolidated balance sheets of The National Security Group, Inc. and subsidiaries as of December 31, 2003 and 2002, and the related consolidated statements of income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of The National Security Group, Inc. and subsidiaries as of December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

BARFIELD, MURPHY, SHANK & SMITH, P.C.

Birmingham, Alabama
February 26, 2004

Board of Directors

Winfield Baird
Chairman of the Board
The National Security Group, Inc.
Financial Advisor
UBS Paine Webber
Birmingham, Alabama

William L. Brunson, Jr.
President & Chief Executive Officer
The National Security Group, Inc.
Elba, Alabama

Jack E. Brunson
President
National Security Fire and
Casualty Company
Elba, Alabama

Mickey Murdock, CPA
Chief Operating Officer and
Senior Vice President
The National Security Group, Inc.
Elba, Alabama

J. R. Brunson
Retired President & Chief Executive Officer
The National Security Group, Inc.
Elba, Alabama

Carolyn E. Brunson
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The Mitchell Company
Mobile, Alabama

L. Brunson White
Vice President & Chief Information Officer
Energen Corporation
Birmingham, Alabama

Donald S. Pittman
Attorney at Law
Enterprise, Alabama

Corporate Information

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334-897-2273

Annual Shareholders Meeting:

April 15, 2004
Executive Offices
Elba, Alabama

Auditors:

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Birmingham, Alabama 35244

Actuaries:

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Wakely Actuarial
33 North Garden Avenue
Suite 1100
Clearwater, Florida 33755-6606

Fire Company-
Milliman & Robertson, Inc.
650 California Street, 17th Floor
San Francisco, CA 94108

The Common Stock of the Company trades on the NASDAQ Stock Market^{SM} under the symbol NSEC. Quotations are furnished by the National Association of Security Dealers Automated Quotations System (NASDAQ) and appear in the Wall Street Journal and other financial publications.

Trade Symbol:

NSEC

Transfer Agent:

The National Security Group, Inc.
661 East Davis Street
Elba, Alabama 36323

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