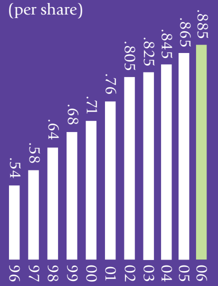
We insure your world.

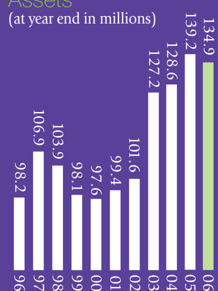
The National Security Group, Inc. 2006 Annual Report

Contents

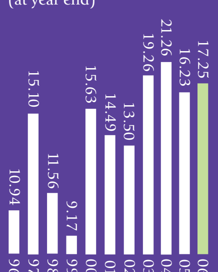
Dividends
(per share)



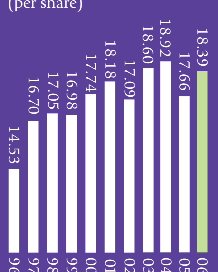
Assets
(at year end in millions)



Market Price
(at year end)



Book Value
(per share)



Our world has changed in a myriad of ways since our humble boardinghouse beginnings in 1947. Generations of a family business philosophy built on individualized customer service and aggressive growth strategies have brought us through 60 years of ups and downs in the community and in the insurance industry. Although our corporate image is updated, our methods more advanced and some of the faces are new, our keen attention to individual needs has remained the same. Families still need life insurance to continue their current standard of living after the death of a loved one. Homeowners still need to rebuild after a natural disaster, and drivers still need dependable coverage for the occasional fender bender. We are The National Security Group, an employee-driven team of insurance professionals, committed to protecting your family and your future from financial disaster. We insure your world, and in this report a few of us will introduce ourselves, put a face on our company and hopefully become more than just a voice on the other end of the phone or name at the other end of an email.

Willene Powell

Brandon Richards

Debbie Stockwell

Lucinda Carpenter

Highlights

(In thousands except per share data)

For the Year	2006	2005	Percent of Change
Earnings Per Share	1.72	.63	173.0%
Earnings	4,250	1,558	172.8%
Net Premium Income	58,874	53,563	9.9%
Net Investment Income	4,463	3,964	12.6%
Return on Average Equity	9.56%	3.50%	173.1%
Average Shares Outstanding	2,467	2,467	
At Year End			
Shareholders' Equity Per Share	18.39	17.66	4.1%
Shareholders' Equity	45,379	43,556	4.2%
Total Assets	134,911	139,226	(3.1)%
Shares Outstanding	2,467	2,467	

	Stock Bid Prices High	Stock Bid Prices Low	Dividends Per Share
2006			
First Quarter	18.25	15.70	.220
Second Quarter	18.11	15.77	.220
Third Quarter	17.90	15.40	.220
Fourth Quarter	17.47	15.64	.225
2005			
First Quarter	23.91	18.23	.215
Second Quarter	24.29	20.65	.215
Third Quarter	22.25	18.10	.215
Fourth Quarter	19.03	15.05	.220

Dana Howell *Noralyn Dawson* *Glenda Adkinson* *Philip Christ* *Brenda McDurmont*

The year began with a fresh face lift for the company's traditional symbol of protection, the shield logo. Our new image does not abandon that symbol, but enhances it to represent a more progressive organization. The new logo maintains our recognizable symbol of protection and strength, while updating the shield to a more contemporary look that better represents an organization committed to recruiting quality employees that can help us maintain our edge in delivering quality insurance products to the markets we serve. We began as an employee driven business committed to serving our customers and continue today with the philosophy that the best service we can provide our customers is personalized service, whether it is a handshake in the field or a friendly voice on the other end of the phone.

The National Security Group
Insuring your world.

Our employees are also our customers and recognize that as time goes on, needs of families change. Once again, operating on the philosophy of delivering personalized service, we are committed to updating our insurance products to meet the needs of those we serve throughout life's changes. You'll find that our insurance products are designed to protect you at home, work, and play and even on the way. Our policyholders trust us to deliver insurance protection for life, home, auto and health. Our delivery methods are focused on customer convenience made available through hometown independent agents, people you know and trust.

Throughout our history our primary focus has remained on delivering quality insurance products to underserved markets. At no other time in our history has this become more apparent and challenging than in recent years with the catastrophic events that have unfolded in the Gulf Coast region of the Southeastern United States, our home for 60 years. In spite of these terrible and unprecedented events, we remain

No company can be successful without the long term commitment of dedicated employees. Bette Ham (far left) and Pat Lindsey (near left) have taken their commitment to what some may describe as extreme. Both can boast that National Security is the only job they've ever known. Bette has been with us since 1948. She retired from full time employment in 1994, but retains a part-time position as secretary to the Board of Directors. As company matriarch, Bette simply sums up her astounding 50+ year career as follows: "I got up each work day for many years looking forward to getting to work! It's been great to work for a company with a management staff that has always been possessed with genuine ethics". Pat often comments that she finished high school on Friday and started with National Security on the following Monday. She's been with us ever since for 47 years holding many positions of increasing responsibility, most recently as Supervisor of the life claims department. Pat remarks that the highlight of her career is "having the privilege to work for a growing company with a great group of people". Pat, the privilege is ours. The National Security Group could not be where it is today without the dedication of employees like Bette and Pat.

committed to continuing to deliver viable insurance products in our own backyard.

In the world of insurance, we realize that we are a small player. However, we believe that our size offers distinct advantages and allows us to be more agile in reacting to changing market conditions and allows more flexibility in tailoring products to meet the needs of our customers. We also realize that in order to maintain our long-term commitments to our customers and continue to attract the best employees to our organization, we must continue to grow. Since entering the new millennium our total assets have grown to exceed $100 million, currently standing just under $135 million. Also, our premium revenues have grown to record levels in each of the last five years to nearly $59 million currently, a 17% compound rate of growth since 2000. We could not have accomplished these milestones without our employees' commitment to delivering quality service to our policyholders and building an organization dedicated to delivering quality service to our agents and policyholders.

Since 2000, premium revenues have averaged a 17% compound rate of growth.

Celebrating the steady success of the new millennium and preparing for tomorrow's challenges, our policyholders, agents and employees have weathered many storms. In order for us to continue to provide the service and protection our policyholders need, we will continue to prepare for the storms to come. We are not just a family of insurance companies, we are a family and we have a deep appreciation for those who have helped us not only survive, but prosper over the past 60 years.

We realize that our organization is only as good as our people; therefore we have developed a number of employee and agent incentive programs designed to encourage

The National Security Group is committed to employee education and professional development. Through education reimbursement and internship programs, we are able to develop the next generation of leaders in our organization. A few of the past and present participants in our education related programs are pictured (from left) Charlie Carter, Peggy Vaughan, Lisa Macon, Kelly Jackson and Justin Maddox. These employees have taken advantage of the education related opportunities to build and enhance careers, build self confidence, serve as role models to others and, in some cases, pursue delayed dreams of obtaining a college education. While the personal reasons for participation in our education related programs are varied, the benefit to our Company is immeasurable as we continue to build upon the success brought to us by our most valuable asset, our employees.

and reward superior service to our customers while also insuring that our success is perpetuated for many years to come. Among those incentives we offer, we put great emphasis on employee education, both traditional and industry specific. We believe that an employee committed to a lifetime of self improvement will provide immeasurable benefits to our future success and also increase the satisfaction level of our employees. Therefore, we promote employee education throughout our organization. All of our employees participate in some form of self improvement each year, either through in-house industry specific training, pursuit of industry recognized professional designations or participation in our tuition reimbursement program made available to those that wish to pursue a traditional college education while maintaining full time employment.

After two years of development, we launched our interactive agent website.

Our commitment to encouraging employee self improvement also allows us to reap the benefits of the knowledge gained. One of our most recent benefits to our commitment to education and innovation is a new product delivery platform launched in our property and casualty operations. In 2006, we launched ARiS, our new interactive agent website which has received a warm welcome among our community of independent agents. The website will offer yet another customer service improvement by allowing agents to deliver insurance policies to our customers more rapidly and streamline the underwriting process allowing us to better manage our risk. This award winning technology was developed to meet four key requirements. It had to be Agile, Reliable, Intelligent and Scalable, hence the project code name, ARiS. ARiS enables property and casualty agents to quickly and accurately perform their most common tasks. Accurate automated quotes can be delivered to policyholders in just minutes. Agents can also improve the service to their policyholders by delivering

William Stuart, shown at left with ARiS team member LaMargaret McArthur is the IT Manager for the property and casualty subsidiaries. Two years ago, they were members of a team charged with the responsibility of investigating, designing, and implementing a new policy administration system that would become ARiS. William provided the overall architecture and design of the system and serves as the IT project manager. LaMargaret served as an IT/business user liaison on the project. The core team also included team members (opposite page from left) Lisa Armstead, Ashley Nelson, and Tim Wilson. The new administration system and website were launched in 2006 and debuted in Tennessee. Additional states are slated to come online throughout 2007. The best explanation of what exactly ARiS is and is capable of was summed up in the A.M. Best presentation at the 2006 E-fusion Award finalist presentations. "National Security created an end-to-end enterprise policy administration system featuring complete web access for agents. Agents can obtain policies immediately and creating endorsements and processing customer payments in real time. This technology was designed to provide another avenue to improve service to our customers, but of course we remain just a phone call away.

Because of our new website's resourceful uses of technology as applied to business strategy in the insurance industry, ARiS was selected as a finalist for the 2006 E-Fusion Awards hosted by A.M. Best, the oldest insurance rating organization in the country. ARiS is one of many examples of our commitment to making insurance easier to buy, easier to use, and easier to sell. Committed to our community and yours, The National Security Group strives to be a good corporate neighbor by participating in the development of the local economy. Our commitment to economic development spans from providing quality rewarding careers to our employees, to providing quality insurance products to our independent agents in eleven states, to direct investment in other businesses that provide jobs to the areas we serve.

We strive to be a good corporate neighbor by participating in the development of the local economy.

We began just after World War II in a rural area of South Alabama, and our roots remain deep here. However, our core commitment continues to be insuring your world. Thanks, to over 1500 independent agents who have helped us continue to grow over our long history. Thanks to the staff at our corporate headquarters, who have always responded promptly when called upon in the best of times and worst of times. Thanks to our shareholders and their families, many of whom have been with us from our humble beginnings. And most importantly, thanks to our customers who have placed their confidence in us to provide protection in times of needs. We look forward to celebrating, in 2007, 60 years of personal service and community growth.

quotes, issue policies, endorse existing policies, valuate risks and even print out applications and declaration pages while the insured is still in the office! An automated expert underwriting system was created that immediately shows red flags, cautionary items, and items that require submission. The system also uses third party integration services that provide protection class lookup, accurate property valuations, instant credit reports and analysis and address verification. Additional features include online payments, agency sweep and online view of accounts, online photo uploads and much more." The successful launch of this innovative system would not have been possible without the dedicated efforts of the team members shown here and the many others involved in this extensive project.

Shareholders

Positive earnings, the 3rd best in Company history, continued premium growth, and resolution of a long standing legal matter were some of the highlights of 2006. The year was also a time for regrouping after back-to-back years with significant hurricane losses. Hurricanes Katrina in 2005 and Ivan in 2004 were, respectively, the largest and second largest catastrophic events the Company has experienced.

Our earnings are the third best in the Company's history.

Consolidated earnings in 2006 were $4.25 million or $1.72 per share versus $1.56 million or $0.63 per share in 2005. While below our targeted level, earnings for the year 2006 constitute the highest reported earnings since 1987. A significant non-recurring item, which negatively impacted earnings, were charges associated with the settlement of a class action relating to our past sales of certain industrial life insurance business, primarily in the 1950's and 1960's. This settlement negatively impacted 2006 earnings by $ 0.41 per share. Additionally, while we were (fortunately) not directly impacted by hurricanes in 2006, the year was not free of catastrophes, as we experienced significant tornado activity in the Spring. April tornado losses were in excess of $1.3 million, negatively impacting earnings by $0.41 per share. And while hurricanes did not have a direct impact on 2006 results, an indirect impact was clearly felt as we were faced with a significant increase in the cost of our catastrophe reinsurance coverage.

Stockholders equity modestly increased 4.2% from $43.6 million to $45.4 million, resulting in a book value per share of $18.39 as of December 31, 2006. 2006 represented the 31st consecutive year in which the Company paid cash dividends, which currently stand at an annual rate of $0.90 per share. Our cash dividend has now been increased on an annual basis for 29 consecutive years.

Core line premium growth remains of major importance. On a consolidated basis, premium revenues were increased $5.3 million or 10%. It remains our belief that growth must be generated in the lines which we know best and have the most expertise and experience. Our focus remains on further developing our core lines, primarily traditional life insurance and personal lines property insurance, supplemented by automobile insurance and health and accident insurance. Since the year 2000, average annual premium growth has averaged 17%. While growth remains an operating objective, our experience has shown that older, more seasoned books of business perform better, and we are satisfied with continuing with modest growth in our writings.

We continued with a number of technology initiatives during the year, the major project being the introduction of a new web-based policy administration system in our property and casualty companies. The project, which we refer to as ARiS, was developed in-house and is an end-to-end policy administration system featuring complete web access for agents. Agents can retrieve quotes, create policies, endorse existing policies, valuate risks, and print applications and declarations while the customer is still in the office. An automated underwriting system immediately shows cautionary items or items that require submission. This project was introduced initially in Tennessee, and is being expanded into other states over the coming months. We believe this system will greatly improve our operating efficiencies as well as enabling our agents to provide better service to policyholders.

We are not planning 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 offerings of specialty products through groups and associations.

We are fortunate to be part of an organization with loyal dedicated employees (several of whom are featured in this Report) and with interested and supportive shareholders. We are committed to achieving our goals of superior growth and profitability in the years to come and to continue as a growing, profitable company that addresses our responsibilities to shareholders, policyholders, agents and employees. Thank you for your interest and support.

William L. Brunson, Jr.
President and CEO

We are fortunate to be a part of an organization with loyal dedicated employees.

The Executive Management Team for The National Security Group, Inc., is page left; William L. Brunson, President and Chief Executive Officer, The National Security Group, Inc. This page from left: Brian McLeod, Chief Financial Officer and Treasurer, The National Security Group, Inc., Jack E. Brunson, President, National Security Fire and Casualty, and Mickey L. Murdock, Chief Operating Officer and Senior Vice President, The National Security Group, Inc.

Eleven Year Financial Review

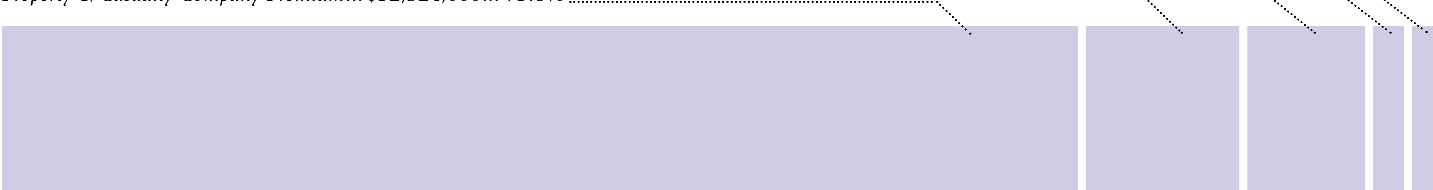
(Dollars in thousands-except per share figures)

Per share figures for 2000 and prior years are restated for a 20% stock dividend issued in 2001.

	2006	2005	2004	2003	2002	2001	2000	1999
Earnings Per Share	**1.72**	0.63	1.26	1.66	0.37	1.67	1.53	1.52
Book Value Per Share	**18.39**	17.66	18.92	18.60	17.09	18.18	17.74	16.98
Total Shareholders' Equity	**45,379**	43,556	46,676	45,872	42,159	44,884	43,780	41,888
Assets	**134,911**	139,226	128,631	127,236	101,602	99,484	97,563	98,105
Earnings	**4,250**	1,558	3,113	4,090	908	4,130	3,776	3,756
Investment Income	**4,463**	3,964	4,230	4,023	4,235	4,506	4,434	4,354
Return on Average Equity (Percent)	**9.6**	3.5	6.7	9.3	2.1	9.3	8.8	8.9
Premium Revenues	**58,874**	53,563	52,985	47,536	32,631	25,357	22,921	25,936
Shares Outstanding (Year-end)	**2,467**	2,467	2,467	2,467	2,467	2,467	2,056	2,056
Combined Ratio-Property & Casualty Companies								
Loss	**63.46**	74.41	68.24	60.0	75.5	54.3	61.7	70.9
Expense	**32.21**	32.21	31.36	30.8	31.9	36.1	34.8	35.8
Combined	**95.67**	106.62	99.60	90.8	107.4	90.4	96.5	106.7
Common Stock Data								
Dividends Paid Per Share	0.885	0.865	.845	.825	0.805	0.76	0.71	0.68
Price at Year End	**17.25**	16.23	21.26	19.26	13.5	14.49	15.63	9.17
Price Range	18.25-15.40	24.29-15.05	26.00-19.03	20.50-11.95	16.00-13.00	15.63-10.21	16.04-9.17	12.50-7.71
P&C Co. Premiums/Surplus Ratio	**1.5**	1.4	1.5	1.5	1.2	0.7	0.6	0.8
Life Co. Insurance in Force (Millions)	**217**	203	178	179	176	176	151	141
BEST's Rating								
P&C Company	**B++**	B++	B++	B++	B++	B++	B++	B++
Life Company	**B**	B	B	B	B	B	B	B
Debt (Thousands)	**20,859**	22,906	15,836	10,921	3,380	2,108	2,401	2,672

Sources of Revenue

Leasing Revenues ..... $1,887,000..... 2.7%
Net Realized Investment Gains ..... $2,615,000..... 3.8%
Investment and Other Income ..... $5,674,000..... 8.2%
Life Company Premium ..... $6,550,000..... 9.5%
Property & Casualty Company Premium... $52,324,000... 75.8%



1998	1997	1996
0.35	1.07	0.48
17.05	16.70	14.53
41,968	46,352	40,519
103,973	106,958	98,219
930	2,998	1,356
4,351	4,204	3,935
2.1	6.9	3.4
28,451	31,156	26,654
2,051	2,313	2,320
87.0	79.3	79.8
40.3	31.0	30.9
127.3	110.3	110.7
0.64	0.58	0.54
11.56	15.10	10.94
17.71-8.75	20.00-10.63	11.88-9.69
0.9	0.9	0.8
132	132	138
B++	A-	A-
B	B	B
3,004	133	182

Financial Results on a Quarterly Basis

(In thousands except per share figures)

	Premium Revenues	Leasing Revenues	Investment & Other Income	Realized Investment Gains	Benefits	Net (Loss) Income	Net (Loss) Income Per Share
2006							
1st QTR	$14,491	$ 453	$1,492	$ 609	$10,680	$(141)	$(0.06)
2nd QTR	14,755	472	1,347	540	9,566	970	0.39
3rd QTR	15,297	406	1,452	770	9,026	1,836	0.74
4th QTR	14,331	556	1,383	696	8,724	1,585	0.65
Total	$58,874	$1,887	$5,674	$2,615	$37,996	$4,250	$ 1.72
2005							
1st QTR	$ 13,664	$ 602	$1,451	$ 198	$ 8,113	$ 1,292	$ 0.52
2nd QTR	13,696	988	1,560	683	8,496	1,346	0.55
3rd QTR	11,969	700	1,273	1,394	15,161	(3,896)	(1.58)
4th QTR	14,234	1,070	1,096	1,452	6,471	2,816	1.14
Total	$53,563	$3,360	$5,380	$3,727	$38,241	$1,558	$ 0.63

Gladys Hataway *Beverly McDaniel* *Judy Medley* *Andy Davis* *Deloris Marsh*

Consolidated Statements of Income

Dollars in thousands except per share amounts	Year ended December 31,		
	2006	2005	2004
Revenues			
Net premiums earned	**$ 58,874**	$ 53,563	$ 52,985
Net investment income	**4,463**	3,964	4,230
Net realized investment gains	**2,615**	3,727	2,162
Net revenues from leasing operations	**1,887**	3,360	2,459
Other income	**1,211**	1,416	1,312
	69,050	66,030	63,148
Benefits and Expenses			
Policyholder benefits paid or provided	**37,996**	38,241	35,067
Amortization of deferred policy acquisition costs	**1,978**	2,704	2,221
Commissions	**8,921**	8,987	8,646
General insurance expenses	**9,141**	7,911	8,608
Expenses from leasing operations	**1,829**	2,404	2,008
Insurance taxes, licenses and fees	**1,729**	2,243	2,018
Interest expense	**1,837**	1,140	727
	63,431	63,630	59,295
Income Before Income Taxes and Minority Interest	**5,619**	2,400	3,853
Income Tax Expense (Benefit)			
Current	1,907	531	482
Deferred	(349)	174	364
	1,558	705	846
Income Before Minority Interest	4,061	1,695	3,007
Loss (Income) of Minority Interest	189	(137)	106
Net Income	$ 4,250	$ 1,558	$ 3,113
Earnings per Common Share			
Net Income	$ 1.72	$ 0.63	$ 1.26

See accompanying notes to consolidated financial statements.

Consolidated Balance Sheets

Dollars in thousands	December 31,	
	2006	2005
Assets		
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2006 - $18,172; 2005 - $18,204)	**$ 18,764**	$ 18,831
Fixed maturities available-for-sale, at estimated fair value (cost: 2006 - $62,980; 2005 - $56,704)	**61,935**	56,124
Equity securities available-for-sale, at estimated fair value (cost: 2006 - $7,224; 2005 - $6,374)	**16,119**	15,169
Receivable for securities	**–**	677
Mortgage loans on real estate, at cost	**504**	387
Investment real estate, at book value (accumulated depreciation: 2006 - $18; 2005 - $18)	**4,154**	3,842
Policy loans	**845**	793
Other invested assets	**2,346**	2,605
Short-term investments	**508**	699
Total Investments	**$ 105,175**	99,127
Cash	**1,106**	2,350
Accrued investment income	**786**	701
Receivable from agents, less allowance for credit losses (2006 - $110; 2005 - $110)	**3,098**	2,663
Accounts receivable, less allowance for credit losses (2006 - $10; 2005 - $48)	**2,047**	2,848
Inventory	**447**	1,238
Reinsurance recoverable	**2,242**	10,193
Deferred policy acquisition costs	**7,922**	6,567
Property and equipment, net	**11,242**	12,393
Other assets	**846**	1,146
Total Assets	**$ 134,911**	$139,226
Liabilities and Shareholders' Equity		
Property and casualty benefit and loss reserves	**$ 12,498**	$ 19,511
Accident and health benefit and loss reserves	**824**	575
Life and annuity benefit and loss reserves	**26,265**	24,552
Unearned Premiums	**17,818**	15,791
Policy and contract claims	**412**	351
Other policyholder funds	**1,275**	1,309
Short term debt	**11,580**	–
Long-term debt	**9,279**	22,906
Accrued income taxes	**1,205**	99
Other liabilities	**5,645**	7,185
Deferred income tax	**2,031**	2,502
Total Liabilities	**$ 88,832**	94,781
Contingencies	**–**	–
Minority interest	**700**	889
Shareholders' equity		
Preferred stock, $1 par value, 500,000 shares authorized, none issued or outstanding	**–**	–
Class A common stock, $1 par value, 2,000,000 shares authorized, none issued or outstanding	**–**	–
Common stock, $1 par value, 10,000,000 shares authorized		
2,466,600 shares issued and outstanding	**2,467**	2,467
Additional paid-in capital	**4,951**	4,951
Accumulated other comprehensive income	**5,616**	5,860
Retained earnings	**32,345**	30,278
Total Shareholders' Equity	**45,379**	43,556
Total Liabilities and Shareholders' Equity	**$ 134,911**	$139,226

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
Balance at December 31, 2003	45,872		29,825	8,629	2,467	4,951
Comprehensive income:						
Net income for 2004	3,113	3,113	3,113	–	–	–
Other comprehensive loss, net of tax						
Unrealized loss on securities, net of reclassification adjustment of $1,483	(225)	(225)	–	(225)	–	–
Comprehensive income		2,888				
Cash dividends ($0.845 per share)	(2,084)		(2,084)	–	–	–
Balance at December 31, 2004	$ 46,676		$ 30,854	$ 8,404	$ 2,467	$ 4,951
Comprehensive loss:						
Net income for 2005	1,558	1,558	1,558	–	–	–
Other comprehensive loss, net of tax						
Unrealized loss on securities, net of reclassification adjustment of $2,504	(2,544)	(2,544)	–	(2,544)	–	–
Comprehensive loss		(986)				
Cash dividends ($0.865 per share)	(2,134)		(2,134)	–	–	–
Balance at December 31, 2005	$ 43,556		$ 30,278	$ 5,860	$ 2,467	$ 4,951
Comprehensive income:						
Net income for 2006	4,250	4,250	4,250	–	–	–
Other comprehensive loss, net of tax						
Unrealized loss on securities, net of reclassification adjustment of $1,845	(244)	(244)	–	(244)	–	–
Comprehensive income		4,006				
Cash dividends ($0.885 per share)	(2,183)		(2,183)	–	–	–
Balance at December 31, 2006	$ 45,379		$ 32,345	$ 5,616	$ 2,467	$ 4,951

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Dollars in thousands

	Year ended December 31,		
	2006	2005	2004
Cash flows from operating activities:			
Net income	**$ 4,250**	$ 1,558	$ 3,113
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Change in accrued investment income	**(85)**	43	186
Change in reinsurance recoverable	**7,951**	(6,875)	(1,519)
Amortization of deferred policy acquisition costs	**1,978**	2,704	2,221
Change in receivable for securities	**677**	(677)	–
Net realized gains on investments	**(2,615)**	(3,727)	(2,162)
Change in accounts receivable	**801**	(2,103)	(265)
Change in inventory	**791**	(1,016)	(178)
Policy acquisition costs deferred	**(3,333)**	(3,054)	(2,621)
Change in prepaid reinsurance premiums	**196**	271	29
Depreciation expense and amortization/accretion	**793**	944	700
Change in policy liabilities and claims	**(5,051)**	8,073	3,396
Change in income tax payable	**1,106**	99	(1,486)
Change in deferred income taxes	**349**	174	362
Change in other liabilities	**(1,540)**	(691)	(1,246)
Loss (gain) of minority interest	**189**	(137)	106
Other, net	**1,345**	(1,035)	250
Net cash provided by (used in) operating activities	7,802	(5,449)	886
Cash flows from investing activities:			
Purchases of held-to-maturity securities	**(1,484)**	(1,193)	(19,379)
Purchases of available-for-sale securities	**(24,396)**	(23,037)	(4,933)
Proceeds from maturities of held-to-maturity securities	**909**	2,770	3,176
Proceeds from sales of available-for-sale securities	**19,569**	22,576	25,687
Proceeds from sales of real estate held for investment	**838**	189	124
Purchases of real estate held for investment	**(821)**	(2,451)	–
Purchase of other invested assets	**–**	–	(3,358)
Proceeds from sales of other invested assets	**259**	368	385
Net proceeds (purchases) from sale of short-term investments	**191**	(449)	50
Advances on policy loans, net	**(52)**	(22)	(41)
Purchase of property and equipment	**(331)**	(457)	(1,327)
Proceeds from sale of property and equipment	**770**	–	–
Capitalized software development costs	**(234)**	4,211	69
Net cash (used in) provided by investing activities	(4,782)	2,505	453
Cash flows from financing activities:			
Proceeds from debt	**–**	9,279	243
Payments on debt	**(2,047)**	(2,209)	(328)
Change in other policyholder funds	**(34)**	(2)	(105)
Dividends paid	**(2,183)**	(2,134)	(2,084)
Net cash (used in) provided by financing activities	(4,264)	4,934	(2,274)
Net (decrease) increase in cash	(1,244)	1,990	(935)
Cash at beginning of year	**2,350**	360	1,295
Cash at end of year	**$ 1,106**	$ 2,350	$ 360

See accompanying notes to consolidated financial statements.

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

(a) 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). All significant intercompany transactions and accounts have been eliminated.

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

(b) Description of Major Products

NSIC is licensed in the states of Alabama, Florida, Georgia, Mississippi, South Carolina and Texas and was organized in 1947 to provide life and burial insurance policies to the homeservice market. Business is now produced by both company and independent agents. Primary products include ordinary life, accident and health, supplemental hospital, and cancer insurance products.

NSFC is licensed in Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, Oklahoma, South Carolina, Tennessee and West Virginia. In addition NSFC operates on a surplus lines basis in Louisiana, Missouri, and Texas. NSFC operates in various property and casualty lines, the most significant of which are dwelling property fire and extended coverage, homeowners, mobile homeowners, ocean marine, nonstandard automobile physical damage and liability and nonstandard commercial auto liability.

Omega is licensed in the states of Alabama and Louisiana. Omega operates in property and casualty lines, the most significant of which are homeowners and nonstandard automobile physical damage and liability.

(c) Basis of Presentation

The significant accounting policies followed by the Company 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.

(d) 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. Among the more significant estimates included in these financial statements are reserves for future policy benefits, losses and loss adjustment expenses and deferred policy acquisition costs. Actual results could differ from those estimates.

(e) 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.

Generally, realized gains and losses on sales of investments are recognized in net income 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 and losses recognized in the determination of net income.

Other invested assets consist principally of state sponsored investments with a portion of the investment yield derived from insurance premium tax credits. These investments are reported at the unpaid principal balance.

(f) Receivable from Agents

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

(g) Accounts Receivable

Accounts receivable are reported at net realizable value. Management determines the allowance for doubtful accounts based on historical losses and current economic conditions. On a continuing basis, management analyzes delinquent receivables and, once these receivables are determined to be uncollectible, they are written off through a charge against an existing allowance account or against earnings.

(h) Inventory

Inventory consists of finished goods inventory and is carried at the lower of cost (first-in, first-out method) or market.

(i) 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. Significant cost incurred for internally developed software are capitalized and amortized over estimated useful lives of 3 years. 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 3-8 years for electronic data processing equipment and furniture and fixtures.

(j) Fair Value of Financial Instruments

The table below 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 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 sheet due to their short-term availability or maturity.

Dollars in thousands	December 31,			
	2006		2005	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets and related Instruments				
Debt and equity securities	$ 95,136	$ 94,545	$ 90,124	$ 89,497
Mortgage loans	504	504	387	387
Policy loans	845	845	793	793
Other invested assets	2,346	2,346	2,605	2,605
Liabilities and related Instruments				
Other policyholder funds	1,275	1,275	1,309	1,309

(k) Statement of Cash Flows

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

(l) Revenue Recognition

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.

Mobile Attic, Inc. recognizes leasing revenues from royalties, storage unit rentals and sales on a monthly basis. Revenues from delivery charges are recognized when these services are billed. Mobile Attic executes franchise agreements that set the terms of its arrangement with each franchisee. The franchisee agreement requires the franchisee to pay an initial, nonrefundable fee ranging from $35,000 to $55,000 and continuing fees based on percentage of rents. The initial term of the franchise is 20 years and, subject to Mobile Attic's approval and payment of a renewal fee, a franchise may generally renew its agreement upon its expiration for an additional 10 years.

When an individual franchise is sold, Mobile Attic agrees to provide certain services to the Franchisee, including training on the operations of the business as well as training on the loading and unloading of the storage containers. Mobile Attic recognizes initial fees as revenue when substantially all initial services required by the franchise agreement are performed, which is generally upon opening of a franchise location.

Mobile Attic sold 5 individual franchise licenses during 2006 and 15 during 2005. Initial fees included in revenues for the years ended December 31, 2006 and 2005 were $300,000 and $625,000, respectively. Deferred revenue at December 31, 2006 and 2005 was $70,000 and $175,000, respectively, and represents that portion of total revenues from franchises not yet open. There were two company-owned locations in operation during the years ended December 31, 2006 and 2005.

As territory is assigned to each franchise sold, Mobile Attic may reach the point where existing markets become saturated and initial franchising revenue declines. Unless new markets are entered, franchise revenues after market saturation will come primarily from renewal fees for existing franchises.

(m) 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.

(n) Policy Liabilities

The liability for future life insurance policy benefits is computed using a net level premium

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES CONTINUED

method including the following assumptions:

Years of Issue	Interest rate
1947 - 1968	4%
1969 - 1978	6% graded to 5%
1979 - 2006	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.

(o) 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.

(p) 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 2005 and 2004).

(q) 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. In 2006, NSFC maintained catastrophe reinsurance protection for losses from a single catastrophic event with an upper limit of $42.5 million with a $3 million deductible and 5% coinsurance on reinsured losses up to $17.5 million.

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 $50,000 of coverage per individual life. The cost of reinsurance is amortized over the contract period of the reinsurance.

(r) 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.

(s) Advertising

The Company expenses advertising costs as incurred except for nondirect-response advertising costs, which are expensed the first time the advertising takes place. Advertising costs charged to expense were $446,000 for the year ended December 31, 2006 ($250,000 and $142,000 for the years ended December 31, 2005 and 2004, respectively). Advertising costs capitalized at December 31, 2005 were $192,000.

(t) 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.

Reinsurance contracts do not relieve the Company of its obligations to policyholders. A failure of a reinsurer to meet their obligation could result in losses to the insurance subsidiaries. Allowances for losses are established if amounts are believed to be uncollectible. At December 31, 2006 and 2005, no amounts were deemed uncollectible. The Company, at least annually, evaluates the financial condition of all reinsurers and evaluates any potential concentrations of credit risk. At December 31, 2006, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

(u) Recently Issued Accounting Standards

During 2006, the Financial Accounting Standards Board (FASB) issued the following pronouncements:

SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* eliminates the exception from applying SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to interests on securitized financial assets so similar instruments are accounted for similarly regardless of form. SFAS No. 155 is effective for all financial instruments acquired or issued in an entity's first fiscal year beginning after September 15, 2006. The adoption of this statement is not expected to have a material impact on the Company's financial position or results of operations.

SFAS No. 156, *Accounting for Servicing of Financial Assets* will require entities to recognize a servicing asset or liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations. It also requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value and allows a choice of either the amortization or fair value measurement method for subsequent measurement. The statement is effective for annual periods beginning after September 15, 2006. The adoption of this statement is not expected to have a material impact on the Company's financial position or results of operations.

FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes* prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties, accounting for income taxes in interim periods, financial disclosures, and transition. This interpretation is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact this interpretation may have on

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES CONTINUED

its financial position or results of operations at the time it is adopted.

SFAS No. 157, *Fair Value Measurements*, changes the requirements for accounting and reporting of a change in accounting principle. The statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The statement is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the potential impact of this statement at the time it is adopted.

SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* will require a company to recognize on a prospective basis an asset for a plan's overfunded status or a liability for a plan's underfunded status in its statement of financial position, to measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year, and to recognize changes in the funded status of a defined postretirement plan in the year in which the changes occur as a component of other comprehensive income. The requirement to recognize the funded status of a benefit plan and the disclosure requirements of the statement are effective for fiscal years ending after December 15, 2006. The requirement to measure the plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. The Company does not have a defined benefit pension plan or other postretirement plans and as a result the adoption of this statement is not expected to have a material impact on the Company's financial position or results of operations.

SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115* permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The adoption of this statement is not expected to have a material impact on the Company's financial position or results of operations.

NOTE 2 – VARIABLE INTEREST ENTITIES

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 (VIE). 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 consolidated its affiliate, Mobile Attic, Inc., upon adoption of FIN 46R in the first quarter 2004 due to the Company's guarantee of Mobile Attic's line of credit. The consolidation of Mobile Attic increased total assets by approximately $15 million and total liabilities by approximately $13 million. There was no effect on total shareholders' equity. The consolidation of Mobile Attic did not have a material impact on the results of operations as the Company previously accounted for the investment under the equity method. See Note 17 for additional information related to the VIE.

In December 2005, the Company formed National Security Capital Trust I (the Trust), a statutory trust created under the Delaware Statutory Trust Act, for the sole purpose of issuing, in private placement transactions, $9 million of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase $9.3 million of variable rate subordinated debentures issued by the Company. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of $9.005 million. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the trust. The Subordinated Debentures, disclosed in Note 8 are reported in the accompanying Consolidated Balance Sheet as a component of long-term debt. The Company's equity investments in the Trust total $279,000 and are included in Other Assets.

NOTE 3 - 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,		
	2006	2005	2004
NSIC - including realized capital (losses) gains of $561, $129, and $(56), respectively	$(1,580)	$(101)	$ 291
NSFC - including realized capital gains of $1,803, $3,098, $1,847, respectively	$ 4,222	$ 729	$ 2,164
OMEGA - including realized capital gains of $180, $180, $35, respectively	$ 621	$ 645	$ 667

NOTE 3 - STATUTORY ACCOUNTING PRACTICES CONTINUED

Dollars in thousands	Year ended December 31,		
	2006	2005	2004
Statutory Risk-Based Adjusted Capital: NSIC - including AVR of $955, $845, and $1,153, respectively	$10,298	$10,776	$ 11,451
NSFC	$32,583	$27,209	$23,766
OMEGA	$ 9,038	$ 8,016	$ 7,573

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 4 - INVESTMENT SECURITIES

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

Dollars in thousands	December 31, 2006			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
Corporate debt securities	$ 11,521	$ 39	$ 133	$ 11,427
Obligations of states and political subdivisions	5,650	23	92	5,581
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	45,809	60	942	44,927
Total fixed maturities	62,980	122	1,167	61,935
Equity securities	7,224	9,261	366	16,119
Total	$70,204	$ 9,383	$ 1,533	$78,054
Held-to-maturity securities:				
Corporate debt securities	$ 244	$ 6	$ –	$ 250
Obligations of states and political subdivisions	2,787	22	54	2,755
U.S. Treasury securities and obligations of U.S. government corporations and agencies	15,733	11	577	15,167
Total	$18,764	$ 39	$ 631	$18,172

Dollars in thousands	December 31, 2005			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
Corporate debt securities	$ 8,958	$ 148	$ 121	$ 8,985
Obligations of states and political subdivisions	6,519	134	101	6,552
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	41,227	114	754	40,587
Total fixed maturities	56,704	396	976	56,124
Equity securities	6,374	9,192	397	15,169
Total	$63,078	$ 9,588	$ 1,373	$71,293
Held-to-maturity securities:				
Corporate debt securities	$ 244	$ –	$ 47	$ 197
Obligations of states and political subdivisions	2,280	7	66	2,221
U.S. Treasury securities and obligations of U.S. government corporations and agencies	16,307	9	530	15,786
Total	$18,831	$ 16	$ 643	$18,204

The amortized cost and aggregate fair value of debt securities at December 31, 2006, 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.

NOTE 4 - INVESTMENT SECURITIES CONTINUED

Dollars in thousands	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	$ 1,691	$ 1,682
Due after one year through five years	15,366	15,228
Due after five years through ten years	19,583	19,248
Due after ten years	26,340	25,777
Total	$ 62,980	$ 61,935
Held-to-maturity securities:		
Due in one year or less	$ –	$ –
Due after one year through five years	2,709	2,647
Due after five years through ten years	7,503	7,249
Due after ten years	8,552	8,276
Total	$ 18,764	$ 18,172

For 2006, gross gains of $2,637,000 ($3,793,000 for 2005 and $2,219,000 for 2004) and gross losses of $86,000 ($66,000 for 2005 and $130,000 for 2004) were realized on sales of available-for-sale-securities.

A summary of securities available-for-sale with unrealized losses as of December 31, 2006 and 2005 along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows:

Dollars in thousands	December 31, 2006						
	Less than 12 months		12 months or longer		Total		
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Total Securities in a Loss Position
Fixed maturities							
Corporate	$ –	$ –	$ 7,780	$ 133	$ 7,780	$ 133	22
Obligations of state and political subdivisions	–	–	4,817	92	4,817	92	19
U.S. Treasury securities and obligations of U.S. Goverment corporations and agencies	–	–	40,056	942	40,056	942	97
Equity securities	–	–	1,571	366	1,571	366	9
	$ –	$ –	$54,224	$ 1,533	$54,224	$ 1,533	147

Dollars in thousands	December 31, 2005						
	Less than 12 months		12 months or longer		Total		
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Total Securities in a Loss Position
Fixed maturities							
Corporate	$ –	$ –	$ 3,562	$ 121	$ 3,562	$ 121	16
Obligations of state and political subdivisions	–	–	3,424	101	3,424	101	17
U.S. Treasury securities and obligations of U.S. Goverment corporations and agencies	–	–	33,426	754	33,426	754	78
Equity securities	–	–	998	397	998	397	7
	$ –	$ –	$41,410	$ 1,373	$41,410	$ 1,373	118

A summary of securities held-to-maturity with unrealized losses as of December 31, 2006 and 2005 along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows:

Dollars in thousands	December 31, 2006						
	Less than 12 months		12 months or longer		Total		
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Total Securities in a Loss Position
Fixed maturities							
Corporate	$ –	$ –	$ –	$ –	$ –	$ –	–
Obligations of state and political subdivisions	–	–	2,222	54	2,222	54	8
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	–	–	14,490	577	14,490	577	43
	$ –	$ –	$16,712	$ 631	$16,712	$ 631	51

NOTE 4 - INVESTMENT SECURITIES CONTINUED

Dollars in thousands	December 31, 2005						
	Less than 12 months		12 months or longer		Total		
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Total Securities in a Loss Position
Fixed maturities							
Corporate	$ –	$ –	$ 244	$ 47	$ 244	$ 47	1
Obligations of state and political subdivisions	–	–	2,078	66	2,078	66	8
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	–	–	15,203	530	15,203	530	43
	$ –	$ –	$17,525	$ 643	$17,525	$ 643	52

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 principal. Management believes the unrealized losses are market driven and no ultimate loss will occur.

NOTE 5 - NET INVESTMENT INCOME

Major categories of investment income are summarized as follows:

Dollars in thousands	Year ended December 31, 2006	2005	2004
Fixed maturities	$ 3,706	$ 3,505	$ 3,704
Equity securities	333	408	503
Mortgage loans on real estate	28	22	18
Investment real estate	60	23	15
Policy loans	58	56	2
Other, principally short-term investments	399	95	223
	4,584	4,109	4,465
Less: Investment expenses	121	145	235
Net investment income	$ 4,463	$ 3,964	$ 4,230

An analysis of investment gains follows:

Dollars in thousands	Year ended December 31, 2006	2005	2004
Net realized investment gains:			
Fixed maturities	$ 99	$ 132	$ 431
Other, principally equity securities	2,516	3,595	1,731
	$ 2,615	$ 3,727	$ 2,162

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

Dollars in thousands	Year ended December 31, 2006	2005	2004
Net decrease in unrealized appreciation on available-for-sale securities before deferred income tax	$(366)	$(3,689)	$(339)
Deferred income tax	122	1,145	114
Net decrease in unrealized appreciation on available-for-sale securities	$(255)	$(2,544)	$(225)

NOTE 6 - PROPERTY AND EQUIPMENT

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

Dollars in thousands	2006	2005
Building and improvements	$ 1,957	$ 1,945
Electronic data processing equipment	2,093	2,027
Leasing equipment	9,932	10,955
Furniture and fixtures	1,021	1,098
	15,003	16,025
Less accumulated depreciation	3,761	3,632
	$ 11,242	$ 12,393

Depreciation expense for the year ended December 31, 2006 was $743,000 ($905,000 for the year ended December 31, 2005 and $805,000 for the year ended December 31, 2004).

NOTE 7 - 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, 2006	2005	2004
Federal income tax rate applied to pre-tax income	$ 1,910	$ 816	$ 1,310
Dividends received deduction and tax-exempt interest	(149)	(183)	(196)
Other, net	(203)	72	(268)
Federal income tax expense	$ 1,558	$ 705	$ 846

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, 2006	2005
General insurance expenses	$ 707	$ 1,233
Unearned premiums	1,212	1,061
Claim liabilities	243	255
Policy liabilities	–	70
Deferred tax assets	2,162	2,619
Depreciation	(216)	(534)
Deferred policy acquisition costs	(1,745)	(2,233)
Unrealized gains on securities available-for-sale	(2,232)	(2,354)
Deferred tax liabilities	(4,193)	(5,121)
Net deferred tax liability	$(2,031)	$(2,502)

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

Dollars in thousands	Year ended December 31, 2006	2005	2004
Deferred policy acquisition costs	$(488)	$ 117	$ 138
Policy liabilities	70	70	69
Unearned premiums	(151)	(88)	(65)
General insurance expenses	526	(55)	(71)
Depreciation	(318)	86	313
Claim liabilities	12	44	(20)
	$(349)	$ 174	$ 364

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, 2006, 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, 2006.

NOTE 8 - NOTES PAYABLE AND LONG-TERM DEBT

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

Dollars in thousands	2006	2005
Note payable to bank with an interest rate based on LIBOR (8.10% at December 31, 2006 and 7.12% at December 31, 2005) dated March, 2002; maturity March, 2007. Payments of $112,953 due quarterly with balloon payment at maturity. Unsecured	$ 2,171	$ –
Note payable to bank with an interest rate based on prime minus 25 basis points (8.00% at December 31, 2006 and 7.00% at December 31, 2005) dated June, 2004; maturity June, 2007. Interest payments due quarterly. Secured by $9,005 of leasing equipment.	9,409	–
	$ 11,580	$ –

NOTE 8 - NOTES PAYABLE AND LONG-TERM DEBT CONTINUED

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

Dollars in thousands	2006	2005
Subordinated debentures issued on December 15, 2005 with fixed interest rate of 8.83% each distribution period thereafter until December 15, 2015 when the coupon rate shall equal the 3-month LIBOR plus 3.75% applied to the outstanding principal; maturity December, 2035. Interest payments due quarterly. Unsecured.........	$ 9,279	$ 9,279
Note payable to bank with an interest rate based on LIBOR (7.12% at December 31, 2005) dated March, 2002; maturity March, 2007. Payments of $112,953 due quarterly with balloon payment at maturity. Unsecured	–	2,439
Note payable to bank with an interest rate based on prime minus 25 basis points (7.00% at December 31, 2005) dated June, 2004; maturity June, 2007. Interest payments due quarterly. Secured by Mobile Attic leasing equipment.	–	11,188
	$ 9,279	$ 22,906

Aggregate maturities of long-term debt for each of the five years subsequent to December 31, 2006 are as follows (dollars in thousands): 2007-$11,580; 2008-$0; 2009-$0; 2010-$0 and 2011-$0. The remaining $9,279 is due in 2035.

The subordinated debentures (debentures) have the same maturities and other applicable terms and features as the associated trust preferred securities (TPS). The debentures bear a fixed interest rate until December 15, 2015. Payment of interest may be deferred for up to 20 consecutive quarters; however, stockholder dividends cannot be paid during any extended interest payment period or any time the debentures are in default. All have stated maturities of thirty years but may be redeemed at any time following the tenth anniversary of issuance. None of the securities require the Company to maintain minimum financial covenants. The Company has guaranteed that amounts paid to the Trust (discussed in Note 2) will be remitted to the holders of the associated TPS. This guarantee, when taken together with the obligations of the Company under the debentures, the Indentures pursuant to which the debentures were issued, and the related trust agreement (including obligations to pay related trust fees, expenses, debt and other obligations with respect to the TPS), provides a full and unconditional guarantee of amounts due the Trust. The amount guaranteed is not expected to at any time exceed the obligations of the TPS, and no additional liability has been recorded related to the guarantee.

NOTE 9 - POLICY AND CLAIM RESERVES

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	2006	2005	2004
Claims and claim adjustment expense reserves at beginning of year................................	$ 19,511	$ 13,094	$ 11,343
Less reinsurance recoverables on unpaid losses........	8,560	2,611	1,232
Net balances at beginning of year.............................	10,951	10,483	10,111
Provisions for claims and claim adjustment expenses for claims arising in current year	32,311	36,660	32,702
Estimated claims and claim adjustment expenses for claims arising in prior years............	1,092	(1,599)	(1,091)
Total increases	33,403	35,061	31,611
Claims and claim adjustment expense payments for claims arising in:			
Current year...	26,056	29,168	25,837
Prior years..	7,583	5,425	5,402
Total payments	33,639	34,593	31,239
Net balance at end of year...	10,715	10,951	10,483
Plus reinsurance recoverables on unpaid losses	1,783	8,560	2,611
Claims and claim adjustment expense reserves at end of year...	$ 12,498	$ 19,511	$ 13,094

The provision for claims and claim adjustment expenses for prior years (net of reinsurance recoveries) increased in 2006 primarily due to adverse development related to significant storm related losses in a concentrated coverage area in December of 2005 with the ultimate settlement of these claims exceeding preliminary estimates and due to adverse development of a single commercial auto policy with a loss occurring in 2004 and increases in reserves on this claim were made in late 2006. The provision for claims and claim adjustment expenses for prior years (net of reinsurance recoveries) decreased in 2005 and 2004 because of lower-than-anticipated losses primarily in homeowners and dwelling fire lines of business. 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 2005 by an additional $500,000.

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. At December 31, 2006, the Company's estimate of unpaid

NOTE 9 - POLICY AND CLAIM RESERVES CONTINUED

losses and adjustment expenses for hurricane related claims incurred in prior years totaled $1 million. Because all remaining outstanding claims are covered by the companies reinsurance contract, net outstanding losses to the Company total less than $10,000 including an allowance for estimated incurred but not reported losses.

NOTE 10 – 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, 2006, reinsurance receivables with a carrying value of $175,000 ($233,000 at December 31, 2005) and prepaid reinsurance premiums of $16,000 ($196,000 at December 31, 2005) were associated with a single reinsurer. The amounts of recoveries pertaining to reinsurance contracts that were deducted from losses incurred during 2006, 2005 and 2004 were approximately $7,525,000, $32,613,000, and $11,284,000, respectively. The Company did not incur any losses from an event occurring in 2006. Amounts reported as ceded incurred losses in 2006 were due to development of losses from prior year catastrophic losses primarily associated with assessments from the Mississippi Windstorm Underwriting Association stemming from losses associated from Hurricane Katrina in 2005. This assessment, while increasing gross losses, was covered by the Company's catastrophe reinsurance contract and no net losses were incurred due to this adverse development. The significant increase in recoveries pertaining to reinsurance contracts in 2005 compared to prior years was due to reinsurance associated with losses incurred from Hurricanes Katrina and Rita. The effect of reinsurance on premiums written and earned was as follows:

Dollars in thousands	2006			
	Life		Property & Casualty	
	Written	Earned	Written	Earned
Direct	$ 6,476	$ 6,592	$ 58,712	$ 56,669
Assumed	–	–	–	–
Ceded..	(42)	(42)	(4,165)	(4,345)
Net..	$ 6,434	$ 6,550	$ 54,547	$ 52,324

Dollars in thousands	2005			
	Life		Property & Casualty	
	Written	Earned	Written	Earned
Direct	$ 6,148	$ 6,280	$ 54,692	$ 53,718
Assumed	–	–	–	–
Ceded..	(46)	(46)	(6,117)	(6,389)
Net..	$ 6,102	$ 6,234	$ 48,575	$ 47,329

Dollars in thousands	2004			
	Life		Property & Casualty	
	Written	Earned	Written	Earned
Direct	$ 6,176	$ 6,200	$ 47,870	$ 51,618
Assumed	–	–	–	–
Ceded..	(27)	(27)	(4,835)	(4,806)
Net..	$ 6,149	$ 6,173	$ 43,035	$ 46,812

NOTE 11 - EMPLOYEE BENEFIT PLAN

In 1989, the Company and its subsidiaries established a retirement savings plan (401K Plan) and transferred the assets from the defined contribution profit sharing plan into the new plan. All full-time employees who have completed six months 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. Company matching contributions for 2006, 2005, and 2004 amounted to $314,000, $217,000, and $189,000, respectively. The Company contributes matching contributions up to 5% of compensation subject to government limitations.

In 1987, the Company established a non-qualified deferred compensation plan for its Board of Directors. The Board members had 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 2006, 2005, and 2004 amounted to approximately $198,000, ($259,000), and $208,000, respectively. The directors' non-qualified deferred compensation plan was frozen on December 31, 2004 and deferrals are no longer allowed. No deferrals of directors' fees were allowed in 2005 prior to adoption of a new non-qualified plan. A new non-qualified plan became effective January 1, 2006 under which directors are allowed to defer all or a portion of directors' fees into various investment options.

NOTE 12 - 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, 2006, NSIC's retained earnings unrestricted for the payment of dividends in 2007 amounted to $934,000.

NOTE 12 - REGULATORY REQUIREMENTS AND DIVIDEND RESTRICTIONS CONTINUED

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. At December 31, 2006, NSFC's retained earnings unrestricted for the payment of dividends in 2007 amounted to $4,222,000.

At December 31, 2006, securities with market values of $3,827,000 ($3,780,000 at December 31, 2005) were deposited with various states pursuant to statutory requirements.

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, NSIC is required to maintain a minimum total surplus (to include both paid-in and contributed and unassigned surplus) of $200,000.

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.

NOTE 13 - 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 14 - 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, 2006, 2005 and 2004 are summarized below:

Dollars in thousands	Total	P&C Operations	Life Insurance Operations	Non-Insurance Operations
Year ended December 31, 2006				
Revenues				
Net premiums earned	$ 58,874	$ 52,324	$ 6,550	$ –
Net investment income	4,463	2,591	1,785	87
Net realized investment gains	2,615	1,983	582	50
Net revenues from leasing operations	1,887	–	–	1,887
Other income	1,211	1,208	2	1
	$ 69,050	$ 58,106	$ 8,919	$ 2,025
Income (loss) before income taxes	$ 7,456	$ 9,282	$(1,741)	$(85)
Interest expense	1,837	–	83	1,754
	$ 5,619	$ 9,282	$(1,824)	$(1,839)
Assets	$134,911	$ 75,893	$ 45,247	$ 13,771
Amortization of deferred policy acquisition costs	$ 2,315	$ 2,478	$(163)	$ –
Depreciation expense	$ 743	$ 245	$ 136	$ 362
Capital expenditures	$ 938	$ 643	$ 268	$ 27
Year ended December 31, 2005				
Revenues				
Net premiums earned	$ 53,563	$ 47,329	$ 6,234	$ –
Net investment income	3,964	2,323	1,619	22
Net realized investment gains	3,727	3,278	215	234
Net revenues from leasing operations	3,360	–	–	3,360
Other income	1,416	1,364	52	–
	$ 66,030	$ 54,294	$ 8,120	$ 3,616
Income (loss) before income taxes	$ 3,540	$ 2,698	$(271)	$ 1,113
Interest expense	1,140	15	114	1,011
	$ 2,400	$ 2,683	$(385)	$ 102
Assets	$139,226	$ 74,967	$ 45,565	$ 18,694
Amortization of deferred policy acquisition costs	$ 2,704	$ 2,256	$ 448	$ –
Depreciation expense	$ 905	$ 100	$ 347	$ 458
Capital expenditures	$ 457	$ 18	$ 321	$ 118

NOTE 14 - INDUSTRY SEGMENTS

Dollars in thousands	Total	P&C Operations	Life Insurance Operations	Non-Insurance Operations
Year ended December 31, 2004				
Revenues				
Net premiums earned	$ 52,985	$ 46,812	$ 6,173	$ –
Net investment income (loss)	4,230	2,315	2,013	(98)
Net realized investment gains	2,162	1,881	276	5
Net revenues from leasing operations	2,459	–	–	2,459
Other income (loss)	1,312	1,325	9	(22)
	$ 63,148	$ 52,333	$ 8,471	$ 2,344
Income (loss) before income taxes	$ 4,580	$ 4,224	$ 216	$ 140
Interest expense	727	–	30	697
	$ 3,853	$ 4,224	$ 186	$(557)
Assets	$128,631	$ 65,462	$ 45,947	$ 17,222
Amortization of deferred policy acquisition costs	$ 2,221	$ 2,115	$ 106	$ –
Depreciation expense	$ 805	$ 188	$ 173	$ 444
Capital expenditures	$ 1,327	$ 130	$ 663	$ 534

NOTE 15 - CONTINGENCIES

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.

On December 12, 2005, the United States District court for the Middle District of Alabama (the "Court") entered an order preliminarily approving a proposed settlement of a case pending against a subsidiary of the Company styled Mary W. Williams, et al v. National Security Insurance Company ("Williams Litigation") and preliminarily certifying such case as a class action. The Williams Litigation related primarily to claims that a subsidiary of the Company sold industrial burial insurance policies to racial minorities on which it charged higher premiums or provided inferior benefits than premiums charged to or policy benefits provided to similarly situated non-minority policyholders. The Company's subsidiary has not sold industrial burial insurance for more than 20 years. Following a fairness hearing held on August 22, 2006, the Court, in an order dated August 30, 2006, granted final approval to the proposed settlement. The effective date of the settlement was September 30, 2006, with an implementation date of December 29, 2006. The settlement provided for the Company's subsidiary to, among other matters, provide additional policyholder benefits, including premiums adjustments and benefits enhancements on existing policies and additional benefits on matured policies and pay attorneys fees. The Company had previously established litigation reserves with respect to this matter and had taken a policy reserve charge with respect to adjustments to the subject policies that were voluntarily made in 2000. The remaining costs associated with this settlement, including costs associated with prospective enhancements, are fully reflected in the attached financial statements for the period ending December 31, 2006. The class, as certified, did not permit any class members to opt out of the settlement and enjoined all similar litigation against the Company's subsidiary. In the settlement, the Company's subsidiary denied all claims and allegations made in the lawsuit.

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

NOTE 16 - SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during 2006 was $1,846,000 ($1,139,000 in 2005 and, $645,000 in 2004). Cash paid for income taxes in 2006 was $300,000 ($400,000 in 2005 and $2,000,000 in 2004). Noncash investing activities in 2006 and 2005 included converting $551,000 and $276,000, respectively, of storage units from furniture and equipment into inventory. Noncash investing activities in 2006 also included converting $746,000 of storage units from inventory into furniture and equipment.

NOTE 17 - RELATED PARTY TRANSACTIONS

During the years ended December 31, 2006, 2005 and 2004 the Company's affiliate Mobile Attic acquired $2,861,000; $2,632,000; and $1,389,000, respectively, of equipment from Cash Brothers Leasing, Inc. (Cash Brothers). The principal owners of Cash Brothers are also stockholders in Mobile Attic. Cash Brothers is also a distributor of the mobile storage units. During 2006, 2005 and 2004 Mobile Attic paid $36,000; $103,000; and $100,000, respectively, in commissions to Cash Brothers. At December 31, 2006 and 2005, Mobile Attic had accrued expenses due Cash Brothers of $10,000 and $16,000, respectively.

Mobile Attic also acquired $4,213,000 and $4,977,000 of equipment from Bridgeville Trailers during the years ended December 31, 2006 and 2005, respectively. Two of the majority shareholders of Bridgeville Trailers each own 25% of Mobile Attic.

NOTE 18 - SUBSEQUENT EVENT

The Company has entered into discussions with a party regarding the sale of its interest in Mobile Attic, Inc. The terms of the agreement have yet to be finalized but the consummation of an agreement would be contingent upon a provision to release the Company from any existing debt guarantees of Mobile Attic and consequently an elimination of the requirement to consolidate Mobile Attic under the provisions of FIN 46R.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders
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, 2006 and 2005 and the related consolidated statements of income, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2006. 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 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 consolidated financial statements are free of material misstatement. The company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, 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, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America.

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

Birmingham, Alabama
March 13, 2007

Board of Directors

Winfield Baird
Chairman of the Board
The National Security Group, Inc.
Chartered Financial Analyst
Baird Financial Management
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

Carolyn E. Brunson
Managing Partner
Brunson Properties
Elba, Alabama

Walter P. Wilkerson, CPA
Partner
Brunson, Wilkerson & Bowden CPAs
Enterprise, Alabama

Fred Clark, Jr.
Chief Operating Officer
Alabama Municipal Electric Authority
Montgomery, Alabama

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& General Counsel
The Mitchell Company
Mobile, Alabama

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Information Officer
Energen Corporation
Birmingham, Alabama

Donald S. Pittman
Attorney at Law
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Fleming Brooks
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Brooks Peanut Company, Inc.
Samson, Alabama

Frank B. O'Neil
Senior Vice President
Corp. Communications and Investor
Relations and Asst. Corp. Secretary
Pro Assurance
Birmingham, Alabama

James B. Saxon
Director Emeritus
Retired Executive
Anderson Products
Square D Company
Birmingham, Alabama

Corporate Information

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Annual Shareholders Meeting:

May 4, 2007
Executive Offices
Elba, Alabama

Auditors:

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Actuaries:

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Palm Harbor, Florida 34684

Fire Company-
Milliman, Inc.
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San Francisco, California 94108

The Common Stock of the Company trades on the NASDAQ Global Market 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: Registrar and Transfer Company
10 Commerce Drive
Cranford, New Jersey 07016

The National Security Group

Insuring your world.

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