

CITIZENS INC  
Form 10-Q  
August 06, 2013

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

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☒ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2013

or

☐ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-16509

CITIZENS, INC.

(Exact name of registrant as specified in its charter)

Colorado

84-0755371

(State or other jurisdiction of incorporation or  
organization)

(I.R.S. Employer Identification No.)

400 East Anderson Lane, Austin, TX

78752

(Address of principal executive offices)

(Zip Code)

(512) 837-7100

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. ☒ Yes ☐ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). ☒ Yes ☐ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a small reporting company. (Check one):

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐ Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

☐ Yes ☒ No

As of August 2, 2013, the Registrant had 49,080,114 shares of Class A common stock, no par value, outstanding and 1,001,714 shares of Class B common stock outstanding.

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TABLE OF CONTENTS

|                                                                                                               | Page<br>Number |
|---------------------------------------------------------------------------------------------------------------|----------------|
| Part I. Financial Information                                                                                 |                |
| Item 1. <u>Financial Statements</u>                                                                           |                |
| <u>Consolidated Statements of Financial Position, June 30, 2013 (Unaudited) and December 31, 2012</u>         | <u>2</u>       |
| <u>Consolidated Statements of Comprehensive Income, Three Months Ended June 30, 2013 and 2012 (Unaudited)</u> | <u>4</u>       |
| <u>Consolidated Statements of Comprehensive Income, Six Months Ended June 30, 2013 and 2012 (Unaudited)</u>   | <u>5</u>       |
| <u>Consolidated Statements of Cash Flows, Six Months Ended June 30, 2013 and 2012 (Unaudited)</u>             | <u>6</u>       |
| <u>Notes to Consolidated Financial Statements</u>                                                             | <u>8</u>       |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>          | <u>27</u>      |
| Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>                                     | <u>48</u>      |
| Item 4. <u>Controls and Procedures</u>                                                                        | <u>49</u>      |
| Part II. Other Information                                                                                    |                |
| Item 1. <u>Legal Proceedings</u>                                                                              | <u>50</u>      |
| Item 1A. <u>Risk Factors</u>                                                                                  | <u>50</u>      |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>                                    | <u>51</u>      |
| Item 3. <u>Defaults Upon Senior Securities</u>                                                                | <u>51</u>      |
| Item 4. <u>Mine Safety Disclosures</u>                                                                        | <u>51</u>      |
| Item 5. <u>Other Information</u>                                                                              | <u>51</u>      |
| Item 6. <u>Exhibits</u>                                                                                       | <u>52</u>      |

Table of Contents

## PART I. FINANCIAL INFORMATION

## Item 1. FINANCIAL STATEMENTS

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Financial Position

(In thousands)

|                                                                                                                           | June 30, 2013<br>(Unaudited) | December 31, 2012 |
|---------------------------------------------------------------------------------------------------------------------------|------------------------------|-------------------|
| Assets                                                                                                                    |                              |                   |
| Investments:                                                                                                              |                              |                   |
| Fixed maturities available-for-sale, at fair value (cost: \$630,177 and \$559,736 in 2013 and 2012, respectively)         | \$ 649,109                   | 604,520           |
| Fixed maturities held-to-maturity, at amortized cost (fair value: \$161,012 and \$193,739 in 2013 and 2012, respectively) | 159,208                      | 187,008           |
| Equity securities available-for-sale, at fair value (cost: \$52,392 and \$52,744 in 2013 and 2012, respectively)          | 52,699                       | 53,741            |
| Mortgage loans on real estate                                                                                             | 687                          | 1,509             |
| Policy loans                                                                                                              | 45,824                       | 42,993            |
| Real estate held for investment (less \$1,357 and \$1,287 accumulated depreciation in 2013 and 2012, respectively)        | 8,509                        | 8,496             |
| Other long-term investments                                                                                               | 56                           | 57                |
| Short-term investments                                                                                                    | —                            | 2,340             |
| Total investments                                                                                                         | 916,092                      | 900,664           |
| Cash and cash equivalents                                                                                                 | 41,013                       | 56,299            |
| Accrued investment income                                                                                                 | 11,378                       | 10,304            |
| Reinsurance recoverable                                                                                                   | 6,673                        | 9,651             |
| Deferred policy acquisition costs                                                                                         | 140,787                      | 135,569           |
| Cost of customer relationships acquired                                                                                   | 24,474                       | 25,116            |
| Goodwill                                                                                                                  | 17,160                       | 17,160            |
| Other intangible assets                                                                                                   | 865                          | 879               |
| Federal income tax receivable                                                                                             | 224                          | 270               |
| Property and equipment, net                                                                                               | 7,138                        | 7,383             |
| Due premiums, net (less \$1,346 and \$1,345 allowance for doubtful accounts in 2013 and 2012, respectively)               | 10,443                       | 10,527            |
| Prepaid expenses                                                                                                          | 1,335                        | 344               |
| Other assets                                                                                                              | 962                          | 782               |
| Total assets                                                                                                              | \$ 1,178,544                 | 1,174,948         |

(Continued)

See accompanying notes to consolidated financial statements.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Financial Position

(In thousands, except share amounts)

|                                                                                                                                                                             | June 30, 2013<br>(Unaudited) | December 31, 2012 |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------|-------------------|
| Liabilities and Stockholders' Equity                                                                                                                                        |                              |                   |
| Liabilities:                                                                                                                                                                |                              |                   |
| Policy liabilities:                                                                                                                                                         |                              |                   |
| Future policy benefit reserves:                                                                                                                                             |                              |                   |
| Life insurance                                                                                                                                                              | \$795,886                    | 762,319           |
| Annuities                                                                                                                                                                   | 53,223                       | 51,750            |
| Accident and health                                                                                                                                                         | 2,712                        | 5,491             |
| Dividend accumulations                                                                                                                                                      | 12,821                       | 11,962            |
| Premiums paid in advance                                                                                                                                                    | 29,811                       | 27,455            |
| Policy claims payable                                                                                                                                                       | 8,809                        | 11,015            |
| Other policyholders' funds                                                                                                                                                  | 8,010                        | 9,440             |
| Total policy liabilities                                                                                                                                                    | 911,272                      | 879,432           |
| Commissions payable                                                                                                                                                         | 2,195                        | 2,606             |
| Deferred federal income tax                                                                                                                                                 | 6,796                        | 17,301            |
| Payable for securities in process of settlement                                                                                                                             | 179                          | 2,358             |
| Other liabilities                                                                                                                                                           | 9,457                        | 10,143            |
| Total liabilities                                                                                                                                                           | 929,899                      | 911,840           |
| Commitments and contingencies (Note 7)                                                                                                                                      |                              |                   |
| Stockholders' equity:                                                                                                                                                       |                              |                   |
| Class A, no par value, 100,000,000 shares authorized, 52,215,852 shares issued and outstanding in 2013 and 2012, including shares in treasury of 3,135,738 in 2013 and 2012 | 259,383                      | 259,383           |
| Class B, no par value, 2,000,000 shares authorized, 1,001,714 shares issued and outstanding in 2013 and 2012                                                                | 3,184                        | 3,184             |
| Accumulated deficit                                                                                                                                                         | (15,172                      | ) (17,335         |
| Accumulated other comprehensive income:                                                                                                                                     |                              |                   |
| Unrealized gains on securities, net of tax                                                                                                                                  | 12,261                       | 28,887            |
| Treasury stock, at cost                                                                                                                                                     | (11,011                      | ) (11,011         |
| Total stockholders' equity                                                                                                                                                  | 248,645                      | 263,108           |
| Total liabilities and stockholders' equity                                                                                                                                  | \$1,178,544                  | 1,174,948         |

See accompanying notes to consolidated financial statements.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Comprehensive Income

Three Months Ended June 30,

(In thousands, except per share amounts)

(Unaudited)

|                                                                                            | 2013       |   | 2012    |
|--------------------------------------------------------------------------------------------|------------|---|---------|
| Revenues:                                                                                  |            |   |         |
| Premiums:                                                                                  |            |   |         |
| Life insurance                                                                             | \$42,223   |   | 39,945  |
| Accident and health insurance                                                              | 406        |   | 417     |
| Property insurance                                                                         | 1,205      |   | 1,234   |
| Net investment income                                                                      | 9,265      |   | 7,612   |
| Realized investment gains, net                                                             | 82         |   | 246     |
| Decrease in fair value of warrants                                                         | —          |   | 37      |
| Other income                                                                               | 427        |   | 111     |
| Total revenues                                                                             | 53,608     |   | 49,602  |
| Benefits and expenses:                                                                     |            |   |         |
| Insurance benefits paid or provided:                                                       |            |   |         |
| Claims and surrenders                                                                      | 16,660     |   | 16,109  |
| Increase in future policy benefit reserves                                                 | 17,896     |   | 16,751  |
| Policyholders' dividends                                                                   | 2,235      |   | 2,281   |
| Total insurance benefits paid or provided                                                  | 36,791     |   | 35,141  |
| Commissions                                                                                | 10,429     |   | 9,731   |
| Other general expenses                                                                     | 7,342      |   | 6,342   |
| Capitalization of deferred policy acquisition costs                                        | (7,672)    | ) | (7,044) |
| Amortization of deferred policy acquisition costs                                          | 4,363      |   | 4,433   |
| Amortization of cost of customer relationships acquired                                    | 560        |   | 660     |
| Total benefits and expenses                                                                | 51,813     |   | 49,263  |
| Income before federal income tax                                                           | 1,795      |   | 339     |
| Federal income tax expense (benefit)                                                       | 488        |   | (64)    |
| Net income                                                                                 | 1,307      |   | 403     |
| Per Share Amounts:                                                                         |            |   |         |
| Basic earnings per share of Class A common stock                                           | \$0.03     |   | 0.01    |
| Basic earnings per share of Class B common stock                                           | 0.01       |   | —       |
| Diluted earnings per share of Class A common stock                                         | 0.03       |   | 0.01    |
| Diluted earnings per share of Class B common stock                                         | 0.01       |   | —       |
| Other comprehensive income (loss):                                                         |            |   |         |
| Unrealized gains (losses) on available-for-sale securities:                                |            |   |         |
| Unrealized holding gains (losses) arising during period                                    | (25,544)   | ) | 6,003   |
| Reclassification adjustment for gains included in net income                               | (73)       | ) | (121)   |
| Unrealized gains (losses) on available-for-sale securities, net                            | (25,617)   | ) | 5,882   |
| Income tax expense (benefit) on unrealized gains (losses) on available-for-sale securities | (8,953)    | ) | 2,063   |
| Other comprehensive income (loss)                                                          | (16,664)   | ) | 3,819   |
| Comprehensive income (loss)                                                                | \$(15,357) | ) | 4,222   |

See accompanying notes to consolidated financial statements.



Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Comprehensive Income

Six Months Ended June 30,

(In thousands, except per share amounts)

(Unaudited)

|                                                                                            | 2013       |   | 2012     |   |
|--------------------------------------------------------------------------------------------|------------|---|----------|---|
| Revenues:                                                                                  |            |   |          |   |
| Premiums:                                                                                  |            |   |          |   |
| Life insurance                                                                             | \$81,637   |   | 77,351   |   |
| Accident and health insurance                                                              | 755        |   | 830      |   |
| Property insurance                                                                         | 2,382      |   | 2,511    |   |
| Net investment income                                                                      | 17,654     |   | 15,189   |   |
| Realized investment gains, net                                                             | 113        |   | 344      |   |
| Decrease in fair value of warrants                                                         | —          |   | 73       |   |
| Other income                                                                               | 613        |   | 209      |   |
| Total revenues                                                                             | 103,154    |   | 96,507   |   |
| Benefits and expenses:                                                                     |            |   |          |   |
| Insurance benefits paid or provided:                                                       |            |   |          |   |
| Claims and surrenders                                                                      | 31,466     |   | 30,863   |   |
| Increase in future policy benefit reserves                                                 | 34,855     |   | 30,892   |   |
| Policyholders' dividends                                                                   | 4,309      |   | 4,155    |   |
| Total insurance benefits paid or provided                                                  | 70,630     |   | 65,910   |   |
| Commissions                                                                                | 19,487     |   | 18,395   |   |
| Other general expenses                                                                     | 14,041     |   | 12,958   |   |
| Capitalization of deferred policy acquisition costs                                        | (14,034)   | ) | (12,983) | ) |
| Amortization of deferred policy acquisition costs                                          | 8,989      |   | 8,559    |   |
| Amortization of cost of customer relationships acquired                                    | 1,138      |   | 1,236    |   |
| Total benefits and expenses                                                                | 100,251    |   | 94,075   |   |
| Income before federal income tax                                                           | 2,903      |   | 2,432    |   |
| Federal income tax expense                                                                 | 740        |   | 517      |   |
| Net income                                                                                 | 2,163      |   | 1,915    |   |
| Per Share Amounts:                                                                         |            |   |          |   |
| Basic earnings per share of Class A common stock                                           | \$0.05     |   | 0.04     |   |
| Basic earnings per share of Class B common stock                                           | 0.02       |   | 0.02     |   |
| Diluted earnings per share of Class A common stock                                         | 0.05       |   | 0.04     |   |
| Diluted earnings per share of Class B common stock                                         | 0.02       |   | 0.02     |   |
| Other comprehensive income (loss):                                                         |            |   |          |   |
| Unrealized gains (losses) on available-for-sale securities:                                |            |   |          |   |
| Unrealized holding gains (losses) arising during period                                    | (25,448)   | ) | 8,564    |   |
| Reclassification adjustment for gains included in net income                               | (104)      | ) | (207)    | ) |
| Unrealized gains (losses) on available-for-sale securities, net                            | (25,552)   | ) | 8,357    |   |
| Income tax expense (benefit) on unrealized gains (losses) on available-for-sale securities | (8,926)    | ) | 2,959    |   |
| Other comprehensive income (loss)                                                          | (16,626)   | ) | 5,398    |   |
| Comprehensive income (loss)                                                                | \$(14,463) | ) | 7,313    |   |
| See accompanying notes to consolidated financial statements.                               |            |   |          |   |



Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Cash Flows

Six Months Ended June 30,

(In thousands)

(Unaudited)

|                                                                                   | 2013     | 2012       |   |
|-----------------------------------------------------------------------------------|----------|------------|---|
| Cash flows from operating activities:                                             |          |            |   |
| Net income                                                                        | \$2,163  | 1,915      |   |
| Adjustments to reconcile net income to net cash provided by operating activities: |          |            |   |
| Realized gains on sale of investments and other assets                            | (113     | ) (344     | ) |
| Net deferred policy acquisition costs                                             | (5,045   | ) (4,424   | ) |
| Amortization of cost of customer relationships acquired                           | 1,138    | 1,236      |   |
| Decrease in fair value of warrants                                                | —        | (73        | ) |
| Depreciation                                                                      | 637      | 607        |   |
| Amortization of premiums and discounts on investments                             | 4,256    | 2,438      |   |
| Deferred federal income tax benefit                                               | (1,579   | ) (1,679   | ) |
| Change in:                                                                        |          |            |   |
| Accrued investment income                                                         | (1,074   | ) (899     | ) |
| Reinsurance recoverable                                                           | 2,978    | 476        |   |
| Due premiums                                                                      | 84       | 399        |   |
| Future policy benefit reserves                                                    | 32,049   | 30,685     |   |
| Other policyholders' liabilities                                                  | (421     | ) 1,925    | ) |
| Federal income tax receivable                                                     | 46       | 820        |   |
| Commissions payable and other liabilities                                         | (1,097   | ) (1,417   | ) |
| Other, net                                                                        | (1,008   | ) (1,515   | ) |
| Net cash provided by operating activities                                         | 33,014   | 30,150     |   |
| Cash flows from investing activities:                                             |          |            |   |
| Sale of fixed maturities, available-for-sale                                      | 58       | 503        |   |
| Maturities and calls of fixed maturities, available-for-sale                      | 33,943   | 105,077    |   |
| Maturities and calls of fixed maturities, held-to-maturity                        | 26,465   | 115,630    |   |
| Purchase of fixed maturities, available-for-sale                                  | (109,596 | ) (118,558 | ) |
| Purchase of fixed maturities, held-to-maturity                                    | —        | (94,276    | ) |
| Calls of equity securities, available-for-sale                                    | 400      | 420        |   |
| Principal payments on mortgage loans                                              | 822      | 22         |   |
| Increase in policy loans, net                                                     | (2,831   | ) (2,024   | ) |
| Sale of other long-term investments                                               | 1        | 4          |   |
| Purchase of other long-term investments                                           | (83      | ) (94      | ) |
| Purchase of property and equipment                                                | (321     | ) (350     | ) |
| Maturity of short-term investments                                                | 2,841    | —          |   |
| Purchase of short-term investments                                                | (531     | ) (2,378   | ) |
| Net cash provided by (used in) investing activities                               | (48,832  | ) 3,976    |   |

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Consolidated Statements of Cash Flows, Continued

Six Months Ended June 30,

(In thousands)

(Unaudited)

|                                                      | 2013     | 2012     |
|------------------------------------------------------|----------|----------|
| Cash flows from financing activities:                |          |          |
| Warrants exercised                                   | \$—      | 68       |
| Annuity deposits                                     | 2,815    | 3,425    |
| Annuity withdrawals                                  | (2,283   | ) (1,958 |
| Net cash provided by financing activities            | 532      | 1,535    |
| Net increase (decrease) in cash and cash equivalents | (15,286  | ) 35,661 |
| Cash and cash equivalents at beginning of year       | 56,299   | 33,255   |
| Cash and cash equivalents at end of period           | \$41,013 | 68,916   |
| Supplemental disclosures of operating activities:    |          |          |
| Cash paid during the period for income taxes, net    | \$2,273  | 1,377    |

## Supplemental Disclosures of Non-Cash Investing Activities:

None.

See accompanying notes to consolidated financial statements.

Table of Contents

CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2013

(Unaudited)

(1) Financial Statements

Basis of Presentation and Consolidation

The accompanying consolidated financial statements of Citizens, Inc. and its wholly-owned subsidiaries have been prepared in conformity with U.S. generally accepted accounting principles ("U.S. GAAP").

The consolidated financial statements include the accounts and operations of Citizens, Inc. ("Citizens"), a Colorado corporation, and its wholly-owned subsidiaries, CICA Life Insurance Company of America ("CICA"), Security Plan Life Insurance Company ("SPLIC"), Security Plan Fire Insurance Company ("SPFIC"), Citizens National Life Insurance Company ("CNLIC"), Computing Technology, Inc. ("CTI") and Insurance Investors, Inc. ("III"). Citizens and its wholly-owned subsidiaries are collectively referred to as "the Company," "we," "us" or "our."

The consolidated statements of financial position for June 30, 2013, and the consolidated statements of comprehensive income and cash flows for the three and six-month periods ended June 30, 2013 and 2012, have been prepared by the Company without audit. In the opinion of management, all adjustments to present fairly the financial position, results of operations, and changes in cash flows at June 30, 2013 and for comparative periods have been made. The consolidated financial statements have been prepared in accordance with U.S. GAAP for interim financial information and with the instructions to Form 10-Q adopted by the Securities and Exchange Commission ("SEC"). Accordingly, the financial statements do not include all of the information and footnotes required for complete financial statements and should be read in conjunction with the Company's consolidated financial statements, and notes thereto, for the year ended December 31, 2012. Operating results for the interim periods disclosed herein are not necessarily indicative of the results that may be expected for a full year or any future period.

We provide primarily life insurance and a small amount of health insurance policies through our insurance subsidiaries: CICA, SPLIC, and CNLIC. CICA and CNLIC issue ordinary whole-life policies, credit life and disability, burial insurance, pre-need policies, and accident and health related policies, throughout the Midwest and southern United States. CICA also issues ordinary whole-life policies to non-U.S. residents. SPLIC offers final expense and home service life insurance in Louisiana, Arkansas and Mississippi and SPFIC, a wholly-owned subsidiary of SPLIC, writes a limited amount of property insurance in Louisiana.

CTI provides data processing systems and services, as well as furniture and equipment, to the Company. III provides aviation transportation to the Company.

Use of Estimates

The preparation of financial statements, in conformity with U.S. GAAP, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The most significant estimates include those used in the evaluation of other-than-temporary impairments on debt and equity securities and valuation allowances on investments, actuarially determined assets and liabilities and assumptions, goodwill impairment, valuation allowance on deferred tax assets, and contingencies relating to litigation

and regulatory matters. Certain of these estimates are particularly sensitive to market conditions, and deterioration and/or volatility in the worldwide debt or equity markets could have a material impact on the Consolidated Financial Statements.

#### Reclassification

Reclassifications have been made in the current year related to certain prior year reported amounts to provide consistent presentation.

Table of Contents

CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

Significant Accounting Policies

For a description of significant accounting policies, see Note 1 of the Notes to Consolidated Financial Statements included in our 2012 Form 10-K Annual Report, which should be read in conjunction with these accompanying Consolidated Financial Statements.

(2) Accounting Pronouncements

Accounting Standards Recently Adopted

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

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

## (3) Segment Information

The Company has three reportable segments: Life Insurance, Home Service Insurance, and Other Non-Insurance Enterprises. The accounting policies of the segments are in accordance with U.S. GAAP and are the same as those used in the preparation of the consolidated financial statements. The Company evaluates profit and loss performance based on U.S. GAAP income before federal income taxes for its three reportable segments.

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

|                                                         | Three Months Ended<br>June 30, 2013 |                              |                                       |              |
|---------------------------------------------------------|-------------------------------------|------------------------------|---------------------------------------|--------------|
|                                                         | Life<br>Insurance                   | Home<br>Service<br>Insurance | Other<br>Non-Insurance<br>Enterprises | Consolidated |
|                                                         | (In thousands)                      |                              |                                       |              |
| Revenues:                                               |                                     |                              |                                       |              |
| Premiums                                                | \$32,850                            | 10,984                       | —                                     | 43,834       |
| Net investment income                                   | 5,584                               | 3,341                        | 340                                   | 9,265        |
| Realized investment gains, net                          | 81                                  | 1                            | —                                     | 82           |
| Other income                                            | 351                                 | 46                           | 30                                    | 427          |
| Total revenue                                           | 38,866                              | 14,372                       | 370                                   | 53,608       |
| Benefits and expenses:                                  |                                     |                              |                                       |              |
| Insurance benefits paid or provided:                    |                                     |                              |                                       |              |
| Claims and surrenders                                   | 11,429                              | 5,231                        | —                                     | 16,660       |
| Increase in future policy benefit reserves              | 17,047                              | 849                          | —                                     | 17,896       |
| Policyholders' dividends                                | 2,216                               | 19                           | —                                     | 2,235        |
| Total insurance benefits paid or provided               | 30,692                              | 6,099                        | —                                     | 36,791       |
| Commissions                                             | 6,697                               | 3,732                        | —                                     | 10,429       |
| Other general expenses                                  | 2,928                               | 3,225                        | 1,189                                 | 7,342        |
| Capitalization of deferred policy acquisition costs     | (6,170)                             | (1,502)                      | —                                     | (7,672)      |
| Amortization of deferred policy acquisition costs       | 3,870                               | 493                          | —                                     | 4,363        |
| Amortization of cost of customer relationships acquired | 154                                 | 406                          | —                                     | 560          |
| Total benefits and expenses                             | 38,171                              | 12,453                       | 1,189                                 | 51,813       |
| Income (loss) before income tax expense                 | \$695                               | 1,919                        | (819)                                 | 1,795        |

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

|                                                            | Six Months Ended<br>June 30, 2013 |                              |                                       |              |
|------------------------------------------------------------|-----------------------------------|------------------------------|---------------------------------------|--------------|
|                                                            | Life<br>Insurance                 | Home<br>Service<br>Insurance | Other<br>Non-Insurance<br>Enterprises | Consolidated |
|                                                            | (In thousands)                    |                              |                                       |              |
| Revenues:                                                  |                                   |                              |                                       |              |
| Premiums                                                   | \$62,967                          | 21,807                       | —                                     | 84,774       |
| Net investment income                                      | 10,488                            | 6,521                        | 645                                   | 17,654       |
| Realized investment gains, net                             | 81                                | 31                           | 1                                     | 113          |
| Other income                                               | 414                               | 136                          | 63                                    | 613          |
| Total revenue                                              | 73,950                            | 28,495                       | 709                                   | 103,154      |
| Benefits and expenses:                                     |                                   |                              |                                       |              |
| Insurance benefits paid or provided:                       |                                   |                              |                                       |              |
| Claims and surrenders                                      | 20,767                            | 10,699                       | —                                     | 31,466       |
| Increase in future policy benefit reserves                 | 33,089                            | 1,766                        | —                                     | 34,855       |
| Policyholders' dividends                                   | 4,275                             | 34                           | —                                     | 4,309        |
| Total insurance benefits paid or provided                  | 58,131                            | 12,499                       | —                                     | 70,630       |
| Commissions                                                | 12,276                            | 7,211                        | —                                     | 19,487       |
| Other general expenses                                     | 5,780                             | 6,491                        | 1,770                                 | 14,041       |
| Capitalization of deferred policy acquisition costs        | (11,256)                          | (2,778)                      | —                                     | (14,034)     |
| Amortization of deferred policy acquisition costs          | 7,855                             | 1,134                        | —                                     | 8,989        |
| Amortization of cost of customer relationships<br>acquired | 321                               | 817                          | —                                     | 1,138        |
| Total benefits and expenses                                | 73,107                            | 25,374                       | 1,770                                 | 100,251      |
| Income (loss) before income tax expense                    | \$843                             | 3,121                        | (1,061)                               | 2,903        |

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

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

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

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

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

## (4) Earnings Per Share

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

|                                                                    | Three Months Ended                          |               |
|--------------------------------------------------------------------|---------------------------------------------|---------------|
|                                                                    | June 30, 2013                               | June 30, 2012 |
|                                                                    | (In thousands,<br>except per share amounts) |               |
| Basic and diluted earnings per share:                              |                                             |               |
| Numerator:                                                         |                                             |               |
| Net income                                                         | \$1,307                                     | 403           |
| Net income allocated to Class A common stock                       | \$1,293                                     | 399           |
| Net income allocated to Class B common stock                       | 14                                          | 4             |
| Net income                                                         | \$1,307                                     | 403           |
| Denominator:                                                       |                                             |               |
| Weighted average shares of Class A outstanding - basic             | 49,080                                      | 48,963        |
| Weighted average shares of Class A outstanding - diluted           | 49,080                                      | 48,989        |
| Weighted average shares of Class B outstanding - basic and diluted | 1,002                                       | 1,002         |
| Basic earnings per share of Class A common stock                   | \$0.03                                      | 0.01          |
| Basic earnings per share of Class B common stock                   | 0.01                                        | —             |
| Diluted earnings per share of Class A common stock                 | 0.03                                        | 0.01          |
| Diluted earnings per share of Class B common stock                 | 0.01                                        | —             |
|                                                                    | Six Months Ended                            |               |
|                                                                    | June 30, 2013                               | June 30, 2012 |
|                                                                    | (In thousands,<br>except per share amounts) |               |
| Basic and diluted earnings per share:                              |                                             |               |
| Numerator:                                                         |                                             |               |
| Net income                                                         | \$2,163                                     | 1,915         |
| Net income allocated to Class A common stock                       | \$2,141                                     | 1,895         |
| Net income allocated to Class B common stock                       | 22                                          | 20            |
| Net income                                                         | \$2,163                                     | 1,915         |
| Denominator:                                                       |                                             |               |
| Weighted average shares of Class A outstanding - basic             | 49,080                                      | 48,961        |
| Weighted average shares of Class A outstanding - diluted           | 49,080                                      | 48,997        |
| Weighted average shares of Class B outstanding - basic and diluted | 1,002                                       | 1,002         |
| Basic earnings per share of Class A common stock                   | \$0.05                                      | 0.04          |
| Basic earnings per share of Class B common stock                   | 0.02                                        | 0.02          |
| Diluted earnings per share of Class A common stock                 | 0.05                                        | 0.04          |
| Diluted earnings per share of Class B common stock                 | 0.02                                        | 0.02          |

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

## (5) Investments

The Company invests primarily in fixed maturity securities, which totaled 84.4% of total investments and cash and cash equivalents at June 30, 2013.

|                                              | June 30, 2013     |                                 | December 31, 2012 |                                 |       |   |
|----------------------------------------------|-------------------|---------------------------------|-------------------|---------------------------------|-------|---|
|                                              | Carrying<br>Value | % of Total<br>Carrying<br>Value | Carrying<br>Value | % of Total<br>Carrying<br>Value |       |   |
|                                              | (In thousands)    |                                 | (In thousands)    |                                 |       |   |
| Fixed maturity securities                    | \$808,317         | 84.4                            | %                 | \$791,528                       | 82.7  | % |
| Equity securities                            | 52,699            | 5.5                             | %                 | 53,741                          | 5.6   | % |
| Mortgage loans                               | 687               | 0.1                             | %                 | 1,509                           | 0.2   | % |
| Policy loans                                 | 45,824            | 4.8                             | %                 | 42,993                          | 4.5   | % |
| Real estate and other long-term investments  | 8,565             | 0.9                             | %                 | 8,553                           | 0.9   | % |
| Short-term investments                       | —                 | —                               | %                 | 2,340                           | 0.2   | % |
| Cash and cash equivalents                    | 41,013            | 4.3                             | %                 | 56,299                          | 5.9   | % |
| Total cash, cash equivalents and investments | \$957,105         | 100.0                           | %                 | \$956,963                       | 100.0 | % |

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

The following tables represent the cost, gross unrealized gains and losses and fair value for fixed maturities and equity securities as of the periods indicated.

|                                       | June 30, 2013  |            |            |         |
|---------------------------------------|----------------|------------|------------|---------|
|                                       | Cost or        | Gross      | Gross      | Fair    |
|                                       | Amortized      | Unrealized | Unrealized | Value   |
|                                       | Cost           | Gains      | Losses     |         |
|                                       | (In thousands) |            |            |         |
| Fixed maturities:                     |                |            |            |         |
| Available-for-sale:                   |                |            |            |         |
| U.S. Treasury securities              | \$ 10,139      | 2,856      | —          | 12,995  |
| U.S. Government-sponsored enterprises | 63,300         | 2,069      | 97         | 65,272  |
| States and political subdivisions     | 347,580        | 10,582     | 9,170      | 348,992 |
| Foreign governments                   | 104            | 29         | —          | 133     |
| Corporate                             | 204,613        | 13,729     | 1,394      | 216,948 |
| Commercial mortgage-backed            | 349            | 13         | —          | 362     |
| Residential mortgage-backed           | 4,092          | 317        | 2          | 4,407   |
| Total available-for-sale securities   | 630,177        | 29,595     | 10,663     | 649,109 |
| Held-to-maturity securities:          |                |            |            |         |
| U.S. Government-sponsored enterprises | 10,446         | 248        | 5          | 10,689  |
| States and political subdivisions     | 118,327        | 2,801      | 1,764      | 119,364 |
| Corporate                             | 30,435         | 606        | 82         | 30,959  |
| Total held-to-maturity securities     | 159,208        | 3,655      | 1,851      | 161,012 |
| Total fixed maturities                | \$789,385      | 33,250     | 12,514     | 810,121 |
| Equity securities:                    |                |            |            |         |
| Stock mutual funds                    | \$ 10,463      | 719        | —          | 11,182  |
| Bond mutual funds                     | 41,505         | 15         | 732        | 40,788  |
| Common stock                          | 17             | —          | 4          | 13      |
| Preferred stock                       | 407            | 309        | —          | 716     |
| Total equity securities               | \$52,392       | 1,043      | 736        | 52,699  |

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

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

At June 30, 2013, the Company had \$4.4 million of mortgage-backed security holdings based on amortized cost, of which \$4.1 million, or 93.2%, were residential U.S. Government-sponsored issues. Mortgage-backed securities are also referred to as securities not due at a single maturity date throughout this report. The majority of the Company's equity securities are diversified stock and bond mutual funds.

## Valuation of Investments in Fixed Maturity and Equity Securities

Held-to-maturity securities are reported in the financial statements at amortized cost and available-for-sale securities are reported at fair value.

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

When an other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis. If the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis, the other-than-temporary impairment is recognized in earnings equal to the

Table of Contents

CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

entire difference between the investment's cost and its fair value at the balance sheet date. If the Company does not intend to sell the security and it is more likely than not that the Company will not be required to sell the security before recovery of its amortized cost basis, the other-than-temporary impairment is separated into the following: (a) the amount representing the credit loss; and (b) the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to other factors is recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the other-than-temporary impairment recognized in earnings becomes the new amortized cost basis of the investment. The new amortized cost basis is not adjusted for subsequent recoveries in fair value.

The Company evaluates whether a credit impairment exists for debt securities by considering primarily the following factors: (a) changes in the financial condition of the security's underlying collateral; (b) whether the issuer is current on contractually obligated interest and principal payments; (c) changes in the financial condition, credit rating and near-term prospects of the issuer; (d) the length of time to which the fair value has been less than the amortized cost of the security; and (e) the payment structure of the security. The Company's best estimate of expected future cash flows used to determine the credit loss amount is a quantitative and qualitative process. Quantitative review includes information received from third party sources such as financial statements, pricing and rating changes, liquidity and other statistical information. Qualitative factors include judgments related to business strategies, economic impacts on the issuer and overall judgment related to estimates and industry factors. The Company's best estimate of future cash flows involves assumptions including, but not limited to, various performance indicators, such as historical and projected default and recovery rates, credit ratings, and current delinquency rates. These assumptions require the use of significant management judgment and include the probability of issuer default and estimates regarding timing and amount of expected recoveries, which may include estimating the underlying collateral value. In addition, projections of expected future debt security cash flows may change based upon new information regarding the performance of the issuer.

The primary factors considered in evaluating whether an impairment exists for an equity security include, but are not limited to: (a) the length of time and the extent to which the fair value has been less than the cost of the security; (b) changes in the financial condition, credit rating and near-term prospects of the issuer; (c) whether the issuer is current on contractually obligated payments; and (d) the intent and ability of the Company to retain the investment for a period of time sufficient to allow for recovery.

The Company did not recognize any other-than-temporary impairments ("OTTI") during the six months ended June 30, 2013 and 2012.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

The following tables present the fair values and gross unrealized losses of fixed maturities and equity securities that have remained in a continuous unrealized loss position for the periods indicated.

|                                            | June 30, 2013       |                   |                 |                        |                   |                 |            |                   |                 |
|--------------------------------------------|---------------------|-------------------|-----------------|------------------------|-------------------|-----------------|------------|-------------------|-----------------|
|                                            | Less than 12 months |                   |                 | Greater than 12 months |                   |                 | Total      |                   |                 |
|                                            | Fair Value          | Unrealized Losses | # of Securities | Fair Value             | Unrealized Losses | # of Securities | Fair Value | Unrealized Losses | # of Securities |
| (In thousands, except for # of securities) |                     |                   |                 |                        |                   |                 |            |                   |                 |
| Fixed maturities:                          |                     |                   |                 |                        |                   |                 |            |                   |                 |
| Available-for-sale securities:             |                     |                   |                 |                        |                   |                 |            |                   |                 |
| U.S.                                       |                     |                   |                 |                        |                   |                 |            |                   |                 |
| Government-sponsored enterprises           | \$8,676             | 97                | 7               | —                      | —                 | —               | 8,676      | 97                | 7               |
| States and political subdivisions          | 192,682             | 8,438             | 214             | 7,875                  | 732               | 8               | 200,557    | 9,170             | 222             |
| Corporate                                  | 44,184              | 1,394             | 30              | —                      | —                 | —               | 44,184     | 1,394             | 30              |
| Residential mortgage-backed                | 3                   | —                 | 1               | 48                     | 2                 | 1               | 51         | 2                 | 2               |
| Total available-for-sale securities        | 245,545             | 9,929             | 252             | 7,923                  | 734               | 9               | 253,468    | 10,663            | 261             |
| Held-to-maturity securities:               |                     |                   |                 |                        |                   |                 |            |                   |                 |
| U.S.                                       |                     |                   |                 |                        |                   |                 |            |                   |                 |
| Government-sponsored enterprises           | 3,908               | 5                 | 2               | —                      | —                 | —               | 3,908      | 5                 | 2               |
| States and political subdivisions          | 53,296              | 1,764             | 47              | —                      | —                 | —               | 53,296     | 1,764             | 47              |
| Corporate                                  | 5,496               | 82                | 4               | —                      | —                 | —               | 5,496      | 82                | 4               |
| Total held-to-maturity securities          | 62,700              | 1,851             | 53              | —                      | —                 | —               | 62,700     | 1,851             | 53              |
| Total fixed maturities                     | \$308,245           | 11,780            | 305             | 7,923                  | 734               | 9               | 316,168    | 12,514            | 314             |
| Equity securities:                         |                     |                   |                 |                        |                   |                 |            |                   |                 |
| Bond mutual funds                          | \$34,028            | 607               | 5               | 2,875                  | 125               | 1               | 36,903     | 732               | 6               |
| Common stocks                              | —                   | —                 | —               | 13                     | 4                 | 1               | 13         | 4                 | 1               |
| Total equities                             | \$34,028            | 607               | 5               | 2,888                  | 129               | 2               | 36,916     | 736               | 7               |

As of June 30, 2013, the Company had 9 fixed maturity available-for-sale securities and no held-to-maturity securities that were in an unrealized loss position for greater than 12 months. These securities consisted of municipals and mortgage-backed securities. There is 1 bond mutual fund that is now in a loss position for greater than 12 months. This is a diversified U.S. Government bond fund that has a large percentage of mortgage exposure in Pass Thru and CMO security types which have refinanced in the current interest rate environment. The fund is comprised of only U.S. Government bond assets.



Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

|                                            | December 31, 2012   |                   |                 | Greater than 12 months |                   |                 | Total               |                   |                 |
|--------------------------------------------|---------------------|-------------------|-----------------|------------------------|-------------------|-----------------|---------------------|-------------------|-----------------|
|                                            | Less than 12 months |                   |                 | Less than 12 months    |                   |                 | Less than 12 months |                   |                 |
|                                            | Fair Value          | Unrealized Losses | # of Securities | Fair Value             | Unrealized Losses | # of Securities | Fair Value          | Unrealized Losses | # of Securities |
| (In thousands, except for # of securities) |                     |                   |                 |                        |                   |                 |                     |                   |                 |
| Fixed maturities:                          |                     |                   |                 |                        |                   |                 |                     |                   |                 |
| Available-for-sale securities:             |                     |                   |                 |                        |                   |                 |                     |                   |                 |
| U.S.                                       |                     |                   |                 |                        |                   |                 |                     |                   |                 |
| Government-sponsored enterprises           | \$10,603            | 22                | 9               | —                      | —                 | —               | 10,603              | 22                | 9               |
| States and political subdivisions          | 54,115              | 443               | 61              | 5,099                  | 334               | 2               | 59,214              | 777               | 63              |
| Corporate                                  | 22,316              | 286               | 16              | —                      | —                 | —               | 22,316              | 286               | 16              |
| Commercial mortgage-backed                 | 94                  | 2                 | 1               | —                      | —                 | —               | 94                  | 2                 | 1               |
| Residential mortgage-backed                | —                   | —                 | —               | 52                     | 2                 | 1               | 52                  | 2                 | 1               |
| Total available-for-sale securities        | 87,128              | 753               | 87              | 5,151                  | 336               | 3               | 92,279              | 1,089             | 90              |
| Held-to-maturity securities:               |                     |                   |                 |                        |                   |                 |                     |                   |                 |
| States and political subdivisions          | 40,611              | 378               | 32              | —                      | —                 | —               | 40,611              | 378               | 32              |
| Total held-to-maturity securities          | 40,611              | 378               | 32              | —                      | —                 | —               | 40,611              | 378               | 32              |
| Total fixed maturities                     | \$127,739           | 1,131             | 119             | 5,151                  | 336               | 3               | 132,890             | 1,467             | 122             |
| Equity securities:                         |                     |                   |                 |                        |                   |                 |                     |                   |                 |
| Stock mutual funds                         | \$—                 | —                 | —               | 972                    | 28                | 1               | 972                 | 28                | 1               |
| Bond mutual funds                          | 3,335               | 88                | 1               | 2,959                  | 41                | 2               | 6,294               | 129               | 3               |
| Common stock                               | 15                  | 2                 | 1               | —                      | —                 | —               | 15                  | 2                 | 1               |
| Total equities                             | \$3,350             | 90                | 2               | 3,931                  | 69                | 3               | 7,281               | 159               | 5               |

We have reviewed these securities for the periods ended June 30, 2013 and December 31, 2012 and determined that no other-than-temporary impairment exists based on our evaluation of the credit worthiness of the issuers and the fact that we do not intend to sell the investments nor is it likely that we will be required to sell the securities before recovery of their amortized cost bases which may be maturity. We continue to monitor all securities on an on-going basis, and future information may become available which could result in impairments being recorded.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

The amortized cost and fair value of fixed maturity securities at June 30, 2013 by contractual maturity are shown in the table below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|                                              | June 30, 2013  |            |
|----------------------------------------------|----------------|------------|
|                                              | Amortized Cost | Fair Value |
|                                              | (In thousands) |            |
| Available-for-sale securities:               |                |            |
| Due in one year or less                      | \$236,253      | 242,160    |
| Due after one year through five years        | 103,078        | 109,314    |
| Due after five years through ten years       | 119,601        | 123,041    |
| Due after ten years                          | 166,804        | 169,825    |
| Securities not due at a single maturity date | 4,441          | 4,769      |
| Total available-for-sale securities          | 630,177        | 649,109    |
| Held-to-maturity securities:                 |                |            |
| Due in one year or less                      | 11,206         | 10,854     |
| Due after one year through five years        | 41,795         | 42,539     |
| Due after five years through ten years       | 38,399         | 39,499     |
| Due after ten years                          | 67,808         | 68,120     |
| Total held-to-maturity securities            | 159,208        | 161,012    |
| Total fixed maturities                       | \$789,385      | 810,121    |

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

The Company uses the specific identification method of the individual security to determine the cost basis used in the calculation of realized gains and losses related to security sales. Proceeds and gross realized gains from sales of securities for the three and six months ended June 30, 2013 and 2012 are summarized as follows.

|                       | Fixed Maturities Available-for-Sale |      |                  |      | Equity Securities  |      |                  |      |
|-----------------------|-------------------------------------|------|------------------|------|--------------------|------|------------------|------|
|                       | Three Months Ended                  |      | Six Months Ended |      | Three Months Ended |      | Six Months Ended |      |
|                       | June 30,                            |      | June 30,         |      | June 30,           |      | June 30,         |      |
|                       | 2013                                | 2012 | 2013             | 2012 | 2013               | 2012 | 2013             | 2012 |
|                       | (In thousands)                      |      |                  |      |                    |      |                  |      |
| Proceeds              | \$—                                 | —    | 58               | 503  | —                  | —    | —                | —    |
| Gross realized gains  | \$—                                 | —    | 1                | 4    | —                  | —    | —                | —    |
| Gross realized losses | \$—                                 | —    | —                | 3    | —                  | —    | —                | —    |

During the six months ended June 30, 2013, one fixed maturity security was sold which resulted in a minimal realized gain. There were no securities sold at a loss during the three or six month periods ended June 30, 2013 or 2012. There were no securities sold from the held-to-maturity portfolio for the six months ended June 30, 2013 or 2012.

Table of Contents

CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

(6) Fair Value Measurements

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. We hold available-for-sale fixed maturity securities and equity securities, which are carried at fair value.

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

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

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

Level 3 - Instruments whose significant value drivers are unobservable.

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

Level 2 includes those financial instruments that are valued by independent pricing services or broker quotes. These models are primarily industry-standard models that consider various inputs, such as interest rates, credit spreads and foreign exchange rates for the underlying financial instruments. All significant inputs are observable, or derived from observable information in the marketplace or are supported by observable levels at which transactions are executed in the marketplace. Financial instruments in this category primarily include corporate securities, U.S.

Government-sponsored enterprise securities, municipal securities and certain mortgage and asset-backed securities.

Level 3 is comprised of financial instruments whose fair value is estimated based on non-binding broker prices utilizing significant inputs not based on or corroborated by readily available market information. This category consists of two private placement mortgage-backed securities.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

The following tables set forth our assets and liabilities that are measured at fair value on a recurring basis as of the dates indicated.

| Available-for-sale investments                          | June 30, 2013     |         |         | Total<br>Fair Value |
|---------------------------------------------------------|-------------------|---------|---------|---------------------|
|                                                         | Level 1           | Level 2 | Level 3 |                     |
|                                                         | (In thousands)    |         |         |                     |
| Financial assets:                                       |                   |         |         |                     |
| Fixed maturities:                                       |                   |         |         |                     |
| U.S. Treasury and U.S. Government-sponsored enterprises | \$12,995          | 65,272  | —       | 78,267              |
| States and political subdivisions                       | —                 | 348,992 | —       | 348,992             |
| Corporate                                               | —                 | 216,948 | —       | 216,948             |
| Commercial mortgage-backed                              | —                 | 14      | 348     | 362                 |
| Residential mortgage-backed                             | —                 | 4,407   | —       | 4,407               |
| Foreign governments                                     | —                 | 133     | —       | 133                 |
| Total fixed maturities                                  | 12,995            | 635,766 | 348     | 649,109             |
| Equity securities:                                      |                   |         |         |                     |
| Stock mutual funds                                      | 11,182            | —       | —       | 11,182              |
| Bond mutual funds                                       | 40,788            | —       | —       | 40,788              |
| Common stock                                            | 13                | —       | —       | 13                  |
| Preferred stock                                         | 716               | —       | —       | 716                 |
| Total equity securities                                 | 52,699            | —       | —       | 52,699              |
| Total financial assets                                  | \$65,694          | 635,766 | 348     | 701,808             |
|                                                         |                   |         |         |                     |
| Available-for-sale investments                          | December 31, 2012 |         |         | Total<br>Fair Value |
|                                                         | Level 1           | Level 2 | Level 3 |                     |
|                                                         | (In thousands)    |         |         |                     |
| Financial assets:                                       |                   |         |         |                     |
| Fixed maturities:                                       |                   |         |         |                     |
| U.S. Treasury and U.S. Government-sponsored enterprises | \$13,943          | 85,581  | —       | 99,524              |
| States and political subdivisions                       | —                 | 282,262 | —       | 282,262             |
| Corporate                                               | —                 | 216,005 | —       | 216,005             |
| Commercial mortgage-backed                              | —                 | 109     | 387     | 496                 |
| Residential mortgage-backed                             | —                 | 6,092   | —       | 6,092               |
| Foreign governments                                     | —                 | 141     | —       | 141                 |
| Total fixed maturities                                  | 13,943            | 590,190 | 387     | 604,520             |
| Equity securities:                                      |                   |         |         |                     |
| Stock mutual funds                                      | 10,685            | —       | —       | 10,685              |
| Bond mutual funds                                       | 41,916            | —       | —       | 41,916              |
| Common stock                                            | 15                | —       | —       | 15                  |
| Preferred stock                                         | 1,125             | —       | —       | 1,125               |
| Total equity securities                                 | 53,741            | —       | —       | 53,741              |
| Total financial assets                                  | \$67,684          | 590,190 | 387     | 658,261             |



Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

## Financial Instruments Valuation

Fixed maturity securities, available-for-sale. At June 30, 2013, our fixed maturity securities, valued using a third-party pricing source, totaled \$635.8 million for Level 2 assets and comprised 90.6% of total reported fair value of our financial assets. The Level 1 and Level 2 valuations are reviewed and updated quarterly through random testing by comparisons to separate pricing models, other third-party pricing services, and back tested to recent trades. In addition, we obtain information relative to the third-party pricing models and review model parameters for reasonableness. Fair values for Level 3 assets are based upon unadjusted broker quotes that are non-binding, and consist of two private placement mortgage-backed securities with a total value of \$0.3 million. Our Level 3 assets are current relative to principal and interest payments and are considered immaterial to our financial statements. For the six months ended June 30, 2013, there were no material changes to the valuation methods or assumptions used to determine fair values, and no broker or third party prices were changed from the values received.

Equity securities, available-for-sale. Our available-for-sale equity securities are classified as Level 1 assets as their fair values are based upon quoted market prices.

The following table presents additional information about fixed maturity securities measured at fair value on a recurring basis that are classified as Level 3 assets and for which we have utilized significant unobservable inputs to determine fair value.

|                                              | June 30,<br>2013<br>(In thousands) | December 31,<br>2012 |
|----------------------------------------------|------------------------------------|----------------------|
| Balance at beginning of period               | \$387                              | 459                  |
| Total realized and unrealized gains (losses) |                                    |                      |
| Included in net income                       | —                                  | —                    |
| Included in other comprehensive income       | (4                                 | ) (6                 |
| Principal paydowns                           | (35                                | ) (66                |
| Transfer in and (out) of Level 3             | —                                  | —                    |
| Balance at end of period                     | \$348                              | 387                  |

We review the fair value hierarchy classifications each reporting period. Changes in the observability of the valuation attributes may result in a reclassification of certain financial assets. Such reclassifications are reported as transfers in and out of Level 3 at the beginning fair value for the reporting period in which the changes occur. There were no transfers in or out of Level 1 or 2.

## Financial Instruments not Carried at Fair Value

Estimates of fair values are made at a specific point in time, based on relevant market prices and information about the financial instruments. The estimated fair values of financial instruments presented below are not necessarily indicative of the amounts the Company might realize in actual market transactions.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

The carrying amount and fair value for the financial assets and liabilities on the consolidated balance sheets not otherwise disclosed for the periods indicated are as follows:

|                                    | June 30, 2013  |            | December 31, 2012 |            |
|------------------------------------|----------------|------------|-------------------|------------|
|                                    | Carrying Value | Fair Value | Carrying Value    | Fair Value |
|                                    | (In thousands) |            |                   |            |
| Financial assets:                  |                |            |                   |            |
| Fixed maturities, held-to-maturity | \$159,208      | 161,012    | 187,008           | 193,739    |
| Mortgage loans                     | 687            | 712        | 1,509             | 1,503      |
| Policy loans                       | 45,824         | 45,824     | 42,993            | 42,993     |
| Short-term investments             | —              | —          | 2,340             | 2,340      |
| Cash and cash equivalents          | 41,013         | 41,013     | 56,299            | 56,299     |
| Financial liabilities:             |                |            |                   |            |
| Annuity benefit reserves           | 53,223         | 58,233     | 51,750            | 54,981     |

Fair values for fixed income securities, which are characterized as Level 2 assets in the fair value hierarchy, are based on quoted market prices for the same or similar securities. In cases where quoted market prices are not available, fair values are based on estimates using present value or other assumptions, including a discount rate and estimates of future cash flows.

Mortgage loans are secured principally by residential and commercial properties. Weighted average interest rates for these loans were approximately 6.5% and 6.6% as of June 30, 2013 and December 31, 2012, respectively, with maturities ranging from 1 to 30 years. Management estimated the fair value using an annual interest rate of 6.25% at June 30, 2013. Our mortgage loans are considered Level 3 assets in the fair value hierarchy.

Policy loans had a weighted average annual interest rate of 7.7% as of June 30, 2013 and December 31, 2012, and no specified maturity dates. The aggregate fair value of policy loans approximates the carrying value reflected on the consolidated balance sheets. These loans typically carry an interest rate that is tied to the crediting rate applied to the related policy and contract reserves. Policy loans are an integral part of the life insurance policies we have in force, cannot be valued separately and are not marketable. Therefore, the fair value of policy loans approximates the carrying value and policy loans are considered Level 3 assets in the fair value hierarchy.

The fair value of short-term investments approximate carrying value due to their short-term nature. Our short-term investments are considered Level 2 assets in the fair value hierarchy.

The fair value of cash and cash equivalents approximate carrying value and are characterized as Level 1 assets in the fair value hierarchy.

The fair value of the Company's liabilities under annuity contract policies, which are considered Level 3 assets, was estimated at June 30, 2013 using discounted cash flows based upon a swap rate curve with interest rates ranging from 0.35% to 3.63% based upon swap rates adjusted for various risk adjustments. The fair value of liabilities under all insurance contracts are taken into consideration in the overall management of interest rate risk, which seeks to minimize exposure to changing interest rates through the matching of investment maturities with amounts due under insurance contracts.

(7) Commitments and Contingencies

We are a defendant in a lawsuit filed on August 6, 1999, in the Texas District Court, Austin, Texas, now styled Delia Bolanos Andrade, et al., Plaintiffs, v. Citizens Insurance Company of America, et al., Defendants in which a class was originally certified by the trial court and reversed by the Texas Supreme Court in 2007 with an order to the trial court to conduct further proceedings

25

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Table of Contents

CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

June 30, 2013

(Unaudited)

consistent with its ruling. The underlying lawsuit alleged that certain life insurance policies CICA made available to non-U.S. residents, when combined with a policy feature that allowed certain cash benefits to be assigned to two non-U.S. trusts for the purpose of accumulating ownership of our Class A common stock, along with allowing the policyholders to make additional contributions to the trusts, were actually offers and sales of securities that occurred in Texas by unregistered dealers in violation of the Texas securities laws. The remedy sought was rescission and return of the insurance premium payments. On December 9, 2009, the trial court denied the recertification of the class after conducting additional proceedings in accordance with the Texas Supreme Court's ruling. The remaining plaintiffs must now proceed individually, and not as a class, if they intend to pursue their claims against us. Since the December 9, 2009 trial court ruling, no individual cases have been further pursued by the plaintiffs. The probability of the plaintiffs further pursuing their cases individually remains unknown. An estimate of any possible loss or range of losses cannot be made at this time in regard to individuals pursuing claims. However, should the plaintiffs further pursue their claims individually, we intend to vigorously defend any proceedings.

In 2007 and in the aftermath of Hurricane Katrina, the Attorney General for the State of Louisiana filed suit against SPFIC and every other homeowner insurer doing business in the State of Louisiana, on behalf of the State of Louisiana and certain Road Home fund recipients. In April 2013, SPFIC and the State of Louisiana reached a settlement agreement resolving all claims against SPFIC in the Road Home matter for approximately \$183,000. This amount has been accrued in the June 30, 2013 financial statements and did not have a material impact on the consolidated financials.

The Company is currently performing an internal audit related to unclaimed property for all legal reporting entities. By letter dated July 2, 2013, the Company was informed that the Louisiana Department of Treasury has authorized an audit of Citizens, Inc. and its affiliates for compliance with unclaimed property laws. This audit is being conducted by Verus Financial LLC on behalf of the state.

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

(8) Income Taxes

The effective tax rate was 27.2% and (18.9)% for the second quarter and 25.5% and 21.3% for the six months ended June 30, 2013 and 2012, respectively. In periods where our effective tax rate is lower than the statutory tax rate of 35%, the difference is primarily due to tax-exempt interest from state and local bonds. The effective tax rate is lower in 2012 compared to 2013 primarily due to 2012 pretax income being lower than in 2013 with tax-exempt income remaining relatively flat.

(9) Related Party Transactions

The Company has various routine related party transactions in conjunction with our holding company structure, such as a management service agreement related to costs incurred, a tax sharing agreement between entities, and inter-company dividends and capital contributions. There were no changes related to these relationships during the six months ended June 30, 2013. See our Annual Report on Form 10-K as of December 31, 2012 for a comprehensive discussion of related party transactions.



Table of Contents

CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

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

FORWARD-LOOKING STATEMENTS

Certain statements contained in this Quarterly Report on Form 10-Q are not statements of historical fact and constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act (the "Act"), including, without limitation, statements specifically identified as forward-looking statements within this document. Many of these statements contain risk factors as well. In addition, certain statements in future filings by the Company with the Securities and Exchange Commission, in press releases, and in oral and written statements made by us or with the approval of the Company, which are not statements of historical fact, constitute forward-looking statements within the meaning of the Act. Examples of forward-looking statements include, but are not limited to: (i) projections of revenues, income or loss, earnings or loss per share, the payment or non-payment of dividends, capital structure, and other financial items, (ii) statements of our plans and objectives by our management or Board of Directors, including those relating to products or services, (iii) statements of future economic performance and (iv) statements of assumptions underlying such statements. Words such as "believes," "anticipates," "assumes," "estimates," "plans," "projects," "could," "expects," "intends," "targeted," "may," "will" and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements.

Forward-looking statements are subject to known and unknown risks, uncertainties and other factors that may cause actual results to differ materially from those contemplated by the forward-looking statements. Factors that could cause the Company's future results to differ materially from expected results include, but are not limited to:

- Changes in foreign and U.S. general economic, market, and political conditions, including the performance of financial markets and interest rates;
- Changes in consumer behavior, which may affect the Company's ability to sell its products and retain business;
- The timely development of and acceptance of new products of the Company and perceived overall value of these products and services by existing and potential customers;
- Fluctuations in experience regarding current mortality, morbidity, persistency and interest rates relative to expected amounts used in pricing and actuarial valuation of the Company's products;
- The performance of our investment portfolio, which may be adversely affected by changes in interest rates, adverse developments and ratings of issuers whose debt securities we may hold, and other adverse macroeconomic events;
- Results of litigation we may be involved in;
- Changes in assumptions related to deferred acquisition costs and the value of any businesses we may acquire;
- Regulatory, accounting or tax changes that may affect the cost of, or the demand for, the Company's products or services;
- Our concentration of business from persons residing in Latin America and the Pacific Rim;
- Changes in tax laws;
- Effects of acquisitions and restructuring, including possible difficulties in integrating and realizing the projected results of acquisitions;
- Changes in statutory or U.S. GAAP accounting principles, policies or practices; and
- Our success at managing risks involved in the foregoing;
- The risk factors discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012 under the heading "Part II. - Item 1A - Risk Factors."

Such forward-looking statements speak only as of the date on which such statements are made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made.

We make available, free of charge, through our Internet website (<http://www.citizensinc.com>), our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, Section 16 Reports filed by officers and directors, news

Table of Contents

CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

releases, and, if applicable, amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as soon as reasonably practicable after we electronically file such reports with, or furnish such reports to, the Securities and Exchange Commission. We are not including any of the information contained on our website as part of, or incorporating it by reference into, this Quarterly Report on Form 10-Q.

Overview

Citizens is an insurance holding company serving the life insurance needs of individuals in the United States since 1969 and internationally since 1975. Through our insurance subsidiaries, we pursue a strategy of offering traditional insurance products in niche markets where we believe we are able to achieve competitive advantages. As of June 30, 2013, we had approximately \$1.2 billion of total assets and approximately \$5.0 billion of insurance in force. Our core insurance operations include issuing and servicing:

- U.S. Dollar-denominated ordinary whole life insurance and endowment policies predominantly to high net worth, high income foreign residents, principally in Latin America and the Pacific Rim through independent marketing consultants;
- ordinary whole life insurance policies to middle income households concentrated in the Midwest and southern United States through independent marketing consultants; and
- final expense and limited liability property policies to middle and lower income households in Louisiana, Arkansas and Mississippi through employee and independent agents in our home service distribution channel.

We were formed in 1969 by our Chairman, Harold E. Riley. Prior to our formation, Mr. Riley had many years of experience in the international and domestic life insurance business. Our Company has experienced significant growth through acquisitions in the domestic market and through market expansion in the international market. We seek to capitalize on the experience of our management team in marketing and operations as we strive to generate bottom line return using knowledge of our niche markets and our well-established distribution channels. We believe our underwriting processes, policy terms, pricing practices and proprietary administrative systems enable us to be competitive in our current markets, while protecting our shareholders and servicing our policyholders.

Current Financial Highlights

Financial highlights for the three and six month periods ended June 30, 2013, compared to the same periods in 2012 were:

Insurance premiums rose for the three and six month periods ended June 30, 2013 to \$43.8 million and \$84.8 million in 2013 from \$41.6 million and \$80.7 million in 2012, an increase of 5.4% and 5.1% driven by increased sales and renewal premiums in our life insurance segment.

Net investment income increased 21.7% and 16.2% for the three and six month periods ended June 30, 2013 compared to 2012. The average yield on the consolidated portfolio increased to an annualized rate of 4.03%, up from 3.77% for the same period in 2012, as prevailing interest rates rose modestly. In addition, the increase in the invested assets due to premium revenue growth contributed to the growth in investment income.

Claims and surrenders expense increased 3.4% and 2.0% for the three and six months ended June 30, 2013 compared to 2012, primarily driven by surrender benefits. Claims reported in the life segment were lower in the current year and claims experience in the home service segment was relatively level.

Changes in reserves resulted in liability increases due to the increased sales of endowment products that build up reserves at a faster pace than whole life longer-term mortality based products. Additionally, the sustained low interest

rate environment also results in a higher reserve development due to the lower interest yield assumptions in the current period.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

## Our Operating Segments

Our business is comprised of three operating business segments, as detailed below.

Life Insurance

Home Service Insurance

Other Non-Insurance Enterprises

Our insurance operations are the primary focus of the Company, as those operations generate the majority of our income. See the discussion under Segment Operations for detailed analysis. The amount of insurance, number of policies, and average face amounts of ordinary life policies issued during the periods indicated are shown below.

|              | Six Months Ended June 30,<br>2013 |                                 |                                            | 2012                             |                                 |                                            |
|--------------|-----------------------------------|---------------------------------|--------------------------------------------|----------------------------------|---------------------------------|--------------------------------------------|
|              | Amount of<br>Insurance<br>Issued  | Number of<br>Policies<br>Issued | Average<br>Policy<br>Face Amount<br>Issued | Amount of<br>Insurance<br>Issued | Number of<br>Policies<br>Issued | Average<br>Policy<br>Face Amount<br>Issued |
| Life         | \$171,646,782                     | 2,840                           | \$60,439                                   | \$150,810,098                    | 2,669                           | \$56,504                                   |
| Home Service | 98,310,532                        | 14,330                          | 6,873                                      | 107,567,079                      | 15,390                          | 6,989                                      |

Note: All discussions of results of operations below compare or state results for the three and six-month periods ended June 30, 2013 compared to the three and six-month periods ended June 30, 2012.

## Consolidated Results of Operations

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

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

## Revenues

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

|                                                 | Three Months Ended<br>June 30,<br>2013 |        | Six Months Ended<br>June 30,<br>2013 |        |
|-------------------------------------------------|----------------------------------------|--------|--------------------------------------|--------|
|                                                 | 2012                                   |        | 2012                                 |        |
|                                                 | (In thousands)                         |        |                                      |        |
| Revenues:                                       |                                        |        |                                      |        |
| Premiums:                                       |                                        |        |                                      |        |
| Life insurance                                  | \$42,223                               | 39,945 | 81,637                               | 77,351 |
| Accident and health insurance                   | 406                                    | 417    | 755                                  | 830    |
| Property insurance                              | 1,205                                  | 1,234  | 2,382                                | 2,511  |
| Net investment income                           | 9,265                                  | 7,612  | 17,654                               | 15,189 |
| Realized investment gains, net                  | 82                                     | 246    | 113                                  | 344    |
| Decrease in fair value of warrants              | —                                      | 37     | —                                    | 73     |
| Other income                                    | 427                                    | 111    | 613                                  | 209    |
| Total revenues                                  | 53,608                                 | 49,602 | 103,154                              | 96,507 |
| Exclude fair value adjustments of warrants      | —                                      | (37    | ) —                                  | (73    |
| Total revenues excluding fair value adjustments | \$53,608                               | 49,565 | 103,154                              | 96,434 |

Premium Income. Premium income derived from life, accident and health, and property insurance sales increased 5.4% and 5.1% for the three and six months ended June 30, 2013 compared to the same periods ending June 30, 2012, primarily because of growth in the life segment as discussed under Segment Operations.

Net investment income performance is summarized as follows.

|                                             | June 30,<br>2013             | December 31,<br>2012 | June 30,<br>2012 |   |
|---------------------------------------------|------------------------------|----------------------|------------------|---|
|                                             | (In thousands, except for %) |                      |                  |   |
| Net investment income, annualized           | \$35,309                     | 31,725               | 30,378           |   |
| Average invested assets, at amortized cost  | 875,868                      | 832,552              | 806,835          |   |
| Annualized yield on average invested assets | 4.03                         | % 3.81               | % 3.77           | % |

Yields on invested assets vary between segment operations due to different portfolio mixes in the segments.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

Investment income from debt securities accounted for approximately 84.7% of total investment income for the three months ended June 30, 2013. In addition, our equity securities portfolio is invested primarily in short duration bond mutual funds as these securities offer a competitive yield.

|                           | Three Months Ended<br>June 30,<br>2013 |       | Six Months Ended<br>June 30,<br>2013 |        |
|---------------------------|----------------------------------------|-------|--------------------------------------|--------|
|                           |                                        | 2012  |                                      | 2012   |
|                           | (In thousands)                         |       |                                      |        |
| Gross investment income:  |                                        |       |                                      |        |
| Fixed maturity securities | \$8,240                                | 6,657 | 15,696                               | 13,199 |
| Equity securities         | 481                                    | 451   | 925                                  | 1,009  |
| Mortgage loans            | 28                                     | 18    | 48                                   | 45     |
| Policy loans              | 882                                    | 803   | 1,704                                | 1,613  |
| Long-term investments     | 53                                     | 56    | 110                                  | 121    |
| Other investment income   | 19                                     | 37    | 38                                   | 57     |
| Total investment income   | 9,703                                  | 8,022 | 18,521                               | 16,044 |
| Investment expenses       | (438)                                  | (410) | (867)                                | (855)  |
| Net investment income     | \$9,265                                | 7,612 | 17,654                               | 15,189 |

We have reduced bond holdings of U.S. Government-sponsored enterprises, such as Federal National Mortgage Association ("FNMA") and Federal Home Loan Mortgage Corporation ("FHLMC"), which comprised 9.3% of the total fixed maturity portfolio based on amortized cost at June 30, 2013 compared to 14.8% at December 31, 2012, due to the low yields in the current environment. We have increased our investment purchases of corporate and municipal securities over the past several quarters, focusing on utility service sectors in corporate securities. As a percent of the total, state and political subdivision holdings at June 30, 2013 increased to 59.0% and corporate holdings totaled 29.8% based upon amortized cost compared to 52.4% and 30.6% at December 31, 2012, respectively. In addition, the increase in policy loans, which represents policyholders utilizing their accumulated policy cash value, contributed to the improvement in investment income.

**Change in Fair Value of Warrants.** Prior to 2013, the Company adjusted the liability related to its outstanding warrants to purchase shares of Class A common stock at each reporting date to reflect the current fair value of the warrants computed based on the Class A common stock value calculated using the Black-Scholes option pricing model. As the Class A common stock value increased and decreased, the change in the warrant liability also would increase and decrease in inverse order. The adjustment to fair value was recorded as an increase or decrease in the fair value of the warrants in the consolidated statement of operations. The remaining warrants were the subject of a cashless exercise transaction whereby the Company issued 12,487 Class A shares on October 6, 2012. There were no warrants outstanding during 2013.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

## Benefits and Expenses

|                                                         | Three Months Ended<br>June 30,<br>2013 |         | Six Months Ended<br>June 30,<br>2013 |          |
|---------------------------------------------------------|----------------------------------------|---------|--------------------------------------|----------|
|                                                         | 2012                                   |         | 2012                                 |          |
|                                                         | (In thousands)                         |         |                                      |          |
| Benefits and expenses:                                  |                                        |         |                                      |          |
| Insurance benefits paid or provided:                    |                                        |         |                                      |          |
| Claims and surrenders                                   | \$ 16,660                              | 16,109  | 31,466                               | 30,863   |
| Increase in future policy benefit reserves              | 17,896                                 | 16,751  | 34,855                               | 30,892   |
| Policyholders' dividends                                | 2,235                                  | 2,281   | 4,309                                | 4,155    |
| Total insurance benefits paid or provided               | 36,791                                 | 35,141  | 70,630                               | 65,910   |
| Commissions                                             | 10,429                                 | 9,731   | 19,487                               | 18,395   |
| Other general expenses                                  | 7,342                                  | 6,342   | 14,041                               | 12,958   |
| Capitalization of deferred policy acquisition costs     | (7,672)                                | (7,044) | (14,034)                             | (12,983) |
| Amortization of deferred policy acquisition costs       | 4,363                                  | 4,433   | 8,989                                | 8,559    |
| Amortization of cost of customer relationships acquired | 560                                    | 660     | 1,138                                | 1,236    |
| Total benefits and expenses                             | \$ 51,813                              | 49,263  | 100,251                              | 94,075   |

Claims and Surrenders. A detail of claims and surrender benefits is provided below.

|                              | Three Months Ended<br>June 30,<br>2013 |        | Six Months Ended<br>June 30,<br>2013 |        |
|------------------------------|----------------------------------------|--------|--------------------------------------|--------|
|                              | 2012                                   |        | 2012                                 |        |
|                              | (In thousands)                         |        |                                      |        |
| Death claims                 | \$ 5,390                               | 5,752  | 10,924                               | 11,477 |
| Surrender benefits           | 5,941                                  | 5,034  | 10,497                               | 9,667  |
| Endowments                   | 3,999                                  | 4,153  | 7,588                                | 7,633  |
| Property claims              | 418                                    | 499    | 969                                  | 863    |
| Accident and health benefits | 119                                    | 63     | 167                                  | 138    |
| Other policy benefits        | 793                                    | 608    | 1,321                                | 1,085  |
| Total claims and surrenders  | \$ 16,660                              | 16,109 | 31,466                               | 30,863 |

Increase in Future Policy Benefit Reserves. The increase in future policy benefit reserves for the three and six months ended June 30, 2013, was influenced by higher reserves for policies issued as we continue to experience growth in new sales of endowment products, which require higher initial reserve levels than whole life products. Internationally, endowment sales have outpaced our whole life products for the past several years. We are experiencing a compounding of reserve increases as these policies build up reserves faster because of the shorter terms when compared to whole life products that build reserves over the expected mortality period.

Policyholder Dividends. The majority of our international policies are participating, and the dividends are factored into the premium rates charged. As policy provisioned dividend rates generally increase each year that a policy is in force, dividend expense is expected to increase as this block of insurance becomes more seasoned.

Commissions. Commission expense is directly related to new and renewal insurance premium fluctuations and production levels by agents and associates. Commission expense for the three and six months ended June 30, 2013

increased due to higher first year premiums in the life segment compared to premium levels for the same periods ended June 30, 2012.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

**Capitalized and Amortized Deferred Policy Acquisition Costs.** Costs capitalized under current accounting guidance include certain commissions, policy issuance costs, and underwriting and agency expenses that relate to successful sales efforts for insurance contracts. The increase for the three and six months ended June 30, 2013, compared to the same periods in 2012 was the result of an increase in first year premium production in the current year, which increased capitalized amounts. Though premium revenue increased for the first six months of 2013, it was primarily related to an increase in renewal premiums compared to the prior year. Commissions paid on renewal premiums are significantly lower than those paid on first year business.

Amortization for the six months ended June 30, 2013, increased approximately \$0.4 million compared to the same period in 2012. Amortization of deferred policy acquisition costs is impacted by persistency and may fluctuate from year to year.

**Other General Expenses.** Expenses rose for the three and six months ended June 30, 2013, compared to the same period in 2012 as overall expenses increased because of higher employee health claims, as we are self-insured, and costs for temporary employees assisting on operations projects.

**Federal Income Tax.** The effective tax rate for the three and six month periods ended June 30, 2013, were 27.2% and 25.5% versus (18.9)% and 21.3% in 2012, respectively. Differences between our effective tax rate and the statutory tax rate result from income and expense items that are treated differently for financial reporting and tax purposes. See Note 8 - Income Taxes in the consolidated financial statements for further discussion.

## Segment Operations

The Company has three reportable segments: Life Insurance, Home Service Insurance and Other Non-Insurance Enterprises. These segments are reported in accordance with U.S. GAAP. The Company evaluates profit and loss performance of its segments based on net income or loss before income taxes.

|                                 | Three Months Ended |       |   | Six Months Ended |       |   |
|---------------------------------|--------------------|-------|---|------------------|-------|---|
|                                 | June 30,           |       |   | June 30,         |       |   |
|                                 | 2013               | 2012  |   | 2013             | 2012  |   |
|                                 | (In thousands)     |       |   |                  |       |   |
| Life Insurance                  | \$695              | (952) | ) | 843              | (863) | ) |
| Home Service Insurance          | 1,919              | 1,846 |   | 3,121            | 4,238 |   |
| Other Non-Insurance Enterprises | (819)              | (555) | ) | (1,061)          | (943) | ) |
| Total                           | \$1,795            | 339   |   | 2,903            | 2,432 |   |

## Life Insurance

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



Table of Contents

CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

International Sales

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

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

International Products

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

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

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

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

The following table sets forth, by country, our direct premiums from our international life insurance business for the periods indicated.

| Country        | Three Months Ended |        | Six Months Ended |        |
|----------------|--------------------|--------|------------------|--------|
|                | June 30,<br>2013   | 2012   | June 30,<br>2013 | 2012   |
|                | (In thousands)     |        |                  |        |
| Venezuela      | \$7,374            | 6,453  | 13,773           | 11,511 |
| Columbia       | 5,634              | 5,622  | 11,617           | 11,215 |
| Taiwan         | 3,715              | 3,530  | 7,589            | 7,351  |
| Ecuador        | 3,823              | 3,650  | 7,205            | 6,823  |
| Argentina      | 2,359              | 2,306  | 4,190            | 4,212  |
| Other Non-U.S. | 8,179              | 7,431  | 15,483           | 14,125 |
| Total          | \$31,084           | 28,992 | 59,857           | 55,237 |

We continue to report increased sales in top producing countries as noted above. Our international business and premium collections could be impacted by future changes relative to laws, regulations or economic events in the countries from which we accept applications. In particular, there are recent law changes in Colombia that may impede the activities of our independent consultants. See "Item 1A. Risk Factors" for additional information.

## Domestic Sales

In the Midwest and the southern United States, we seek to serve middle income households through the sale of cash accumulation ordinary whole life insurance products. The majority of our inforce business results from blocks of business of insurance companies we have acquired over the past fifteen years.

## Domestic Products

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

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

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

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

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

|              | Three Months Ended |       | Six Months Ended |       |
|--------------|--------------------|-------|------------------|-------|
|              | June 30,<br>2013   | 2012  | June 30,<br>2013 | 2012  |
|              | (In thousands)     |       |                  |       |
| State        |                    |       |                  |       |
| Texas        | \$694              | 1,113 | 1,338            | 2,354 |
| Indiana      | 332                | 388   | 698              | 808   |
| Mississippi  | 225                | 279   | 453              | 471   |
| Missouri     | 143                | 189   | 285              | 351   |
| Louisiana    | 133                | 91    | 255              | 219   |
| Other States | 855                | 705   | 1,190            | 1,475 |
| Total        | \$2,382            | 2,765 | 4,219            | 5,678 |

A number of domestic life insurance companies we acquired had blocks of accident and health insurance policies, which we did not consider to be a core part of our business. We have ceded this business to Puritan Life Insurance Company ("Puritan"), an unaffiliated insurance company under a coinsurance agreement, under which it assumes substantially all of our accident and health policies. The premium amounts ceded under the coinsurance agreement for the six months ended June 30, 2013 and 2012 were \$0.5 million and \$2.0 million, respectively. The coinsurance agreement allows for full assumption by Puritan of this business upon approval by state insurance authorities. The decrease in premiums for the six months ended June 30, 2013 is due to the fact that Puritan received state approval in several states and intends to complete full assumption in 2013.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

The results of operations for the life insurance segment for the periods indicated are as follows.

|                                                         | Three Months Ended<br>June 30,<br>2013 |         | Six Months Ended<br>June 30,<br>2013 |          |
|---------------------------------------------------------|----------------------------------------|---------|--------------------------------------|----------|
|                                                         | 2012                                   |         | 2012                                 |          |
|                                                         | (In thousands)                         |         |                                      |          |
| Revenue:                                                |                                        |         |                                      |          |
| Premiums                                                | \$32,850                               | 30,601  | 62,967                               | 58,770   |
| Net investment income                                   | 5,584                                  | 4,253   | 10,488                               | 8,411    |
| Realized investment gains, net                          | 81                                     | 187     | 81                                   | 189      |
| Other income                                            | 351                                    | 75      | 414                                  | 132      |
| Total revenue                                           | 38,866                                 | 35,116  | 73,950                               | 67,502   |
| Benefits and expenses:                                  |                                        |         |                                      |          |
| Insurance benefits paid or provided:                    |                                        |         |                                      |          |
| Claims and surrenders                                   | 11,429                                 | 10,772  | 20,767                               | 20,699   |
| Increase in future policy benefit reserves              | 17,047                                 | 16,201  | 33,089                               | 29,419   |
| Policyholders' dividends                                | 2,216                                  | 2,268   | 4,275                                | 4,130    |
| Total insurance benefits paid or provided               | 30,692                                 | 29,241  | 58,131                               | 54,248   |
| Commissions                                             | 6,697                                  | 5,990   | 12,276                               | 11,012   |
| Other general expenses                                  | 2,928                                  | 2,411   | 5,780                                | 5,331    |
| Capitalization of deferred policy acquisition costs     | (6,170)                                | (5,507) | (11,256)                             | (10,019) |
| Amortization of deferred policy acquisition costs       | 3,870                                  | 3,749   | 7,855                                | 7,400    |
| Amortization of cost of customer relationships acquired | 154                                    | 184     | 321                                  | 393      |
| Total benefits and expenses                             | 38,171                                 | 36,068  | 73,107                               | 68,365   |
| Income (loss) before income tax expense                 | \$695                                  | (952)   | 843                                  | (863)    |

Premiums. Premium revenues increased for the three and six month periods ended June 30, 2013, compared to the same period in 2012. Growth in international renewal business, which is experiencing strong persistency as it ages accounted for 5.5% of the increase in each period. Higher first year premium revenues for the three and six months ended June 30, 2013, increased 18.7% and 18.4% driven by sales internationally with endowment to age sixty-five and the twenty-year endowment products being the top performers.

Life insurance premium breakout is detailed below.

|                | Three Months Ended<br>June 30,<br>2013 |        | Six Months Ended<br>June 30,<br>2013 |        |
|----------------|----------------------------------------|--------|--------------------------------------|--------|
|                | 2012                                   |        | 2012                                 |        |
|                | (In thousands)                         |        |                                      |        |
| Premiums:      |                                        |        |                                      |        |
| First year     | \$5,095                                | 4,293  | 9,033                                | 7,632  |
| Renewal        | 27,755                                 | 26,308 | 53,934                               | 51,138 |
| Total premiums | \$32,850                               | 30,601 | 62,967                               | 58,770 |

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

Net Investment Income. Net investment income increased as the impact of the sustained low interest rate environment has leveled and yields are beginning to rise modestly.

|                                             | Six Months Ended<br>June 30,<br>2013<br>(In thousands, except for %) | Year Ended<br>December 31,<br>2012 | Six Months Ended<br>June 30,<br>2012 |   |
|---------------------------------------------|----------------------------------------------------------------------|------------------------------------|--------------------------------------|---|
| Net investment income, annualized           | \$20,976                                                             | 17,828                             | 16,822                               |   |
| Average invested assets, at amortized cost  | \$530,678                                                            | 494,289                            | 474,530                              |   |
| Annualized yield on average invested assets | 3.95                                                                 | % 3.61                             | % 3.55                               | % |

Claims and Surrenders. These amounts fluctuate from period to period but were within anticipated ranges based upon management's expectations.

|                              | Three Months Ended<br>June 30,<br>2013<br>(In thousands) |        | Six Months Ended<br>June 30,<br>2013 |        |
|------------------------------|----------------------------------------------------------|--------|--------------------------------------|--------|
|                              |                                                          | 2012   |                                      | 2012   |
| Death claims                 | \$1,485                                                  | 1,786  | 2,714                                | 3,766  |
| Surrender benefits           | 5,217                                                    | 4,305  | 9,267                                | 8,343  |
| Endowment benefits           | 3,994                                                    | 4,147  | 7,579                                | 7,620  |
| Accident and health benefits | 64                                                       | 51     | 110                                  | 106    |
| Other policy benefits        | 669                                                      | 483    | 1,097                                | 864    |
| Total claims and surrenders  | \$11,429                                                 | 10,772 | 20,767                               | 20,699 |

Death claims expense was lower for the three and six months ended June 30, 2013 due to fewer reported claims.

• Mortality experience is closely monitored by the Company as a key performance indicator and these amounts were within expected levels.

• The majority of policy surrender benefits paid is attributable to our international business and was related to policies that have been in force over twenty years, where surrender charges are no longer applicable.

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

• Other policy benefits resulted primarily from interest paid on premium deposits and policy benefit accumulations and increased as these policy liabilities also increased.

Increase in Future Policy Benefit Reserves. Policy benefit reserves increased for the three and six months ended June 30, 2013 compared to the same period in 2012, from the effect of the current low interest rate environment on reserve development for policies issued and because we continue to experience growth in new sales of endowment products, which require higher initial reserve levels than whole life products. Endowment sales have become more popular with our international clients in the past few years, representing approximately 77% and 79% of total new first year premium in the six months ended June 30, 2013 and 2012, respectively.

Commissions. Commission expense increased for the three and six months ended June 30, 2013, compared to the same periods in 2012. This expense fluctuates directly with new premium revenues, which were higher for the periods in 2013 compared to 2012. Commission rates paid to associates are higher on first year premium sales, which were up as noted above for the three and six months ended June 30, 2013, compared to 2012. Renewal premiums for the three and six months, for which we pay commissions at lower rates, also rose.



Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

Other General Expenses. The expenses are allocated by segment, based upon an annual expense study performed by the Company, and were up for the three and six months ended June 30, 2013, compared to the same period in 2012 as overall expenses increased related to employee health claims, as we are self-insured, and costs for temporary employees assisting on operations projects.

Capitalization of Deferred Policy Acquisition Costs ("DAC"). Capitalized costs increased for the three and six months ended June 30, 2013, due to higher first year premiums and an increase in renewal commissions paid compared to 2012 as discussed above. DAC capitalization is directly correlated to fluctuations in first year commissions.

Amortization of Deferred Policy Acquisition Costs. Amortization for 2013 increased and is impacted by overall persistency related to this segment. As previously noted, persistency is monitored closely by the Company and was within expectations.

## Home Service Insurance

We operate in the Home Service market through our subsidiaries Security Plan Life Insurance Company ("SPLIC") and Security Plan Fire Insurance Company ("SPFIC"), and focus on the life insurance needs of the middle and lower income markets, primarily in Louisiana, Mississippi and Arkansas. Our policies are sold and serviced through a home service marketing distribution system of employee-agents who work full time on a route system and through funeral homes that sell policies, collect premiums and service policyholders.

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

| State        | Three Months Ended |        | Six Months Ended |        |
|--------------|--------------------|--------|------------------|--------|
|              | June 30,<br>2013   | 2012   | June 30,<br>2013 | 2012   |
|              | (In thousands)     |        |                  |        |
| Louisiana    | \$ 10,482          | 10,486 | 20,856           | 20,812 |
| Arkansas     | 425                | 438    | 861              | 965    |
| Mississippi  | 122                | 111    | 240              | 221    |
| Other States | 229                | 226    | 437              | 464    |
| Total        | \$ 11,258          | 11,261 | 22,394           | 22,462 |

## Home Service Insurance Products

Our home service insurance products consist primarily of small face amount ordinary whole life and pre-need policies, which are designed to fund final expenses for the insured, primarily consisting of funeral and burial costs. To a much lesser extent, our home service insurance segment sells limited-liability, named-peril property policies covering dwellings and contents. We provide \$30,000 maximum coverage on any one dwelling and contents, while content only coverage and dwelling only coverage is limited to \$20,000, respectively.

We provide final expense ordinary life insurance and annuity products primarily to middle and lower income individuals primarily in Louisiana, Mississippi and Arkansas. New products were approved for sale in Mississippi in 2012 and we expect to increase sales as we expand our marketing force in this state.



Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

The results of operations for the home service insurance segment for the periods indicated are as follows.

|                                                         | Three Months Ended<br>June 30,<br>2013 |         | Six Months Ended<br>June 30,<br>2013 |         |
|---------------------------------------------------------|----------------------------------------|---------|--------------------------------------|---------|
|                                                         | 2012                                   |         | 2012                                 |         |
|                                                         | (In thousands)                         |         |                                      |         |
| Revenue:                                                |                                        |         |                                      |         |
| Premiums                                                | \$ 10,984                              | 10,995  | 21,807                               | 21,922  |
| Net investment income                                   | 3,341                                  | 3,075   | 6,521                                | 6,230   |
| Realized investment gains, net                          | 1                                      | 40      | 31                                   | 127     |
| Other income                                            | 46                                     | 6       | 136                                  | 12      |
| Total revenue                                           | 14,372                                 | 14,116  | 28,495                               | 28,291  |
| Benefits and expenses:                                  |                                        |         |                                      |         |
| Insurance benefits paid or provided:                    |                                        |         |                                      |         |
| Claims and surrenders                                   | 5,231                                  | 5,337   | 10,699                               | 10,164  |
| Increase in future policy benefit reserves              | 849                                    | 550     | 1,766                                | 1,473   |
| Policyholders' dividends                                | 19                                     | 13      | 34                                   | 25      |
| Total insurance benefits paid or provided               | 6,099                                  | 5,900   | 12,499                               | 11,662  |
| Commissions                                             | 3,732                                  | 3,741   | 7,211                                | 7,383   |
| Other general expenses                                  | 3,225                                  | 3,006   | 6,491                                | 5,970   |
| Capitalization of deferred policy acquisition costs     | (1,502)                                | (1,537) | (2,778)                              | (2,964) |
| Amortization of deferred policy acquisition costs       | 493                                    | 684     | 1,134                                | 1,159   |
| Amortization of cost of customer relationships acquired | 406                                    | 476     | 817                                  | 843     |
| Total benefits and expenses                             | 12,453                                 | 12,270  | 25,374                               | 24,053  |
| Income before income tax expense                        | \$ 1,919                               | 1,846   | 3,121                                | 4,238   |

Premiums. Premiums were essentially flat for the three and six month periods ended June 30, 2013, as new business for this segment was offset by higher lapses in the current year compared to the same period in 2012.

Net Investment Income. Net investment income for our home service insurance segment was as follows.

|                                             | Six Months Ended<br>June 30,<br>2013 | Year Ended<br>December 31,<br>2012 | Six Months Ended<br>June 30,<br>2012 |   |
|---------------------------------------------|--------------------------------------|------------------------------------|--------------------------------------|---|
|                                             | (In thousands, except for %)         |                                    |                                      |   |
| Net investment income, annualized           | \$ 13,042                            | 12,724                             | 12,460                               |   |
| Average invested assets, at amortized cost  | 294,073                              | 291,229                            | 289,373                              |   |
| Annualized yield on average invested assets | 4.43                                 | % 4.37                             | % 4.31                               | % |

Realized Investment Gains, Net. Net realized gains for the three and six months ended June 30, 2013 and 2012, were due to calls of debt securities.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

Claims and Surrenders. Claims and surrenders decreased slightly for the three months and increased for the six months ended June 30, 2013, compared to the same periods in 2012, as reported claims levels fluctuated compared to the prior year, but were within expected ranges.

|                              | Three Months Ended<br>June 30, |       | Six Months Ended<br>June 30, |        |
|------------------------------|--------------------------------|-------|------------------------------|--------|
|                              | 2013                           | 2012  | 2013                         | 2012   |
|                              | (In thousands)                 |       |                              |        |
| Death claims                 | \$3,905                        | 3,966 | 8,210                        | 7,711  |
| Surrender benefits           | 724                            | 729   | 1,230                        | 1,324  |
| Endowment benefits           | 5                              | 6     | 9                            | 13     |
| Property claims              | 418                            | 499   | 969                          | 863    |
| Accident and health benefits | 55                             | 12    | 57                           | 32     |
| Other policy benefits        | 124                            | 125   | 224                          | 221    |
| Total claims and surrenders  | \$5,231                        | 5,337 | 10,699                       | 10,164 |

Death claims expense increased for the six months in 2013, largely reflecting the release of \$0.5 million of incurred but unreported death claims liability by the Company during the three months ended March 31, 2012. Mortality experience is closely monitored by the Company as a key performance indicator and amounts were within expected levels.

Property claims increased 12.3% for the six months ended June 30, 2013 related to an increase in weather related claims reported in the first three months of 2013 compared to 2012.

Increase in Future Policy Benefit Reserves. The increase in future policy benefit reserves for the three and six months ended June 30, 2013 was higher than the same period of 2012 due to an approximately \$0.2 million decrease in reserves recorded in 2012 related to ungrouping of certain plans for reserve modeling assumptions.

Commissions. Commission expense fluctuates based upon sales and premium volume and decreased slightly during 2013 compared to 2012 based upon premium levels reported.

Other General Expenses. The expenses are allocated by segment based upon an annual expense study performed by the Company and increased between 2013 and 2012, as overall consolidated expenses increased related to employee health claims, as we are self-insured, and employee costs related to temporary employees assisting on operations projects.

Capitalization of Deferred Policy Acquisition Costs ("DAC"). Capitalized costs decreased slightly for the three and six months ended June 30, 2013, as commissions expense also decreased slightly during the period. DAC capitalization is directly correlated to fluctuations in new business and commissions.

Amortization of Deferred Policy Acquisition Costs. Amortization for the three and six months ended in the current year decreased compared to the prior year as a change was made in 2012 relative to ungrouping certain plans for developing actuarial derived values which had an impact of increasing amortization for the six months ended by \$0.4 million.

Other Non-Insurance Enterprises

This segment represents the administrative support entities to the insurance operations whose revenues are primarily intercompany and have been eliminated in consolidation under GAAP, which typically results in a segment loss.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

## Investments

The administration of our investment portfolios is handled by our management, pursuant to board-approved investment guidelines, with all trading activity approved by a committee of the respective boards of directors of our insurance company subsidiaries. The guidelines used require that fixed maturities, both government and corporate, are investment grade and comprise a majority of the investment portfolio. State insurance statutes prescribe the quality and percentage of the various types of investments that may be made by insurance companies and generally permit investment in qualified state, municipal, federal and foreign government obligations, high quality corporate bonds, preferred and common stock, mortgage loans and real estate within certain specified percentages. The assets are intended to mature in accordance with the average maturity of the insurance products and to provide the cash flow for our insurance company subsidiaries to meet their respective policyholder obligations.

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

|                                                         | June 30, 2013  |                           | December 31, 2012 |                           |
|---------------------------------------------------------|----------------|---------------------------|-------------------|---------------------------|
|                                                         | Carrying Value | % of Total Carrying Value | Carrying Value    | % of Total Carrying Value |
|                                                         | (In thousands) |                           | (In thousands)    |                           |
| Marketable securities:                                  |                |                           |                   |                           |
| U.S. Treasury and U.S. Government-sponsored enterprises | \$88,713       | 9.3                       | \$128,156         | 13.4                      |
| States and political subdivisions                       | 467,319        | 48.8                      | 407,896           | 42.6                      |
| Corporate                                               | 247,383        | 25.8                      | 248,747           | 26.0                      |
| Mortgage-backed <sup>(1)</sup>                          | 4,769          | 0.5                       | 6,588             | 0.7                       |
| Foreign governments                                     | 133            | —                         | 141               | —                         |
| Short-term investments                                  | —              | —                         | 2,340             | 0.2                       |
| Total marketable securities                             | 808,317        | 84.4                      | 793,868           | 82.9                      |
| Cash and cash equivalents                               | 41,013         | 4.3                       | 56,299            | 5.9                       |
| Other investments:                                      |                |                           |                   |                           |
| Policy loans                                            | 45,824         | 4.8                       | 42,993            | 4.5                       |
| Equity securities                                       | 52,699         | 5.5                       | 53,741            | 5.6                       |
| Mortgage loans                                          | 687            | 0.1                       | 1,509             | 0.2                       |
| Real estate                                             | 8,509          | 0.9                       | 8,496             | 0.9                       |
| Other long-term investments                             | 56             | —                         | 57                | —                         |
| Total cash, cash equivalents and investments            | \$957,105      | 100.0                     | \$956,963         | 100.0                     |

<sup>(1)</sup> Includes \$4.4 million and \$6.1 million of U.S. Government-sponsored enterprises at June 30, 2013, and December 31, 2012, respectively.

The Company increased holdings in investment grade municipal securities during the six months of 2013 while reducing holdings in U.S. Treasury and U.S. Government-sponsored enterprises due to the very low yield environment. Cash and cash equivalents decreased as of June 30, 2013 due to timing of cash inflows and investment into marketable securities. Mortgage loans decreased during the quarter ended June 30, 2013, because one loan totaling approximately \$0.7 million was paid off.

The held-to-maturity portfolio as of June 30, 2013, represented 19.7% of the total fixed maturity securities owned based upon carrying values, with the remaining 80.3% classified as available-for-sale. Held-to-maturity securities are reported in the financial statements at amortized cost and available-for-sale securities are reported at fair value.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

The following table sets forth the distribution of the credit ratings of our portfolio of fixed maturity securities by carrying value as of June 30, 2013 and December 31, 2012.

|              | June 30, 2013  |                           | December 31, 2012 |                           |
|--------------|----------------|---------------------------|-------------------|---------------------------|
|              | Carrying Value | % of Total Carrying Value | Carrying Value    | % of Total Carrying Value |
|              | (In thousands) |                           | (In thousands)    |                           |
| AAA          | \$58,848       | 7.3                       | \$60,752          | 7.7                       |
| AA           | 365,634        | 45.2                      | 375,926           | 47.5                      |
| A            | 239,833        | 29.7                      | 199,302           | 25.2                      |
| BBB          | 126,337        | 15.6                      | 134,119           | 16.9                      |
| BB and other | 17,665         | 2.2                       | 21,429            | 2.7                       |
| Totals       | \$808,317      | 100.0                     | \$791,528         | 100.0                     |

During the first six months of 2013 the Company made new investments primarily in A rated state municipals and corporate bonds, primarily public utility issues.

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

The Company has no direct sovereign European debt exposure as of June 30, 2013. We do have indirect exposure in one bond mutual fund holding, but the amount is deemed immaterial to the current investment holdings and consolidated financials.

As of June 30, 2013, the Company held municipal securities that include third party guarantees. Detailed below is a presentation by NRSRO rating of our municipal holdings by funding type.

## Municipals shown including third party guarantees

June 30, 2013

|              | General Obligation |                | Special Revenue |                | Other      |                | Total      |                | % Based on     |
|--------------|--------------------|----------------|-----------------|----------------|------------|----------------|------------|----------------|----------------|
|              | Fair Value         | Amortized Cost | Fair Value      | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Amortized Cost |
|              | (In thousands)     |                |                 |                |            |                |            |                |                |
| AAA          | \$29,179           | 27,623         | 14,896          | 14,485         | —          | —              | 44,075     | 42,108         | 9.0            |
| AA           | 96,206             | 95,553         | 152,045         | 149,191        | 11,424     | 11,124         | 259,675    | 255,868        | 54.9           |
| A            | 36,157             | 37,399         | 104,181         | 105,707        | 8,025      | 8,348          | 148,363    | 151,454        | 32.5           |
| BBB          | 1,736              | 1,775          | 13,663          | 13,904         | —          | —              | 15,399     | 15,679         | 3.4            |
| BB and other | —                  | —              | 844             | 798            | —          | —              | 844        | 798            | 0.2            |
| Total        | \$163,278          | 162,350        | 285,629         | 284,085        | 19,449     | 19,472         | 468,356    | 465,907        | 100.0          |



Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

Municipals shown excluding third party guarantees

June 30, 2013

|              | General Obligation |                | Special Revenue |                | Other      | Total          |            | % Based on     |                |
|--------------|--------------------|----------------|-----------------|----------------|------------|----------------|------------|----------------|----------------|
|              | Fair Value         | Amortized Cost | Fair Value      | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Amortized Cost |
|              | (In thousands)     |                |                 |                |            |                |            |                |                |
| AAA          | \$29,179           | 27,623         | 14,896          | 14,485         | 11,424     | 11,124         | 55,499     | 53,232         | 11.4           |
| AA           | 88,998             | 88,150         | 115,908         | 113,830        | 7,010      | 7,307          | 211,916    | 209,287        | 44.9           |
| A            | 42,617             | 44,056         | 131,391         | 131,898        | 1,015      | 1,041          | 175,023    | 176,995        | 38.0           |
| BBB          | 1,736              | 1,775          | 21,668          | 22,053         | —          | —              | 23,404     | 23,828         | 5.1            |
| BB and other | 748                | 746            | 1,766           | 1,819          | —          | —              | 2,514      | 2,565          | 0.6            |
| Total        | \$163,278          | 162,350        | 285,629         | 284,085        | 19,449     | 19,472         | 468,356    | 465,907        | 100.0          |

The Company held investments in special revenue bonds that had a greater than 10% exposure based upon activity as noted in the table below.

|           | Fair Value     | Amortized Cost | % of Total Fair Value |
|-----------|----------------|----------------|-----------------------|
|           | (In thousands) |                |                       |
| Utilities | \$101,349      | 101,407        | 21.6                  |

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

The tables below represent the Company's exposure of municipal holdings in Louisiana and Texas, which exceed 10% of the total municipal portfolio as of June 30, 2013.

|                                                       | June 30, 2013      |                |                 |                |            |                |            |                |
|-------------------------------------------------------|--------------------|----------------|-----------------|----------------|------------|----------------|------------|----------------|
|                                                       | General Obligation |                | Special Revenue |                | Other      |                | Total      |                |
|                                                       | Fair Value         | Amortized Cost | Fair Value      | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost |
| (In thousands)                                        |                    |                |                 |                |            |                |            |                |
| Louisiana securities including third party guarantees |                    |                |                 |                |            |                |            |                |
| AA                                                    | \$8,298            | 7,829          | 24,480          | 24,466         | —          | —              | 32,778     | 32,295         |
| A                                                     | 6,070              | 6,199          | 19,276          | 18,957         | 1,016      | 1,041          | 26,362     | 26,197         |
| BBB                                                   | 1,736              | 1,775          | —               | —              | —          | —              | 1,736      | 1,775          |
| BB and other                                          | —                  | —              | 844             | 798            | —          | —              | 844        | 798            |
| Total                                                 | \$16,104           | 15,803         | 44,600          | 44,221         | 1,016      | 1,041          | 61,720     | 61,065         |
| Louisiana securities excluding third party guarantees |                    |                |                 |                |            |                |            |                |
| AA                                                    | \$8,298            | 7,829          | 16,671          | 16,949         | —          | —              | 24,969     | 24,778         |
| A                                                     | 6,070              | 6,199          | 21,246          | 20,436         | —          | —              | 27,316     | 26,635         |
| BBB                                                   | 1,736              | 1,775          | 4,917           | 5,018          | 1,016      | 1,041          | 7,669      | 7,834          |
| BB and other                                          | —                  | —              | 1,766           | 1,818          | —          | —              | 1,766      | 1,818          |
| Total                                                 | \$16,104           | 15,803         | 44,600          | 44,221         | 1,016      | 1,041          | 61,720     | 61,065         |
| Texas securities including third party guarantees     |                    |                |                 |                |            |                |            |                |
| AAA                                                   | \$29,179           | 27,623         | 8,743           | 8,448          | —          | —              | 37,922     | 36,071         |
| AA                                                    | 21,696             | 22,124         | 13,432          | 13,279         | —          | —              | 35,128     | 35,403         |
| A                                                     | 1,350              | 1,386          | 11,485          | 11,497         | —          | —              | 12,835     | 12,883         |
| BBB                                                   | —                  | —              | 10,203          | 10,289         | —          | —              | 10,203     | 10,289         |
| BB and other                                          | —                  | —              | —               | —              | —          | —              | —          | —              |
| Total                                                 | \$52,225           | 51,133         | 43,863          | 43,513         | —          | —              | 96,088     | 94,646         |
| Texas securities excluding third party guarantees     |                    |                |                 |                |            |                |            |                |
| AAA                                                   | \$29,179           | 27,623         | 8,743           | 8,448          | —          | —              | 37,922     | 36,071         |
| AA                                                    | 18,188             | 18,535         | 10,533          | 10,331         | —          | —              | 28,721     | 28,866         |
| A                                                     | 4,110              | 4,229          | 14,384          | 14,444         | —          | —              | 18,494     | 18,673         |
| BBB                                                   | —                  | —              | 10,203          | 10,290         | —          | —              | 10,203     | 10,290         |
| BB and other                                          | 748                | 746            | —               | —              | —          | —              | 748        | 746            |
| Total                                                 | \$52,225           | 51,133         | 43,863          | 43,513         | —          | —              | 96,088     | 94,646         |

The Company invests in municipal securities of issuers in the state of Louisiana and receives a credit that reduces its premium tax liability in that state. At June 30, 2013, total holdings of municipal securities in Louisiana represented

13.2% of all municipal holdings based upon fair value. The Company also holds 20.5% of its municipal holdings in Texas issuers. There were no other states or individual issuer holdings that represented or exceeded 10% of the total municipal portfolio as of June 30, 2013.

Table of Contents

CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

Valuation of Investments

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

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

The Company did not recognize any other-than-temporary impairments for the three and six months ended June 30, 2013 or 2012.

Liquidity and Capital Resources

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

Liquidity requirements of the Company are met primarily by funds provided from operations. Premium deposits and revenues, investment income and investment maturities are the primary sources of funds, while investment purchases, policy benefits, and operating expenses are the primary uses of funds. We historically have not had to liquidate investments relative to our insurance operations to provide cash flow and did not do so during the first six months of 2013. Our investments as of June 30, 2013, consist of 70.9% of marketable debt securities classified as available-for-sale that could be readily converted to cash for liquidity needs.

A primary liquidity concern is the risk of an extraordinary level of early policyholder withdrawals. We include provisions within our insurance policies, such as surrender charges, that help limit and discourage early withdrawals. Since these contractual withdrawals, as well as the level of surrenders experienced, were largely consistent with our assumptions in asset liability management, our associated cash outflows have, to date, not had an adverse impact on our overall liquidity. Individual life insurance policies are less susceptible to withdrawal than annuity reserves and deposit liabilities because policyholders may incur surrender charges and undergo a new

underwriting process in order to obtain a new insurance policy. Cash flow projections and cash flow tests under various market interest rate scenarios are also performed annually to assist in evaluating liquidity needs and adequacy. We currently anticipate that available liquidity sources and future cash flows will be adequate to meet our needs for funds.

Cash flows from our insurance operations have been sufficient to meet current needs. Cash flows from operating activities were \$33.0 million and \$30.2 million for the six months ended June 30, 2013 and 2012, respectively. We have traditionally also had significant cash flows from both scheduled and unscheduled investment security maturities, redemptions, and prepayments. These cash flows, for the most part, are reinvested in fixed income securities. Net cash outflows from investing activities totaled \$48.8 million for the six months ended June 30, 2013 compared to net cash inflows of \$4.0 million for the six months ended June 30,

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

2012. The investing activities fluctuate from period to period due to timing of securities activities such as calls and maturities and reinvestment of those funds.

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

All insurance subsidiaries were above the RBC minimums at December 31, 2012. The ratios of adjusted statutory capital to control level RBC are shown below.

|       | December 31,<br>2012 |   |
|-------|----------------------|---|
| CICA  | 551                  | % |
| CNLIC | 2,380                | % |
| SPFIC | 421                  | % |
| SPLIC | 1,282                | % |

## Contractual Obligations and Off-balance Sheet Arrangements

There have been no material changes in contractual obligations from those reported in the Company's Form 10-K for the year ended December 31, 2012. The Company does not have off-balance sheet arrangements at June 30, 2013, and does not expect any future effects on the Company's financial condition related to any such arrangements. We do not utilize special purpose entities as investment vehicles, nor are there any such entities in which we have an investment that engage in speculative activities of any nature, and we do not use such investments to hedge our investment positions.

## Parent Company Liquidity and Capital Resources

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

## Critical Accounting Policies

We have prepared a current assessment of our critical accounting policies and estimates in connection with preparing our interim unaudited consolidated financial statements as of and for the three and six months ended June 30, 2013 and 2012. We believe that the accounting policies set forth in the Notes to our Consolidated Financial Statements and “Critical Accounting Policies and Estimates” in the Management’s Discussion and Analysis of Consolidated Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2012 continue to describe the significant judgments and estimates used in the preparation of our consolidated financial statements except as specifically noted below.

Table of Contents

## CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

## Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

## General

The nature of our business exposes us to market risk relative to our invested assets and policy liabilities. Market risk is the risk of loss that may occur when changes in interest rates and public equity prices adversely affect the value of our invested assets. Interest rate risk is our primary market risk exposure. Substantial and sustained increases and decreases in market interest rates can affect the fair value of our investments. The fair value of our fixed maturity portfolio generally increases when interest rates decrease and decreases when interest rates increase. For additional information regarding market risks to which we are subject, see "Item 1 Financial Statements - Note 5. Investments - Valuation of Investments in Fixed Maturity and Equity Securities" above.

The following table summarizes net unrealized gains and losses as of the dates indicated.

|                                         | June 30, 2013     |               | Net<br>Unrealized<br>Gains<br>(Losses) | December 31, 2012 |               | Net<br>Unrealized<br>Gains<br>(Losses) |
|-----------------------------------------|-------------------|---------------|----------------------------------------|-------------------|---------------|----------------------------------------|
|                                         | Amortized<br>Cost | Fair<br>Value |                                        | Amortized<br>Cost | Fair<br>Value |                                        |
|                                         | (In thousands)    |               |                                        |                   |               |                                        |
| Fixed maturities,<br>available-for-sale | \$630,177         | 649,109       | 18,932                                 | 559,736           | 604,520       | 44,784                                 |
| Fixed maturities, held-to-maturity      | 159,208           | 161,012       | 1,804                                  | 187,008           | 193,739       | 6,731                                  |
| Total fixed maturities                  | \$789,385         | 810,121       | 20,736                                 | 746,744           | 798,259       | 51,515                                 |
| Total equity securities                 | \$52,392          | 52,699        | 307                                    | 52,744            | 53,741        | 997                                    |

## Market Risk Related to Interest Rates

Our exposure to interest rate changes results from our significant holdings of fixed maturity investments, which comprised 88.2% of our investment portfolio based on carrying value as of June 30, 2013. These investments are mainly exposed to changes in U.S. Treasury rates. Our fixed maturities investments include U.S.

Government-sponsored enterprises, U.S. Government bonds, securities issued by government agencies, municipal bonds and corporate bonds.

To manage interest rate risk, we perform periodic projections of asset and liability cash flows to evaluate the potential sensitivity of our investments and liabilities. We assess interest rate sensitivity annually with respect to our available-for-sale fixed maturities investments using hypothetical test scenarios that assume either upward or downward shifts in the prevailing interest rates. The changes in fair values of our debt and equity securities as of June 30, 2013, were within the expected range of this analysis.

Changes in interest rates typically have a sizable effect on the fair values of our debt and equity securities. The interest rate of the ten-year U.S. Treasury bond increased to 2.5% during the quarter ended June 30, 2013, from 1.8% at December 31, 2012. Net unrealized gains on fixed maturity securities totaled \$20.8 million at June 30, 2013, compared to \$51.5 million at December 31, 2012.

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

There are no fixed maturities or other investments classified as trading instruments. Approximately 80.1% of fixed maturities were held in available-for-sale and 19.9% in held-to-maturity based upon fair value at June 30, 2013. At June 30, 2013, and December 31, 2012, we had no investments in derivative instruments, nor did we have any subprime or collateralized debt obligation risk.

Table of Contents

CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

Market Risk Related to Equity Prices

Changes in the level or volatility of equity prices affect the value of equity securities we hold as investments. Our equity investments portfolio represented 5.8% of our total investments at June 30, 2013, with 98.6% invested in diversified equity and bond mutual funds. We believe that significant decreases in the equity markets would not have a material adverse impact on our total investment portfolio.

Item 4. CONTROLS AND PROCEDURES

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

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

During the three months ended June 30, 2013, there were no changes in the Company's internal controls over financial reporting that have materially affected or are reasonably likely to materially affect, the Company's internal controls over financial reporting (as defined in rules 13a-15(f) and 15d-15(f) under the Exchange Act).

Table of Contents

CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

We are a defendant in a lawsuit filed on August 6, 1999, in the Texas District Court, Austin, Texas, now styled Delia Bolanos Andrade, et al., Plaintiffs, v. Citizens Insurance Company of America, et al., Defendants in which a class was originally certified by the trial court and reversed by the Texas Supreme Court in 2007 with an order to the trial court to conduct further proceedings consistent with its ruling. The underlying lawsuit alleged that certain life insurance policies CICA made available to non-U.S. residents, when combined with a policy feature that allowed certain cash benefits to be assigned to two non-U.S. trusts for the purpose of accumulating ownership of our Class A common stock, along with allowing the policyholders to make additional contributions to the trusts, were actually offers and sales of securities that occurred in Texas by unregistered dealers in violation of the Texas securities laws. The remedy sought was rescission and return of the insurance premium payments. On December 9, 2009, the trial court denied the recertification of the class after conducting additional proceedings in accordance with the Texas Supreme Court's ruling. The remaining plaintiffs must now proceed individually, and not as a class, if they intend to pursue their claims against us. Since the December 9, 2009 trial court ruling, no individual cases have been further pursued by the plaintiffs. The probability of the plaintiffs further pursuing their cases individually remains unknown. An estimate of any possible loss or range of losses cannot be made at this time in regard to individuals pursuing claims. However, should the plaintiffs further pursue their claims individually, we intend to vigorously defend any proceedings.

In 2007 and in the aftermath of Hurricane Katrina, the Attorney General for the State of Louisiana filed suit against SPFIC and every other homeowner insurer doing business in the State of Louisiana, on behalf of the State of Louisiana and certain Road Home fund recipients. In April 2013, SPFIC and the State of Louisiana reached a settlement agreement resolving all claims against SPFIC in the Road Home matter for approximately \$183,000. This amount has been accrued in the June 30, 2013 financial statements and did not have a material impact on the consolidated financials.

Item 1A. RISK FACTORS

There are no updates to our risk factors as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2012 except as noted below.

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

The Company is currently performing an internal audit that began in 2012 related to unclaimed property for all legal reporting entities. By letter dated July 2, 2013 the Company was informed that the Louisiana Department of Treasury has authorized an audit of Citizens Inc. and its affiliates for compliance with unclaimed property laws. This audit is being conducted by Verus Financial LLC on behalf of the state.

Our internal audit and the external audit performed on behalf of Louisiana may result in additional payments to beneficiaries, additional escheatment of funds deemed abandoned under state laws, administrative penalties, interest, and changes to the Company's procedures for the identification and escheatment of abandoned property. At this time, the Company is not able to estimate any of these possible amounts, but such costs could be substantial for a company our size.

Recent changes in Colombian law may impede the activities of our independent consultants in Colombia.

Our independent consultants are contractually obligated to comply with the laws and regulations of the jurisdictions in which they operate. Certain independent consultants in Colombia have indicated new laws that became effective in July 2013 could impede their routine activities relative to introducing new clients to company product offerings and facilitating renewal premium collections. We are unable to quantify the effect of the Colombian law changes upon our business, but believe they could have an adverse impact upon the Colombian portion of our business. For the six months ended June 30, 2013, approximately 19% of our direct premiums from international clients was generated through our Colombian consultants See “Managements Discussion and Analysis of Financial Condition and Results of Operations - Segment Operations - Life Insurance - International Products.”

Table of Contents

CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

Item 3. DEFAULTS UPON SENIOR SECURITIES

None.

Item 4. MINE SAFETY DISCLOSURES

Not applicable.

Item 5. OTHER INFORMATION

On August 6, 2013, the Company issued a news release (the "Release") reporting, among things, results of operations for its second quarter of 2013. A copy of the Release is furnished as Exhibit 99.1 to this Quarterly Report on Form 10-Q. Citizens also announced that it would hold a conference call to discuss its financial results at 10:00 a.m. Central Daylight Time on Wednesday, August 7, 2013.

Table of Contents

CITIZENS, INC. AND CONSOLIDATED SUBSIDIARIES

June 30, 2013

Item 6. EXHIBITS

| Exhibit<br>Number | The following exhibits are filed herewith:                                                                    |
|-------------------|---------------------------------------------------------------------------------------------------------------|
| 11                | Statement re: Computation of per share earnings (see financial statements)                                    |
| 31.1              | Certification of Chief Executive Officer and Vice Chairman pursuant to Section 302 of the Sarbanes-Oxley Act* |
| 31.2              | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act*                   |
| 32.1              | Certification of Chief Executive Officer and Vice Chairman pursuant to Section 906 of the Sarbanes-Oxley Act* |
| 32.2              | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act*                   |
| 99.1              | News Release reporting second quarter and six months results issued on August 6, 2013 (furnished herewith)    |
| 101.INS           | XBRL Instance Document (furnished herewith)                                                                   |
| 101.SCH           | XBRL Taxonomy Extension Schema (furnished herewith)                                                           |
| 101.CAL           | XBRL Taxonomy Extension Calculation Linkbase (furnished herewith)                                             |
| 101.DEF           | XBRL Taxonomy Extension Definition Linkbase (furnished herewith)                                              |
| 101.LAB           | XBRL Taxonomy Extension Label Linkbase (furnished herewith)                                                   |
| 101.PRE           | XBRL Taxonomy Extension Presentation Linkbase (furnished herewith)                                            |

\* Filed herewith.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CITIZENS, INC.

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

By: /s/ Rick D. Riley  
Rick D. Riley  
Vice Chairman and President

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

Date: August 6, 2013