FIRST ACCEPTANCE CORP /DE/
Form 10-Q
February 07, 2011

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

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended December 31, 2010
Commission File Number: 001-12117
FIRST ACCEPTANCE CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	**75-1328153**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3813 Green Hills Village Drive Nashville, Tennessee	**37215**
(Address of principal executive offices)	(Zip Code)

(615) 844-2800
(Registrant s telephone number, including area code)
Not applicable
(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 þ No o

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller Reporting Company þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

At February 7, 2011, there were 48,532,033 shares outstanding of the registrant s common stock, par value $0.01 per share.

FIRST ACCEPTANCE CORPORATION
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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands, except per share data)

	December 31, 2010 (Unaudited)	June 30, 2010
ASSETS		
Investments, available-for-sale at fair value (amortized cost of $181,097 and $187,907, respectively)	$ 190,022	$ 196,550
Cash and cash equivalents	29,078	26,184
Premiums and fees receivable, net of allowance of $369 and $418	39,469	41,276
Other assets	8,938	8,733
Property and equipment, net	2,860	3,524
Deferred acquisition costs	3,641	3,623
Goodwill	70,092	70,092
Identifiable intangible assets	6,360	6,360
TOTAL ASSETS	$ 350,460	$ 356,342
LIABILITIES AND STOCKHOLDERS EQUITY		
Loss and loss adjustment expense reserves	$ 70,295	$ 73,198
Unearned premiums and fees	49,566	52,563
Debentures payable	41,240	41,240
Other liabilities	13,189	12,151
Total liabilities	174,290	179,152
Stockholders equity:		
Preferred stock, $.01 par value, 10,000 shares authorized		
Common stock, $.01 par value, 75,000 shares authorized; 48,532 and 48,509 shares issued and outstanding, respectively	485	485
Additional paid-in capital	466,227	465,831
Accumulated other comprehensive income	8,925	8,643
Accumulated deficit	(299,467)	(297,769)
Total stockholders equity	176,170	177,190
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 350,460	$ 356,342

See notes to consolidated financial statements.

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FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)
(in thousands, except per share data)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	**2009**	**2010**	**2009**
Revenues:				
Premiums earned	$ 42,520	$ 45,199	$ 86,454	$ 93,666
Commission and fee income	7,065	6,966	14,341	13,920
Investment income	2,124	2,033	4,261	3,946
Net realized losses on investments, available-for-sale	(32)	(423)	(256)	(445)
	51,677	53,775	104,800	111,087
Costs and expenses:				
Losses and loss adjustment expenses	33,338	29,871	65,395	63,024
Insurance operating expenses	18,393	19,711	36,901	39,281
Other operating expenses	291	750	678	1,023
Litigation settlement	(5)	102	(5)	(279)
Stock-based compensation	173	272	365	655
Depreciation and amortization	465	500	941	964
Interest expense	991	992	1,982	1,981
	53,646	52,198	106,257	106,649
Income (loss) before income taxes	(1,969)	1,577	(1,457)	4,438
Provision for income taxes	121	102	241	203
Net income (loss)	$ (2,090)	$ 1,475	$ (1,698)	$ 4,235
Net income (loss) per share:				
Basic and diluted	$ (0.04)	$ 0.03	$ (0.04)	$ 0.09
Number of shares used to calculate net income (loss) per share:				
Basic	48,138	47,960	48,087	47,919
Diluted	48,138	48,387	48,087	48,348
Reconciliation of net income (loss) to comprehensive income (loss):				
Net income (loss)	$ (2,090)	$ 1,475	$ (1,698)	$ 4,235
Net unrealized change in investments	(3,538)	(627)	282	3,548

Comprehensive income (loss)	$ (5,628)	$ 848	$ (1,416)	$ 7,783
Detail of net realized losses on investments, available-for-sale:				
Net realized gains on sales	$	$ 15	$ 80	$ 314
Unrealized losses on investments with other-than-temporary impairment charges	(32)	(1,128)	(338)	(1,449)
Non-credit portion included in comprehensive income (loss)		690	2	690
Other-than-temporary impairment charges recognized in income (loss)	(32)	(438)	(336)	(759)
Net realized losses on investments, available-for-sale	$ (32)	$ (423)	$ (256)	$ (445)

See notes to consolidated financial statements.

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FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(in thousands)

	Six Months Ended December 31,	
	2010	**2009**
Cash flows from operating activities:		
Net income (loss)	$ (1,698)	$ 4,235
Adjustments to reconcile net income (loss) to cash used in operating activities:		
Depreciation and amortization	941	964
Stock-based compensation	365	655
Other-than-temporary impairment on investment securities	336	759
Net realized gains on sales of investments	(80)	(314)
Other	293	789
Change in:		
Premiums and fees receivable	1,758	5,566
Loss and loss adjustment expense reserves	(2,903)	(6,427)
Unearned premiums and fees	(2,997)	(7,190)
Litigation settlement	(39)	669
Other	893	(3,903)
Net cash used in operating activities	(3,131)	(4,197)
Cash flows from investing activities:		
Purchases of investments, available-for-sale	(1,913)	(61,439)
Maturities and paydowns of investments, available-for-sale	8,225	6,704
Sales of investments, available-for-sale		11,566
Capital expenditures	(280)	(592)
Other		(21)
Net cash provided by (used in) investing activities	6,032	(43,782)
Cash flows from financing activities:		
Payments on borrowings	(39)	(28)
Net proceeds from issuance of common stock	32	33
Net cash provided by (used in) financing activities	(7)	5
Net increase (decrease) in cash and cash equivalents	2,894	(47,974)
Cash and cash equivalents, beginning of period	26,184	77,201
Cash and cash equivalents, end of period	$ 29,078	$ 29,227

See notes to consolidated financial statements.

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FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. General

The consolidated financial statements of First Acceptance Corporation (the Company) included herein have been prepared without audit pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, certain information and disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been omitted. In the opinion of management, the consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) necessary for a fair statement of the interim periods. Certain reclassifications have been made to the prior year s consolidated financial statements to conform with the current year presentation.

The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full year. These consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements included in its Annual Report on Form 10-K for the fiscal year ended June 30, 2010.

2. Investments

Fair Value

Fair value is the price that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Company holds available-for-sale investments, which are carried at fair value.

Fair value measurements are generally based upon observable and unobservable inputs. Observable inputs are based on market data from independent sources, while unobservable inputs reflect the Company s view of market assumptions in the absence of observable market information. All assets and liabilities that are carried at fair value are classified and disclosed in one of the following categories:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Quoted market prices for similar assets or liabilities in active markets; quoted prices by independent pricing services for identical or similar assets or liabilities in markets that are not active; and valuations, using models or other valuation techniques, that use observable market data. 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 market place.

Level 3 - Instruments that use non-binding broker quotes or model driven valuations that do not have observable market data.

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FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

The following tables present the fair-value measurements for each major category of assets that are measured on a recurring basis (in thousands).

		Fair Value Measurements Using		
December 31, 2010	**Total**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Fixed maturities, available-for-sale:				
U.S. government and agencies	$ 29,405	$ 29,405	$	$
State	7,745		7,745	
Political subdivisions	1,651		1,651	
Revenue and assessment	28,059		28,059	
Corporate bonds	77,621		77,621	
Collateralized mortgage obligations:				
Agency backed	24,398		24,398	
Non-agency backed residential	5,981		5,981	
Non-agency backed commercial	7,039		7,039	
Redeemable preferred stock	176	176		
Total fixed maturities, available-for-sale	182,075	29,581	152,494	
Investment in mutual fund, available-for-sale	7,947	7,947		
Total investments, available-for-sale	190,022	37,528	152,494	
Cash and cash equivalents	29,078	29,078		
Total	$ 219,100	$ 66,606	$ 152,494	$

		Fair Value Measurements Using		
June 30, 2010	**Total**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**

Fixed maturities, available-for-sale:				
U.S. government and agencies	$ 29,499	$ 29,499	$	$
State	7,848		7,848	
Political subdivisions	1,830		1,830	
Revenue and assessment	29,286		29,286	
Corporate bonds	78,803		78,803	
Collateralized mortgage obligations:				
Agency backed	28,036		28,036	
Non-agency backed residential	6,612		6,612	
Non-agency backed commercial	7,180		7,180	
Total fixed maturities, available-for-sale	189,094	29,499	159,595	
Investment in mutual fund, available-for-sale	7,456	7,456		
Total investments, available-for-sale	196,550	36,955	159,595	
Cash and cash equivalents	26,184	26,184		
Total	$ 222,734	$ 63,139	$ 159,595	$

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FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

The fair values of the Company s investments are determined by management after taking into consideration available sources of data. All of the portfolio valuations classified as Level 1 or Level 2 in the above tables are priced exclusively by utilizing the services of independent pricing sources using observable market data. The Level 2 classified security valuations are obtained from a single independent pricing service. There were no transfers between Level 1 and Level 2 for the three and six months ended December 31, 2010 and 2009. The Company s policy is to recognize transfers between levels at the end of the reporting period. The Company has not made any adjustments to the prices obtained from the independent pricing sources.

The Company has reviewed the pricing techniques and methodologies of the Level 2 independent pricing service and believes that their policies adequately consider market activity, either based on specific transactions for the security valued or based on modeling of securities with similar credit quality, duration, yield and structure that were recently traded. The Company monitored security-specific valuation trends and has made inquiries with the pricing service about material changes or the absence of expected changes to understand the underlying factors and inputs and to validate the reasonableness of the pricing.

Based on the above categorization, there were no Level 3 classified security valuations at December 31, 2010 and June 30, 2010. The following tables represent the quantitative disclosure for those assets classified as Level 3 during the three and six months ended December 31, 2009 (in thousands).

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)			
		Collateralized mortgage obligations		
Three Months Ended December 31, 2009:	**Corporate bonds**	**Non-agency backed residential**	**Non-agency backed commercial**	**Total**
Balance at October 1, 2009	$	$ 3,294	$	$ 3,294
Total gains or losses (realized or unrealized):				
Included in net income (loss)		(97)		(97)
Included in other comprehensive income (loss)	71	221		292
Purchases, sales, issuances and settlements	3,903			3,903
Transfers in to Level 3		870		870
Transfers out of Level 3		(1,688)		(1,688)
Balance at December 31, 2009	$ 3,974	$ 2,600	$	$ 6,574

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)			
		Collateralized mortgage obligations		
Six Months Ended December 31, 2009:	**Corporate bonds**	**Non-agency backed residential**	**Non-agency backed commercial**	**Total**
Balance at July 1, 2009	$	$ 1,930	$ 707	$ 2,637
Total gains or losses (realized or unrealized):				
Included in net income (loss)		(97)		(97)
Included in other comprehensive income (loss)	71	424	91	586

Purchases, sales, issuances and settlements	3,903			3,903
Transfers in to Level 3		880		880
Transfers out of Level 3		(537)	(798)	(1,335)
Balance at December 31, 2009	$ 3,974	$ 2,600	$	$ 6,574

FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Investment Income and Net Realized Gains and Losses

The major categories of investment income follow (in thousands).

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Fixed maturities, available-for-sale	$ 2,077	$ 2,164	$ 4,201	$ 4,193
Investment in mutual fund, available-for-sale	178		323	
Cash and cash equivalents	3	4	6	23
Other	29	29	59	59
Investment expenses	(163)	(164)	(328)	(329)
	$ 2,124	$ 2,033	$ 4,261	$ 3,946

The components of net realized losses on investments, available-for-sale follow (in thousands).

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Gains	$ 1	$ 16	$ 81	$ 319
Losses	(1)	(1)	(1)	(5)
Other-than-temporary impairment	(32)	(438)	(336)	(759)
	$ (32)	$ (423)	$ (256)	$ (445)

Realized gains and losses on sales of securities are computed based on specific identification. The non-credit related portion of other-than-temporary impairment (OTTI) charges is included in other comprehensive income (loss). At December 31, 2010, the amounts of such charges taken for securities still owned was $0.4 million for non-agency backed residential collateralized mortgage obligations (CMOs). At June 30, 2010, the amount of such charges taken for securities still owned was $0.6 million for non-agency backed residential CMOs and $0.3 million for non-agency backed commercial CMOs.

Investments, Available-for-Sale

The following tables summarize the Company s investment securities (in thousands).

December 31, 2010	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government and agencies	$ 28,228	$ 1,177	$	$ 29,405
State	7,424	321		7,745
Political subdivisions	1,647	25	(21)	1,651
Revenue and assessment	27,131	1,076	(148)	28,059
Corporate bonds	73,238	4,681	(298)	77,621
Collateralized mortgage obligations:				
Agency backed	22,877	1,521		24,398
Non-agency backed residential	6,121	240	(380)	5,981
Non-agency backed commercial	6,754	285		7,039

Redeemable preferred stock	176			176
Total fixed maturities, available-for-sale	173,596	9,326	(847)	182,075
Investment in mutual fund, available-for-sale	7,501	446		7,947
	$ 181,097	$ 9,772	$ (847)	$ 190,022

FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

June 30, 2010	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government and agencies	$ 28,263	$ 1,236	$	$ 29,499
State	7,461	387		7,848
Political subdivisions	1,792	52	(14)	1,830
Revenue and assessment	28,209	1,217	(140)	29,286
Corporate bonds	73,868	5,181	(246)	78,803
Collateralized mortgage obligations:				
Agency backed	26,262	1,774		28,036
Non-agency backed residential	7,189	56	(633)	6,612
Non-agency backed commercial	7,363	158	(341)	7,180
Total fixed maturities, available-for-sale	180,407	10,061	(1,374)	189,094
Investment in mutual fund, available-for-sale	7,500		(44)	7,456
	$ 187,907	$ 10,061	$ (1,418)	$ 196,550

The following tables set forth the scheduled maturities of the Company s fixed maturity securities based on their fair values (in thousands). Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

December 31, 2010	Securities with Unrealized Gains	Securities with Unrealized Losses	Securities with No Unrealized Gains or Losses	All Fixed Maturity Securities
One year or less	$ 13,507	$ 125	$	$ 13,632
After one through five years	77,775			77,775
After five through ten years	37,601			37,601
After ten years	9,690	5,959		15,649
No single maturity date	34,131	2,638	649	37,418
	$ 172,704	$ 8,722	$ 649	$ 182,075

June 30, 2010	Securities with Unrealized Gains	Securities with Unrealized Losses	Securities with No Unrealized Gains or Losses	All Fixed Maturity Securities
One year or less	$ 9,137	$	$	$ 9,137
After one through five years	82,250	642		82,892
After five through ten years	39,567			39,567
After ten years	8,607	7,063		15,670

No single maturity date	33,676	8,085	67	41,828
	$ 173,237	$ 15,790	$ 67	$ 189,094

The following table reflects the number of securities with gross unrealized gains and losses. Gross unrealized losses are further segregated by the length of time that individual securities have been in a continuous unrealized loss position.

	Gross Unrealized Losses		
At:	**Less than or equal to 12 months**	**Greater than 12 months**	**Gross Unrealized Gains**
December 31, 2010	4	6	161
June 30, 2010	6	18	153

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FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

The following tables reflect the fair value and gross unrealized losses of those securities in a continuous unrealized loss position for greater than 12 months. Gross unrealized losses are further segregated by the percentage of amortized cost (in thousands, except number of securities).

Gross Unrealized Losses at December 31, 2010:	Number of Securities	Fair Value	Gross Unrealized Losses
Less than 10%	2	$ 1,810	$ (82)
Greater than 10%	4	2,458	(634)
	6	$ 4,268	$ (716)

Gross Unrealized Losses at June 30, 2010:	Number of Securities	Fair Value	Gross Unrealized Losses
Less than 10%	11	$ 7,931	$ (276)
Greater than 10%	7	3,366	(965)
	18	$ 11,297	$ (1,241)

The following tables set forth the amount of gross unrealized losses by current severity (as compared to amortized cost) and length of time that individual securities have been in a continuous unrealized loss position (in thousands).

			Severity of Gross Unrealized Losses		
Length of Gross Unrealized Losses at December 31, 2010:	Fair Value of Securities with Gross Unrealized Losses	Gross Unrealized Losses	Less than 5%	5% to 10%	Greater than 10%
Less than or equal to:					
Three months	$ 3,539	$ (89)	$ (89)	$	$
Six months	915	(42)	(42)		
Nine months					
Twelve months					
Greater than twelve months	4,268	(716)	(2)	(80)	(634)
Total	$ 8,722	$ (847)	$ (133)	$ (80)	$ (634)

Fair Value of Securities

Length of Gross Unrealized Losses at June 30, 2010:	with Gross Unrealized Losses	Gross Unrealized Losses	Severity of Gross Unrealized Losses: Less than 5%	5% to 10%	Greater than 10%
Less than or equal to:					
Three months	$ 11,291	$ (170)	$ (145)	$ (25)	$
Six months					
Nine months	152	(2)	(2)		
Twelve months	505	(5)	(5)		
Greater than twelve months	11,297	(1,241)	(153)	(123)	(965)
Total	$ 23,245	$ (1,418)	$ (305)	$ (148)	$ (965)

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FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Other-Than-Temporary Impairment

In accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 320-10-65, *Recognition and Presentation of Other-Than-Temporary Impairments* (FASB ASC 320-10-65), the Company separates OTTI into the following two components: (i) the amount related to credit losses, which is recognized in the consolidated statement of operations and (ii) the amount related to all other factors, which is recorded in other comprehensive income (loss). The credit-related portion of an OTTI is measured by comparing a security s amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge.

The determination of whether unrealized losses are other-than-temporary requires judgment based on subjective as well as objective factors. The Company routinely monitors its investment portfolio for changes in fair value that might indicate potential impairments and performs detailed reviews on such securities. Changes in fair value are evaluated to determine the extent to which such changes are attributable to (i) fundamental factors specific to the issuer or (ii) market-related factors such as interest rates or sector declines.

Securities with declines attributable to issuer-specific fundamentals are reviewed to identify all available evidence to estimate the potential for impairment. Resources used include historical financial data included in filings with the SEC for corporate bonds and performance data regarding the underlying loans for CMOs. Securities with declines attributable solely to market or sector declines where 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 the full recovery of its amortized cost basis are not deemed to be other-than-temporary.

The issuer-specific factors considered in reaching the conclusion that securities with declines are not other-than-temporary include (i) the extent and duration of the decline in fair value, including the duration of any significant decline in value, (ii) whether the security is current as to payments of principal and interest, (iii) a valuation of any underlying collateral, (iv) current and future conditions and trends for both the business and its industry, (v) changes in cash flow assumptions for CMOs and (vi) rating agency actions. Based on these factors, the Company makes a determination as to the probability of recovering principal and interest on the security.

The number and amount of securities for which the Company has recognized OTTI charges in net income (loss) are presented in the following tables (in thousands, except for the number of securities).

	Three Months Ended December 31,			
	2010		2009	
	Number of Securities	OTTI	Number of Securities	OTTI
Collateralized mortgage obligations:				
Non-agency backed residential	3	$ (6)	7	$ (1,128)
Non-agency backed commercial	3	(26)		
	6	(32)	7	(1,128)
Portion of loss recognized in accumulated other comprehensive income				690
Net OTTI recognized in net income (loss)		$ (32)		$ (438)

FIRST ACCEPTANCE CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

	Six Months Ended December 31,			
	2010		2009	
	Number of Securities	OTTI	Number of Securities	OTTI
Collateralized mortgage obligations:				
Non-agency backed residential	4	$ (42)	8	$ (1,449)
Non-agency backed commercial	5	(296)		
	9	(338)	8	(1,449)
Portion of loss recognized in accumulated other comprehensive income		2		690
Net OTTI recognized in net income (loss)		$ (336)		$ (759)

Since the adoption of FASB ASC 320-10-65, the following is a progression of the credit-related portion of OTTI on investments owned at December 31, 2010 and 2009 (in thousands).

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Beginning balance	$ (3,605)	$ (2,639)	$ (3,301)	$ (2,870)
Additional credit impairments on:				
Previously impaired securities	(32)	(221)	(336)	(270)
Securities without previous impairments		(217)		(489)
	(32)	(438)	(336)	(759)
Reductions for securities sold (realized)	47		47	552
	$ (3,590)	$ (3,077)	$ (3,590)	$ (3,077)

On a quarterly basis, the Company reviews cash flow estimates for certain non-agency backed CMOs of lesser credit quality following the guidance of FASB ASC 325-40-65, *Amendments to the Impairment Guidance of EITF Issue No. 99-20* (FASB ASC 325-40-65). Accordingly, when changes in estimated cash flows from the cash flows previously estimated occur due to actual or estimated prepayment or credit loss experience, and the present value of the revised cash flows is less than the present value previously estimated, OTTI is deemed to have occurred. For non-agency backed CMOs not subject to FASB ASC 325-40-65, the Company reviews quarterly projected cash flow analyses and recognizes OTTI when it determines that a loss is probable. The Company has recognized OTTI related to certain non-agency backed CMOs as the underlying cash flows have been adversely impacted due to a reduction in prepayments from mortgage refinancing and an increase in actual and projected delinquencies in the underlying mortgages.

The Company s review of non-agency backed CMOs included an analysis of available information such as collateral quality, anticipated cash flows, credit enhancements, default rates, loss severities, the securities relative position in their respective capital structures, and credit ratings from statistical rating agencies. The Company reviews quarterly projected cash flow analyses for each security utilizing current assumptions regarding (i) actual and anticipated delinquencies, (ii) delinquency transition-to-default rates and (iii) loss severities. Based on its quarterly reviews, the Company determined that there had not been an adverse change in projected cash flows, except in the case of those securities for which OTTI charges have been recorded. The Company believes that the unrealized losses on the remaining non-agency backed CMOs for which OTTI charges have not been recorded are not necessarily predictive of the ultimate performance of the underlying collateral. The Company does not intend to sell these securities and it is more likely than not that the Company will not be required to sell these securities before the recovery of their amortized cost basis.

The Company believes that the remaining securities having unrealized losses at December 31, 2010 were not other-than-temporarily impaired. The Company also does not intend to sell any of these securities and it is more likely than not that the Company will not be required to sell any of these securities before the recovery of their amortized cost basis.

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3. Net Income (Loss) Per Share

The following table sets forth the computation of basic and diluted net income (loss) per share (in thousands, except per share data).

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Net income (loss)	$ (2,090)	$ 1,475	$ (1,698)	$ 4,235
Weighted average common basic shares	48,138	47,960	48,087	47,919
Effect of dilutive securities		427		429
Weighted average common dilutive shares	48,138	48,387	48,087	48,348
Basic and diluted net income (loss) per share	$ (0.04)	$ 0.03	$ (0.04)	$ 0.09

For the three months ended December 31, 2010, the computation of diluted net loss per share did not include 0.4 million shares of unvested restricted common stock as their inclusion would have been anti-dilutive. For the three months ended December 31, 2009, the computation of diluted net income per share included 0.5 million shares of unvested restricted common stock. Options to purchase approximately 4.6 million shares for the three months ended December 31, 2010 and 2009, respectively, were not included in the computation of diluted net income (loss) per share as their exercise prices were in excess of the average stock prices for the periods presented.

For the six months ended December 31, 2010, the computation of diluted net loss per share did not include 0.4 million shares of unvested restricted common stock as their inclusion would have been anti-dilutive. For the six months ended December 31, 2009, the computation of diluted net income per share included 0.5 million shares of unvested restricted common stock. Options to purchase approximately 4.6 million shares for the six months ended December 31, 2010 and 2009, respectively, were not included in the computation of diluted net income (loss) per share as their exercise prices were in excess of the average stock prices for the periods presented.

4. Income Taxes

The provision for income taxes consisted of the following (in thousands).

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Federal:				
Current	$	$	$	$
Deferred				
State:				
Current	121	102	241	203
Deferred				
	121	102	241	203

	$ 121	$ 102	$ 241	$ 203

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The provision for income taxes differs from the amounts computed by applying the statutory federal corporate tax rate of 35% to income (loss) before income taxes as a result of the following (in thousands).

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Provision (benefit) for income taxes at statutory rate	$ (689)	$ 552	$ (510)	$ 1,553
Tax effect of:				
Tax-exempt investment income	(4)	(4)	(8)	(8)
Change in the beginning of the period balance of the valuation allowance for deferred tax assets allocated to income taxes	609	(516)	429	(1,471)
Restricted stock	80		81	
State income taxes, net of federal income tax benefit	121	65	241	120
Other	4	5	8	9
	$ 121	$ 102	$ 241	$ 203

The Company had a valuation allowance of $17.4 million and $16.9 million at December 31, 2010 and June 30, 2010, respectively, to reduce deferred tax assets to the amount that is more likely than not to be realized, which included all net deferred tax assets at December 31, 2010 and June 30, 2010. The change in the total valuation allowance for the six months ended December 31, 2010 was an increase of $0.5 million. For the six months ended December 31, 2010, the change in the valuation allowance included a reduction of $0.1 million related to the unrealized change on investments included in other comprehensive income (loss).

In assessing the realization of deferred tax assets, management considered whether it was more likely than not that some portion or all of the deferred tax assets will not be realized. The Company is required to assess whether a valuation allowance should be established against the Company s deferred tax assets based on the consideration of all available evidence using a more likely than not standard. In making such judgments, significant weight is given to evidence that can be objectively verified. In assessing the Company s ability to support the realizability of its deferred tax assets, management considered both positive and negative evidence. The Company placed greater weight on historical results than on the Company s outlook for future profitability and established a deferred tax valuation allowance against all net deferred tax assets at December 31, 2010 and June 30, 2010. The deferred tax valuation allowance may be adjusted in future periods if management determines that it is more likely than not that some portion or all of the deferred tax assets will be realized. In the event the deferred tax valuation allowance is adjusted, the Company would record an income tax benefit for the adjustment.

5. Goodwill and Identifiable Intangible Assets

Goodwill and other identifiable intangible assets are attributable to the Company s insurance operations and were initially recorded at their estimated fair values at the date of acquisition. Goodwill and other intangible assets, primarily comprised of trade names, having an indefinite useful life are not amortized for financial statement purposes. The Company performs required annual impairment tests of its goodwill and intangible assets during the fourth quarter of each fiscal year. In the event that facts and circumstances indicate that the goodwill and other identifiable intangible assets may be impaired, an interim impairment test would be required.

The goodwill impairment test is a two-step process that requires management to make judgments in determining what assumptions to use in the calculation. The first step of the process consists of estimating the fair value of each reporting unit based on valuation techniques, including a discounted cash flow model using revenue and profit forecasts, and comparing those estimated fair values with the carrying values of those assets and liabilities, which includes the allocated goodwill. If the estimated fair value is less than the carrying value, a second step is performed to compute the amount of the impairment, if any, by determining an implied fair value of goodwill. The determination of the implied fair value of goodwill of a reporting unit requires the Company to allocate the estimated fair value of the reporting unit to the assets and liabilities of the reporting unit. Any unallocated fair value represents the implied fair value of goodwill, which is compared to its corresponding carrying value.

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The Company s evaluation includes multiple assumptions, including estimated discounted cash flows and other estimates that may change over time. If future discounted cash flows become less than those projected by the Company, impairment charges may become necessary that could have a materially adverse impact on the Company s results of operations and financial condition. As quoted market prices in active stock markets are relevant evidence of fair value, a significant decline in the Company s common stock trading price may indicate an impairment of goodwill.

6. Fair Value of Financial Instruments

The carrying values and fair values of certain of the Company s financial instruments at December 31, 2010 and June 30, 2010 were as follows (in thousands).

	December 31, 2010		June 30, 2010	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets:				
Investments, available-for-sale	$ 190,022	$ 190,022	$ 196,550	$ 196,550
Liabilities:				
Debentures payable	41,240	18,715	41,240	19,701

The fair values as presented represent the Company s best estimates and may not be substantiated by comparisons to independent markets. The fair value of the debentures payable was based on current market rates offered for debt with similar risks and maturities. Carrying values of certain financial instruments, such as cash and cash equivalents and premiums and fees receivable, approximate fair value due to the short-term nature of the instruments and are not required to be disclosed. Therefore, the aggregate of the fair values presented in the table does not purport to represent the Company s underlying value.

7. Segment Information

The Company operates in two business segments with its primary focus being the selling, servicing and underwriting of non-standard personal automobile insurance. The real estate and corporate segment consists of the activities related to the disposition of foreclosed real estate held for sale, interest expense associated with all debt and other general corporate overhead expenses.

The following table presents selected financial data by business segment (in thousands).

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Revenues:				
Insurance	$ 51,647	$ 53,745	$ 104,740	$ 111,028
Real estate and corporate	30	30	60	59
Consolidated total	$ 51,677	$ 53,775	$ 104,800	$ 111,087
Income (loss) before income taxes:				
Insurance	$ (546)	$ 3,560	$ 1,505	$ 8,035
Real estate and corporate	(1,423)	(1,983)	(2,962)	(3,597)
Consolidated total	$ (1,969)	$ 1,577	$ (1,457)	$ 4,438

	December 31, 2010	June 30, 2010
Total assets:		
Insurance	$ 336,332	$ 343,499
Real estate and corporate	14,128	12,843
Consolidated total	$ 350,460	$ 356,342

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
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8. Recent Accounting Pronouncements

In December 2009, the FASB issued Accounting Standards Update (ASU) No. 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities (Topic 810)* (FASB ASU No. 2009-17), which amends FASB ASC 810-10, *Variable Interest Entities*. FASB ASU No. 2009-17 amends the evaluation criteria to identify the primary beneficiary of a variable interest entity and requires ongoing reassessment of whether an enterprise is the primary beneficiary of the variable interest entity. The Company adopted the provisions of FASB ASU No. 2009-17 in the quarter ended September 30, 2010. The adoption did not have an impact on the Company s results of operations or financial condition.

In October 2010, the FASB issued ASU No. 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force) (Topic 944)* (FASB ASU No. 2010-26), which amends FASB ASC 944-340, *Other Assets and Deferred Costs*. FASB ASU No. 2010-26 clarifies what costs should be deferred by insurance companies when issuing or renewing insurance contracts. FASB ASU 2010-26 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2011. The Company is currently evaluating the impact that the adoption of FASB ASU 2010-26 will have on future consolidated financial statements.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Management s Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements which involve risks and uncertainties. Our actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such a difference include those discussed in Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010. The following discussion should be read in conjunction with our consolidated financial statements included with this report and our consolidated financial statements and related Management s Discussion and Analysis of Financial Condition and Results of Operations for the fiscal year ended June 30, 2010 included in our Annual Report on Form 10-K.

General

At December 31, 2010, we leased and operated 393 retail locations (or stores) staffed by employee-agents who primarily sell non-standard personal automobile insurance products underwritten by us as well as certain commissionable ancillary products. In certain states, our employee-agents also sell other complementary insurance products underwritten by us. At December 31, 2010, we wrote non-standard personal automobile insurance in 12 states and were licensed in 13 additional states. See the discussion in Item 1. Business General in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010 for additional information with respect to our business.

The following table shows the number of our retail locations. Retail location counts are based upon the date that a location commenced or ceased writing business.

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Retail locations beginning of period	393	415	394	418
Opened	1		1	
Closed	(1)	(6)	(2)	(9)
Retail locations end of period	393	409	393	409

The following tables show the number of our retail locations by state.

	December 31,		September 30,		June 30,	
	2010	2009	2010	2009	2010	2009
Alabama	25	25	25	25	25	25
Florida	31	34	31	36	31	39
Georgia	60	61	60	61	60	61
Illinois	73	76	74	78	74	78
Indiana	17	18	17	18	17	18
Mississippi	8	8	8	8	8	8
Missouri	12	12	12	12	12	12
Ohio	27	27	27	27	27	27
Pennsylvania	16	17	16	17	16	17
South Carolina	26	27	26	27	26	27
Tennessee	20	19	19	20	19	20
Texas	78	85	78	86	79	86
Total	393	409	393	415	394	418

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Consolidated Results of Operations

Overview

Our primary focus is the selling, servicing and underwriting of non-standard personal automobile insurance. Our real estate and corporate segment consists of activities related to the disposition of real estate held for sale, interest expense associated with debt, and other general corporate overhead expenses. Our insurance operations generate revenues from selling, servicing and underwriting non-standard personal automobile insurance policies in 12 states. We conduct our underwriting operations through three insurance company subsidiaries: First Acceptance Insurance Company, Inc., First Acceptance Insurance Company of Georgia, Inc. and First Acceptance Insurance Company of Tennessee, Inc. Our insurance revenues are primarily generated from:

premiums earned, including policy and renewal fees, from sales of policies written and assumed by our insurance company subsidiaries;

commission and fee income, including installment billing fees on policies written, agency fees and commissions and fees for other ancillary products and services; and

investment income earned on the invested assets of the insurance company subsidiaries.

The following table presents premiums earned by state (in thousands).

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Premiums earned:				
Georgia	$ 9,343	$ 9,960	$ 18,934	$ 20,861
Illinois	5,774	6,075	11,580	12,406
Texas	5,708	5,714	11,617	11,626
Florida	4,628	4,933	9,446	10,194
Alabama	4,126	4,709	8,513	9,918
Ohio	3,265	2,909	6,490	5,862
Tennessee	2,582	2,855	5,295	5,958
South Carolina	2,351	2,727	4,851	5,866
Pennsylvania	2,302	2,610	4,719	5,429
Indiana	1,121	1,211	2,265	2,433
Missouri	684	782	1,422	1,609
Mississippi	636	714	1,322	1,504
Total premiums earned	$ 42,520	$ 45,199	$ 86,454	$ 93,666

The following table presents the change in the total number of policies in force (PIF) for the insurance operations. PIF increase as a result of new policies issued and decrease as a result of policies that are canceled or expire and are not renewed.

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Policies in force beginning of period	150,175	152,866	154,655	158,222
Net decrease during period	(5,593)	(5,776)	(10,073)	(11,132)
Policies in force end of period	144,582	147,090	144,582	147,090

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The following tables present total PIF for the insurance operations segregated by policies that were sold through our open and closed retail locations as well as our independent agents. For our retail locations, PIF are further segregated by (i) newly-issued policies and renewal policies and (ii) liability-only or full coverage. Renewal policies are defined as those policies which renewed after completing their full uninterrupted policy term. Newly-issued policies are defined as those policies issued to first-time customers and customers who have reinstated a lapsed or cancelled policy. Liability-only policies are defined as those policies including only bodily injury (or no-fault) and property damage coverages, which are the required coverages in most states. For comparative purposes, the PIF data with respect to closed retail locations for each of the periods presented below includes all retail locations closed as of December 31, 2010.

	December 31,	
	2010	**2009**
Retail locations:		
Open retail locations:		
New	63,020	63,775
Renewal	77,527	75,678
	140,547	139,453
Closed retail locations:		
New	197	2,201
Renewal	1,985	3,143
	2,182	5,344
Independent agents	1,853	2,293
Total policies in force	144,582	147,090

	December 31,	
	2010	**2009**
Retail locations:		
Open retail locations:		
Liability-only	85,577	82,730
Full coverage	54,970	56,723
	140,547	139,453
Closed retail locations:		
Liability-only	1,255	3,263
Full coverage	927	2,081
	2,182	5,344
Independent agents	1,853	2,293
Total policies in force	144,582	147,090

Insurance companies present a combined ratio as a measure of their overall underwriting profitability. The components of the combined ratio are as follows.

Loss Ratio Loss ratio is the ratio (expressed as a percentage) of losses and loss adjustment expenses incurred to premiums earned and is a basic element of underwriting profitability. We calculate this ratio based on all direct and assumed premiums earned.

Expense Ratio Expense ratio is the ratio (expressed as a percentage) of insurance operating expenses to premiums earned. Insurance operating expenses are reduced by commission and fee income from insureds. This is a measurement that illustrates relative management efficiency in administering our operations.

Combined Ratio Combined ratio is the sum of the loss ratio and the expense ratio. If the combined ratio is at or above 100%, an insurance company cannot be profitable without sufficient investment income.

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The following table presents the loss, expense and combined ratios for our insurance operations.

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Loss and loss adjustment expense	78.4%	66.1%	75.6%	67.3%
Expense	26.6%	28.2%	26.1%	27.1%
Combined	105.0%	94.3%	101.7%	94.4%

The non-standard personal automobile insurance industry is cyclical in nature. Accordingly, adverse economic conditions impact our customers and many will choose to reduce their coverage or go uninsured during a weak economy.

Investments

We use the services of an independent investment manager to manage our investment portfolio. The investment manager conducts, in accordance with our investment policy, all of the investment purchases and sales for our insurance company subsidiaries. Our investment policy has been established by the Investment Committee of our Board of Directors and specifically addresses overall investment goals and objectives, authorized investments, prohibited securities, restrictions on sales by the investment manager and guidelines as to asset allocation, duration and credit quality. Management and the Investment Committee meet regularly with our investment manager to review the performance of the portfolio and compliance with our investment guidelines.

The invested assets of the insurance company subsidiaries consist substantially of marketable, investment grade, U.S. government securities, municipal bonds, corporate bonds and collateralized mortgage obligations (CMOs). We also invest a portion of the portfolio in certain securities issued by political subdivisions, which enable our insurance company subsidiaries to obtain premium tax credits. Investment income is comprised primarily of interest earned on these securities, net of related investment expenses. Realized gains and losses may occur from time to time as changes are made to our holdings based upon changes in interest rates or the credit quality of specific securities.

Our consolidated investment portfolio was $190.0 million at December 31, 2010 and consisted of fixed maturity securities and an investment in a mutual fund, all carried at fair value with unrealized gains and losses reported as a separate component of stockholders equity. At December 31, 2010, we had gross unrealized gains of $9.8 million and gross unrealized losses of $0.8 million.

At December 31, 2010, 95.1% of the fair value of our fixed maturity portfolio was rated investment grade (a credit rating of AAA to BBB-) by nationally recognized rating organizations. The average credit rating of our fixed maturity portfolio was AA- at December 31, 2010. Investment grade securities generally bear lower yields and have lower degrees of risk than those that are unrated or non-investment grade. We believe that a high quality investment portfolio is more likely to generate a stable and predictable investment return.

Investments in CMOs had a fair value of $37.4 million at December 31, 2010 and represented 21% of our fixed maturity portfolio. At December 31, 2010, 86% of our CMOs were considered investment grade by nationally recognized rating agencies. In addition, 79% of our CMOs were rated AAA and 65% of our CMOs were backed by agencies of the United States government. Of the non-agency backed CMOs, 41% were rated AAA.

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The following table summarizes our investment securities at December 31, 2010 (in thousands).

December 31, 2010	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government and agencies	$ 28,228	$ 1,177	$	$ 29,405
State	7,424	321		7,745
Political subdivisions	1,647	25	(21)	1,651
Revenue and assessment	27,131	1,076	(148)	28,059
Corporate bonds	73,238	4,681	(298)	77,621
Collateralized mortgage obligations:				
Agency backed	22,877	1,521		24,398
Non-agency backed residential	6,121	240	(380)	5,981
Non-agency backed commercial	6,754	285		7,039
Redeemable preferred stock	176			176
Total fixed maturities, available-for-sale	173,596	9,326	(847)	182,075
Investment in mutual fund, available-for-sale	7,501	446		7,947
	$ 181,097	$ 9,772	$ (847)	$ 190,022

The following table sets forth the scheduled maturities of our fixed maturity securities at December 31, 2010 based on their fair values (in thousands). Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

December 31, 2010	Securities with Unrealized Gains	Securities with Unrealized Losses	Securities with No Unrealized Gains or Losses	All Fixed Maturity Securities
One year or less	$ 13,507	$ 125	$	$ 13,632
After one through five years	77,775			77,775
After five through ten years	37,601			37,601
After ten years	9,690	5,959		15,649
No single maturity date	34,131	2,638	649	37,418
	$ 172,704	$ 8,722	$ 649	$ 182,075

Other-Than-Temporary Impairment

In accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 320-10-65, *Recognition and Presentation of Other-Than-Temporary Impairments*, we separate other-than-temporary impairment (OTTI) into the following two components: (i) the amount related to credit losses, which is recognized in the consolidated statement of operations and (ii) the amount related to all other factors, which is recorded in other comprehensive income (loss). The credit-related portion of an OTTI is measured by comparing a security s amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge.

The determination of whether unrealized losses are other-than-temporary requires judgment based on subjective as well as objective factors. We routinely monitor our investment portfolio for changes in fair value that might indicate potential impairments and perform detailed reviews on such securities. Changes in fair value are evaluated to determine the extent to which such changes are attributable to (i) fundamental factors specific to the issuer or (ii) market-related factors such as interest rates or sector declines.

Securities with declines attributable to issuer-specific fundamentals are reviewed to identify all available evidence to estimate the potential for impairment. Resources used include historical financial data included in filings with the Securities and Exchange Commission for corporate bonds and performance data regarding the underlying loans for CMOs. Securities with declines attributable solely to market or sector declines where we do not intend to sell the security and it is more likely than not that we will not be required to sell the security before the full recovery of its amortized cost basis are not deemed to be other-than-temporary.

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The issuer-specific factors considered in reaching the conclusion that securities with declines are not other-than-temporary include (i) the extent and duration of the decline in fair value, including the duration of any significant decline in value, (ii) whether the security is current as to payments of principal and interest, (iii) a valuation of any underlying collateral, (iv) current and future conditions and trends for both the business and its industry, (v) changes in cash flow assumptions for CMOs and (vi) rating agency actions. Based on these factors, we make a determination as to the probability of recovering principal and interest on the security.

On a quarterly basis, we review cash flow estimates for certain non-agency backed CMOs of lesser credit quality following the guidance of FASB ASC 325-40-65, *Amendments to the Impairment Guidance of EITF Issue No. 99-20* (FASB ASC 325-40-65). Accordingly, when changes in estimated cash flows from the cash flows previously estimated occur due to actual or estimated prepayment or credit loss experience, and the present value of the revised cash flows is less than the present value previously estimated, OTTI is deemed to have occurred. For non-agency backed CMOs not subject to FASB ASC 325-40-65, we review quarterly projected cash flow analyses and recognize OTTI when it is determined that a loss is probable. We have recognized OTTI related to certain non-agency backed CMOs as the underlying cash flows have been adversely impacted due to a reduction in prepayments from mortgage refinancing and an increase in actual and projected delinquencies in the underlying mortgages.

Our review of non-agency backed CMOs included an analysis of available information such as collateral quality, anticipated cash flows, credit enhancements, default rates, loss severities, the securities relative position in their respective capital structures and credit ratings from statistical rating agencies. We review quarterly projected cash flow analyses for each security utilizing current assumptions regarding (i) actual and anticipated delinquencies, (ii) delinquency transition-to-default rates and (iii) loss severities. Based on our quarterly reviews, we determined that there had not been an adverse change in projected cash flows, except in the case of those securities discussed in Note 2 to our consolidated financial statements which incurred OTTI charges of $0.3 million and $0.8 million for the six months ended December 31, 2010 and 2009, respectively. We believe that the unrealized losses on the remaining non-agency backed CMOs are not necessarily predictive of the ultimate performance of the underlying collateral. We do not intend to sell these securities and it is more likely than not that we will not be required to sell these securities before the recovery of their amortized cost basis.

We believe that the remaining securities having unrealized losses at December 31, 2010 were not other-than-temporarily impaired. We also do not intend to sell any of these securities and it is more likely than not that we will not be required to sell any of these securities before the recovery of their amortized cost basis.

Three and Six Months Ended December 31, 2010 Compared with the Three and Six Months Ended December 31, 2009

Consolidated Results

Revenues for the three months ended December 31, 2010 decreased 4% to $51.7 million from $53.8 million in the same period in the prior year. Loss before income taxes for the three months ended December 31, 2010 was $2.0 million, compared with income before income taxes of $1.6 million for the three months ended December 31, 2009. Net loss for the three months ended December 31, 2010 was $2.1 million, compared with net income of $1.5 million for the three months ended December 31, 2009. Basic and diluted net loss per share was $0.04 for the three months ended December 31, 2010, compared with basic and diluted net income per share of $0.03 for the three months ended December 31, 2009.

Revenues for the six months ended December 31, 2010 decreased 6% to $104.8 million from $111.1 million in the same period in the prior year. Loss before income taxes for the six months ended December 31, 2010 was $1.5 million, compared with income before income taxes of $4.4 million for the six months ended December 31, 2009. Net loss for the six months ended December 31, 2010 was $1.7 million, compared with net income of $4.2 million for the six months ended December 31, 2009. Basic and diluted net loss per share was $0.04 for the six months ended December 31, 2010, compared with basic and diluted net income per share of $0.09 for the six months ended December 31, 2009.

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Insurance Operations

Revenues from insurance operations were $51.6 million for the three months ended December 31, 2010, compared with $53.7 million for the three months ended December 31, 2009. Revenues from insurance operations were $104.7 million for the six months ended December 31, 2010, compared with $111.0 million for the six months ended December 31, 2009.

Loss before income taxes from insurance operations for the three months ended December 31, 2010 was $0.5 million, compared with income before income taxes from insurance operations of $3.6 million for the three months ended December 31, 2009. Income before income taxes from insurance operations for the six months ended December 31, 2010 was $1.5 million, compared with $8.0 million for the six months ended December 31, 2009.

Premiums Earned

Premiums earned decreased by $2.7 million, or 6%, to $42.5 million for the three months ended December 31, 2010, from $45.2 million for the three months ended December 31, 2009. For the six months ended December 31, 2010, premiums earned decreased by $7.2 million, or 8%, to $86.5 million from $93.7 million for the six months ended December 31, 2009. The decreases in premiums earned were primarily due to a decline in the number of PIF from 147,090 at December 31, 2009 to 144,582 at December 31, 2010, which was impacted by the closure of underperforming stores. At December 31, 2010, we operated 393 stores, compared with 409 stores at December 31, 2009. Premiums earned were also negatively impacted by an increase in the percentage of PIF with liability-only coverage, as well as a decline in newly-issued PIF at December 31, 2010 compared with the same date in the prior year. The number of PIF sold through our open stores increased from 139,453 at December 31, 2009 to 140,547 at December 31, 2010.

Commission and Fee Income

Commission and fee income increased 1% to $7.1 million for the three months ended December 31, 2010, from $7.0 million for the three months ended December 31, 2009. For the six months ended December 31, 2010, commission and fee income increased 3% to $14.3 million from $13.9 million for the six months ended December 31, 2009. The increases in commission and fee income were a result of higher fee income related to commissionable ancillary products sold through our retail locations offset by the decrease in the number of PIF.

Investment Income

Investment income increased to $2.1 million during the three months ended December 31, 2010 from $2.0 million during the three months ended December 31, 2009. For the six months ended December 31, 2010, investment income increased to $4.3 million from $3.9 million during the six months ended December 31, 2009. The increases in investment income were primarily a result of the higher yield obtained on the mutual fund investment made in June 2010. At December 31, 2010 and 2009, the tax-equivalent book yields for our fixed maturities portfolio were 4.6% and 4.3%, respectively, with effective durations of 3.12 and 3.35 years, respectively.

Net realized losses on investments, available-for-sale

Net realized losses on investments, available-for-sale during the three months ended December 31, 2010 included $32 thousand of charges related to OTTI on certain non-agency backed CMOs. Net realized losses on investments, available-for-sale during the three months ended December 31, 2009 included $0.4 million of charges related to OTTI on certain non-agency backed CMOs.

For the six months ended December 31, 2010, net realized losses on investments, available-for-sale included $0.1 million in net realized gains on sales and $0.3 million of charges related to OTTI on certain non-agency backed CMOs. Net realized losses on investments, available-for-sale during the six months ended December 31, 2009 included $0.3 million in net realized gains on sales and $0.8 million of charges related to OTTI on certain non-agency backed CMOs. For additional information with respect to the determination of OTTI losses on investment securities, see Note 2 to our consolidated financial statements.

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Loss and Loss Adjustment Expenses

The loss and loss adjustment expense ratio was 78.4% for the three months ended December 31, 2010, compared with 66.1% for the three months ended December 31, 2009. The loss and loss adjustment expense ratio was 75.6% for the six months ended December 31, 2010 compared with 67.3% for the six months ended December 31, 2009. We experienced unfavorable development related to prior periods of $3.1 million for the three months ended December 31, 2010, compared with favorable development of $2.4 million for the three months ended December 31, 2009. For the six months ended December 31, 2010, we experienced unfavorable development related to prior periods of $1.0 million, compared with favorable development of $6.1 million for the six months ended December 31, 2009. The unfavorable development for the three and six months ended December 31, 2010 was primarily due to higher than anticipated paid severity on accidents occurring during the first six months of calendar year 2010. The higher than anticipated paid severity was primarily related to no-fault (or Personal Injury Protection) losses in Florida and Bodily Injury losses in Florida and Georgia.

Excluding the development related to prior periods, the loss and loss adjustment expense ratios for the three months ended December 31, 2010 and 2009 were 71.1% and 71.4%, respectively. Excluding the development related to prior periods, the loss and loss adjustment expense ratios for the six months ended December 31, 2010 and 2009 were 74.5% and 73.8%, respectively. The increase for the six months ended December 31, 2010 compared with the same period in the prior year was due to higher loss adjustment expense resulting from (i) the increase in the percentage of claims related to liability-only coverage policies and (ii) increased investigative efforts with regards to no-fault claims in Florida.

As previously disclosed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010, we are in the process of implementing a new multivariate pricing program in all states in which we conduct business. We believe that this new pricing program will provide us with greater pricing segmentation and improve our pricing relative to the risk we are insuring. In connection with this new pricing program and specific to the states mentioned above, we filed new rates in Florida, which became effective in November 2010, and in Georgia, which are currently awaiting regulatory approval.

Operating Expenses

Insurance operating expenses decreased 7% to $18.4 million for the three months ended December 31, 2010 from $19.7 million for the three months ended December 31, 2009. For the six months ended December 31, 2010, insurance operating expenses decreased 6% to $36.9 million from $39.3 million for the six months ended December 31, 2009. The decreases were primarily a result of a reduction in costs (such as employee-agent commissions and premium taxes) that varied along with the decrease in premiums earned as well as savings realized from the closure of underperforming stores.

The expense ratio decreased from 28.2% for the three months ended December 31, 2009 to 26.6% for the same period in the current fiscal year. The expense ratio decreased from 27.1% for the six months ended December 31, 2009 to 26.1% for the same period in the current fiscal year. The year-over-year decreases in the expense ratio were primarily due to the reduction in fixed costs and savings realized from the closure of underperforming stores.

Overall, the combined ratio increased to 105.0% for the three months ended December 31, 2010 from 94.3% for the three months ended December 31, 2009. For the six months ended December 31, 2010, the combined ratio increased to 101.7% from 94.4% for the six months ended December 31, 2009.

Provision for Income Taxes

The provision for income taxes was $0.1 million for both the three months ended December 31, 2010 and 2009. For both the six months ended December 31, 2010 and 2009, the provision for income taxes was $0.2 million. The provision for income taxes related to current state income taxes for certain subsidiaries with taxable income. At December 31, 2010 and 2009, we established a full valuation allowance against all net deferred tax assets.

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Real Estate and Corporate

Loss before income taxes from real estate and corporate operations for the three months ended December 31, 2010 was $1.4 million, compared with a loss before income taxes from real estate and corporate operations of $2.0 million for the three months ended December 31, 2009. Loss before income taxes from real estate and corporate operations for the six months ended December 31, 2010 was $3.0 million, compared with a loss before income taxes from real estate and corporate operations of $3.6 million for the six months ended December 31, 2009. Segment losses consist of other operating expenses not directly related to our insurance operations, interest expense and stock-based compensation offset by investment income on corporate invested assets. We incurred $1.0 million and $2.0 million, respectively, of interest expense during the three and six months ended December 31, 2010 and 2009 related to the debentures issued in June 2007.

Liquidity and Capital Resources

Our primary sources of funds are premiums, fees and investment income from our insurance company subsidiaries and commissions and fee income from our non-insurance company subsidiaries. Our primary uses of funds are the payment of claims and operating expenses. Net cash used in operating activities for the six months ended December 31, 2010 was $3.1 million compared with net cash used in operating activities of $4.2 million for the same period in the prior fiscal year. Net cash used in operating activities for the six months ended December 31, 2010 and 2009 was primarily the result of a decrease in cash collected from premiums written. Net cash provided by investing activities for the six months ended December 31, 2010 was $6.0 million compared with net cash used in investing activities of $43.8 million for the same period in the prior fiscal year. The six months ended December 31, 2010 included net reductions in our investment portfolio of $6.3 million, while the same period in the prior fiscal year included net additions to our investment portfolio of $43.2 million. The net reductions in the current fiscal year were a result of maturities and paydowns. The net additions in the prior fiscal year were primarily the result of the reinvestment of the proceeds from sales in the prior fiscal year of investments to generate taxable income to utilize expiring net operating losses.

Our holding company requires cash for general corporate overhead expenses and for debt service related to our debentures payable. The holding company s primary source of unrestricted cash to meet its obligations is the sale of ancillary products to our insureds and, if necessary, the holding company may receive dividends from our insurance company subsidiaries. The holding company also receives cash from operating activities as a result of investment income. Through an intercompany tax allocation arrangement, taxable losses of the holding company provide cash to the holding company to the extent that taxable income is generated by the insurance company subsidiaries. At December 31, 2010, we had $10.9 million available in unrestricted cash and investments outside of the insurance company subsidiaries. These funds and the additional unrestricted cash from the sources noted above will be used to pay our future cash requirements outside of the insurance company subsidiaries.

The holding company has debt service requirements related to the debentures payable. The debentures are interest-only and mature in full in July 2037. Interest is fixed annually through July 2012 at $3.9 million. The debentures pay a fixed rate of 9.277% until July 30, 2012, after which time the rate becomes variable (LIBOR plus 375 basis points).

State insurance laws limit the amount of dividends that may be paid from our insurance company subsidiaries. Based on our earned surplus at December 31, 2010, we believe that we have total dividend capacity for the next twelve months of $18.5 million, of which $6.6 million is subject to regulatory approval.

The National Association of Insurance Commissioners Model Act for risk-based capital provides formulas to determine each December 31 on an annual basis, the amount of statutory capital and surplus that an insurance company needs to ensure that it has an acceptable expectation of not becoming financially impaired. There are also statutory guidelines that suggest that on an annual calendar year basis, an insurance company should not exceed a ratio of net premiums written to statutory capital and surplus of 3-to-1. On a combined basis, the ratios for our insurance company subsidiaries of net premiums written to statutory capital and surplus were 1.5-to-1 and 1.6-to-1 at December 31, 2010 and 2009, respectively. Based on our current forecast on a combined basis, we anticipate that our risk-based capital levels will be adequate and that our ratio of net premiums written to statutory capital and surplus will not exceed 2-to-1 for the reasonably foreseeable future. We therefore believe that our insurance company subsidiaries have sufficient statutory capital and surplus available to support their net premium writings in this time frame.

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We believe that existing cash and investment balances, when combined with anticipated cash flows as noted above, will be adequate to meet our expected liquidity needs, for both the holding company and our insurance company subsidiaries, in both the short-term and the reasonably foreseeable future. Any future growth strategy may require external financing, and we may from time to time seek to obtain external financing. We cannot assure that additional sources of financing will be available to us on favorable terms, or at all, or that any such financing would not negatively impact our results of operations.

Critical Accounting Policies

There have been no significant changes to our critical accounting policies and estimates during the three months ended December 31, 2010 compared with those disclosed in Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Estimates included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010.

Off-Balance Sheet Arrangements

We have not entered into any new off-balance sheet arrangements since June 30, 2010. For information with respect to our off-balance sheet arrangements at June 30, 2010, see Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Off-Balance Sheet Arrangements included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010.

Forward-Looking Statements

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements made in this report, other than statements of historical fact, are forward-looking statements. You can identify these statements from our use of the words may, should, could, potential, continue, plan, forecast, estimate, project, believe, expect, target, is likely, will, or the negative of these terms and similar expressions. These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements may include, among other things statements and assumptions relating to:

- our future growth, income, income per share and other financial performance measures;
- the anticipated effects on our results of operations or financial condition from recent and expected developments or events;
- the financial condition of, and other issues relating to the strength of and liquidity available to, issuers of securities held in our investment portfolio;
- the accuracy and adequacy of our loss reserving methodologies; and
- our business and growth strategies.

We believe that our expectations are based on reasonable assumptions. However, these forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause our actual results, performance or achievements, or industry results to differ materially from our expectations of future results, performance or achievements expressed or implied by these forward-looking statements. In addition, our past results of operations do not necessarily indicate our future results. We discuss these and other uncertainties in Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended June 30, 2010.

You should not place undue reliance on any forward-looking statements. These statements speak only as of the date of this report. Except as otherwise required by applicable laws, we undertake no obligation to publicly update or revise any forward-looking statements or the risk factors described in this report, whether as a result of new information, future events, changed circumstances or any other reason after the date of this report.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk represents the potential economic loss arising from adverse changes in the fair value of financial instruments. Our exposures to market risk relate primarily to our investment portfolio, which is exposed primarily to interest rate risk and credit risk. The fair value of our investment portfolio is directly impacted by changes in market interest rates; generally, the fair value of fixed-income investments moves inversely with movements in market interest rates. Our fixed maturity portfolio is comprised of substantially all fixed rate investments with primarily short-term and intermediate-term maturities. Likewise, the underlying investments of our current mutual fund investment are also fixed-income investments. This portfolio composition allows flexibility in reacting to fluctuations of interest rates. The portfolios of our insurance company subsidiaries are managed to achieve an adequate risk-adjusted return while maintaining sufficient liquidity to meet policyholder obligations.

Interest Rate Risk

The fair values of our fixed maturity investments fluctuate in response to changes in market interest rates. Increases and decreases in prevailing interest rates generally translate into decreases and increases, respectively, in the fair values of those instruments. Additionally, the fair values of interest rate sensitive instruments may be affected by the creditworthiness of the issuer, prepayment options, relative values of alternative investments, the liquidity of the instrument and other general market conditions.

The following table summarizes the estimated effects of hypothetical increases and decreases in interest rates resulting from parallel shifts in market yield curves on our fixed maturity portfolio (in thousands). It is assumed that the effects are realized immediately upon the change in interest rates. The hypothetical changes in market interest rates do not reflect what could be deemed best or worst case scenarios. Variations in market interest rates could produce significant changes in the timing of repayments due to prepayment options available. For these reasons, actual results might differ from those reflected in the table.

	Sensitivity to Instantaneous Interest Rate Changes (basis points)					
	(100)	**(50)**	**0**	**50**	**100**	**200**
Fair value of fixed maturity portfolio	$ 188,505	$ 185,257	$ 182,075	$ 178,977	$ 175,970	$ 170,205

The following table provides information about our fixed maturity investments at December 31, 2010 which are sensitive to interest rate risk. The table shows expected principal cash flows (at par value, which differs from amortized cost as a result of premiums or discounts at the time of purchase and OTTI) by expected maturity date for each of the next five fiscal years and collectively for all fiscal years thereafter (in thousands). Callable bonds and notes are included based on call date or maturity date depending upon which date produces the most conservative yield. CMOs are included based on maturity year adjusted for expected payment patterns. Actual cash flows may differ from those expected.

Year Ended June 30,	**Securities with Unrealized Gains**	**Securities with Unrealized Losses**	**Securities with No Unrealized Gains or Losses**	**Amount**
2011	$ 7,285	$	$	$ 7,285
2012	16,280	125		16,405
2013	24,215			24,215
2014	20,365			20,365
2015	19,410			19,410
Thereafter	74,965	8,972	500	84,437

Total	$ 162,520	$ 9,097	$ 500	$ 172,117
Fair value	$ 172,704	$ 8,722	$ 649	$ 182,075

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On June 15, 2007, our trust entity, First Acceptance Statutory Trust I, used the proceeds from its sale of trust preferred securities to purchase $41.2 million of junior subordinated debentures. The debentures pay a fixed rate of 9.277% until July 30, 2012, after which the rate becomes variable (LIBOR plus 375 basis points).

Credit Risk

Credit risk is managed by diversifying the portfolio to avoid concentrations in any single industry group or issuer and by limiting investments in securities with lower credit ratings. The largest investment in any one investment, excluding U.S. government and agency securities, is the $7.9 million investment in a single mutual fund, or 4% of the investment portfolio. The top five investments make up 16% of the investment portfolio. The average credit quality rating for our fixed maturity portfolio was AA- at December 31, 2010.

The following table presents the underlying ratings of our fixed maturity portfolio by nationally recognized securities rating organizations at December 31, 2010 (in thousands).

Comparable Rating	Amortized Cost	% of Amortized Cost	Fair Value	% of Fair Value
AAA	$ 68,572	39.5%	$ 72,026	39.6%
AA+, AA, AA-	35,903	20.7%	37,998	20.9%
A+, A, A-	46,815	27.0%	49,036	26.9%
BBB+, BBB, BBB-	13,295	7.6%	14,022	7.7%
Total investment grade	164,585	94.8%	173,082	95.1%
Not rated	3,803	2.2%	3,875	2.1%
BB+, BB, BB-	1,684	1.0%	1,716	0.9%
B+, B, B-	1,137	0.6%	1,201	0.7%
CCC+, CCC, CCC-	1,006	0.6%	1,043	0.6%
CC+, CC, CC-	1,054	0.6%	798	0.4%
C+, C, C-	327	0.2%	360	0.2%
Total non-investment grade	5,208	3.0%	5,118	2.8%
Total	$ 173,596	100.0%	$ 182,075	100.0%

The mortgage industry has experienced a rise in mortgage delinquencies and foreclosures, particularly among lower quality exposures (sub-prime and Alt-A). As a result of these increasing delinquencies and foreclosures, many CMOs with underlying sub-prime and Alt-A mortgages as collateral experienced significant declines in fair value. At December 31, 2010, our fixed maturity portfolio included three CMOs having sub-prime exposure with a fair value of $0.9 million and no exposure to Alt-A investments.

Our investment portfolio consists of $37.5 million of municipal bonds, of which $23.3 million are insured. Of the insured bonds, 68% are insured with MBIA, 14% with AMBAC and 18% with XL Capital. These securities are paying their principal and periodic interest timely.

The following table presents the underlying ratings at December 31, 2010, represented by the lower of either Standard and Poor s, Fitch s, or Moody s ratings, of the municipal bond portfolio (in thousands).

	Insured		Uninsured		Total	
	Fair	% of Fair	Fair	% of Fair	Fair	% of Fair

	Value	Value	Value	Value	Value	Value
AAA	$		$ 4,705	33%	$ 4,705	13%
AA+, AA, AA-	12,541	54%	5,506	39%	18,047	48%
A+, A, A-	9,131	39%	3,970	28%	13,101	35%
BBB+, BBB, BBB-	1,602	7%			1,602	4%
Total	$ 23,274	100%	$ 14,181	100%	$ 37,455	100%

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management team, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended, or the Exchange Act) as of December 31, 2010. Based on that evaluation, our Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer) concluded that our disclosure controls and procedures were effective as of December 31, 2010 to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms.

Changes in Internal Control Over Financial Reporting

During the period covered by this report, there has been no change in our internal control over financial reporting that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

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PART II OTHER INFORMATION

Item 6. Exhibits

The following exhibits are attached to this report:

31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a).
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a).
32.1	Chief Executive Officer s Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Chief Financial Officer s Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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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.

FIRST ACCEPTANCE CORPORATION

February 7, 2011

By: /s/ Kevin P. Cohn
Kevin P. Cohn
Senior Vice President and Chief Financial Officer
(Principal Financial Officer and Principal Accounting Officer)