

KANSAS CITY LIFE INSURANCE CO  
Form 10-Q  
October 28, 2011  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2011 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 2-40764

**KANSAS CITY LIFE INSURANCE COMPANY**

(Exact name of registrant as specified in its charter)

Missouri  
(State or other jurisdiction of  
incorporation or organization)

44-0308260  
(I.R.S. Employer  
Identification No.)

3520 Broadway, Kansas City, Missouri  
(Address of principal executive offices)

64111-2565  
(Zip Code)

816-753-7000

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 x

No ..

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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 smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock, \$1.25 par  
Class

11,345,527 shares  
Outstanding September 30, 2011

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**KANSAS CITY LIFE INSURANCE COMPANY**

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**Table of Contents****Part I. Financial Information****Item 1. Financial Statements**

Amounts in thousands, except share data, or as otherwise noted

**Kansas City Life Insurance Company****Consolidated Balance Sheets**

|   | September 30<br>2011 | December 31<br>2010 |
|---|----------------------|---------------------|
|   | (Unaudited)          |                     |
| <b>ASSETS</b>   |                      |                     |
| Investments:  |                      |                     |
| Fixed maturity securities available for sale, at fair value | \$ 2,664,189         | \$ 2,648,888        |
| Equity securities available for sale, at fair value         | 36,900               | 38,321              |
| Mortgage loans  | 623,368              | 559,167             |
| Real estate   | 122,349              | 119,909             |
| Policy loans  | 81,762               | 84,281              |
| Short-term investments                                      | 40,536               | 15,713              |
| Other investments   | 4,092                | 5,009               |
| Total investments   | 3,573,196            | 3,471,288           |
| Cash  | 6,408                | 5,445               |
| Accrued investment income                                   | 38,636               | 35,742              |
| Deferred acquisition costs                                  | 174,718              | 192,943             |
| Reinsurance receivables                                     | 192,130              | 187,123             |
| Property and equipment                                      | 22,984               | 23,514              |
| Other assets  | 65,545               | 78,018              |
| Separate account assets                                     | 304,425              | 339,029             |
| Total assets  | \$ 4,378,042         | \$ 4,333,102        |
| <b>LIABILITIES</b>  |                      |                     |
| Future policy benefits                                      | \$ 886,218           | \$ 884,380          |
| Policyholder account balances                               | 2,089,809            | 2,065,878           |
| Policy and contract claims                                  | 34,606               | 43,866              |
| Other policyholder funds                                    | 150,744              | 145,560             |
| Other liabilities   | 188,137              | 174,917             |
| Separate account liabilities                                | 304,425              | 339,029             |
| Total liabilities   | 3,653,939            | 3,653,630           |
| <b>STOCKHOLDERS EQUITY</b>                                  |                      |                     |
| Common stock, par value \$1.25 per share                    |                      |                     |
| Authorized 36,000,000 shares, issued 18,496,680 shares      | 23,121               | 23,121              |
| Additional paid in capital                                  | 41,097               | 41,085              |

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|  |              |              |
|--|--------------|--------------|
| Retained earnings  | 778,269      | 767,126      |
| Accumulated other comprehensive income                                     | 45,014       | 7,807        |
| Treasury stock, at cost (2011 - 7,151,153 shares; 2010 - 7,029,575 shares) | (163,398)    | (159,667)    |
| Total stockholders' equity   | 724,103      | 679,472      |
| Total liabilities and stockholders' equity                                 | \$ 4,378,042 | \$ 4,333,102 |

*See accompanying Notes to Consolidated Financial Statements (Unaudited)*

**Table of Contents****Kansas City Life Insurance Company****Consolidated Statements of Income**

|   | Quarter Ended<br>September 30 |                 | Nine Months Ended<br>September 30 |                     |
|---|-------------------------------|-----------------|-----------------------------------|---------------------|
|   | 2011<br>(Unaudited)           | 2010            | 2011<br>(Unaudited)               | 2010<br>(Unaudited) |
| <b>REVENUES</b>   |                               |                 |                                   |                     |
| Insurance revenues:   |                               |                 |                                   |                     |
| Premiums, net   | \$ 32,476                     | \$ 35,786       | \$ 96,902                         | \$ 104,934          |
| Contract charges  | 25,427                        | 26,643          | 75,413                            | 79,985              |
| <b>Total insurance revenues</b>                                       | <b>57,903</b>                 | <b>62,429</b>   | <b>172,315</b>                    | <b>184,919</b>      |
| Investment revenues:  |                               |                 |                                   |                     |
| Net investment income   | 43,093                        | 44,120          | 133,377                           | 130,696             |
| Realized investment gains, excluding impairment losses                | 210                           | 263             | 3,115                             | 3,079               |
| Net impairment losses recognized in earnings:                         |                               |                 |                                   |                     |
| Total other-than-temporary impairment losses                          | (167)                         | (1,080)         | (674)                             | (4,129)             |
| Portion of impairment losses recognized in other comprehensive income | 17                            | 170             | 131                               | 309                 |
| <b>Net impairment losses recognized in earnings</b>                   | <b>(150)</b>                  | <b>(910)</b>    | <b>(543)</b>                      | <b>(3,820)</b>      |
| <b>Total investment revenues</b>                                      | <b>43,153</b>                 | <b>43,473</b>   | <b>135,949</b>                    | <b>129,955</b>      |
| Other revenues  | 2,215                         | 2,223           | 7,289                             | 6,913               |
| <b>Total revenues</b>   | <b>103,271</b>                | <b>108,125</b>  | <b>315,553</b>                    | <b>321,787</b>      |
| <b>BENEFITS AND EXPENSES</b>  |                               |                 |                                   |                     |
| Policyholder benefits   | 38,540                        | 46,374          | 122,679                           | 136,789             |
| Interest credited to policyholder account balances                    | 21,119                        | 21,561          | 62,366                            | 64,301              |
| Amortization of deferred acquisition costs                            | 11,577                        | 8,652           | 21,866                            | 19,777              |
| Operating expenses  | 24,593                        | 24,752          | 76,956                            | 75,332              |
| <b>Total benefits and expenses</b>                                    | <b>95,829</b>                 | <b>101,339</b>  | <b>283,867</b>                    | <b>296,199</b>      |
| <b>Income before income tax expense</b>                               | <b>7,442</b>                  | <b>6,786</b>    | <b>31,686</b>                     | <b>25,588</b>       |
| Income tax expense  | 2,976                         | 2,330           | 11,256                            | 10,109              |
| <b>NET INCOME</b>   | <b>\$ 4,466</b>               | <b>\$ 4,456</b> | <b>\$ 20,430</b>                  | <b>\$ 15,479</b>    |
| Comprehensive income, net of taxes:                                   |                               |                 |                                   |                     |
| Change in net unrealized gains on securities available for sale       | \$ 20,312                     | \$ 25,616       | \$ 37,207                         | \$ 71,730           |
| <b>Other comprehensive income</b>                                     | <b>20,312</b>                 | <b>25,616</b>   | <b>37,207</b>                     | <b>71,730</b>       |

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|                             |           |           |           |           |
|-----------------------------|-----------|-----------|-----------|-----------|
| <b>COMPREHENSIVE INCOME</b> | \$ 24,778 | \$ 30,072 | \$ 57,637 | \$ 87,209 |
|-----------------------------|-----------|-----------|-----------|-----------|

Basic and diluted earnings per share:

|            |         |         |         |         |
|------------|---------|---------|---------|---------|
| Net income | \$ 0.39 | \$ 0.39 | \$ 1.78 | \$ 1.35 |
|------------|---------|---------|---------|---------|

*See accompanying Notes to Consolidated Financial Statements (Unaudited)*

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**Kansas City Life Insurance Company**  
**Consolidated Statement of Stockholders Equity**

|  | Nine Months Ended<br>September 30,<br>2011<br>(Unaudited) |
|--|---|
| <b>COMMON STOCK</b> , beginning and end of period            | \$ 23,121   |
| <br>   |   |
| <b>ADDITIONAL PAID IN CAPITAL</b>                            |   |
| Beginning of period  | 41,085  |
| Excess of proceeds over cost of treasury stock sold          | 12  |
| End of period  | 41,097  |
| <br>   |   |
| <b>RETAINED EARNINGS</b>                                     |   |
| Beginning of period  | 767,126   |
| Net income   | 20,430  |
| Stockholder dividends of \$0.81 per share                    | (9,287)   |
| End of period  | 778,269   |
| <br>   |   |
| <b>ACCUMULATED OTHER COMPREHENSIVE INCOME</b> , net of taxes |   |
| Beginning of period  | 7,807   |
| Other comprehensive income                                   | 37,207  |
| End of period  | 45,014  |
| <br>   |   |
| <b>TREASURY STOCK</b> , at cost                              |   |
| Beginning of period  | (159,667)   |
| Cost of 122,301 shares acquired                              | (3,741)   |
| Cost of 723 shares sold                                      | 10  |
| End of period  | (163,398)   |
| <br>   |   |
| <b>TOTAL STOCKHOLDERS EQUITY</b>                             | \$ 724,103  |

*See accompanying Notes to Consolidated Financial Statements (Unaudited)*





**Table of Contents****Kansas City Life Insurance Company****Consolidated Statements of Cash Flows**

|   | Nine Months Ended<br>September 30 |                 |
|---|-----------------------------------|-----------------|
|   | 2011                              | 2010            |
|   | (Unaudited)                       |                 |
| <b>OPERATING ACTIVITIES</b>   |                                   |                 |
| Net income  | \$ 20,430                         | \$ 15,479       |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                   |                 |
| Amortization of investment premium  | 2,268                             | 2,292           |
| Depreciation  | 2,345                             | 2,093           |
| Acquisition costs capitalized   | (26,383)                          | (27,820)        |
| Amortization of deferred acquisition costs  | 21,866                            | 19,777          |
| Realized investment (gains) losses  | (2,572)                           | 741             |
| Changes in assets and liabilities:  |                                   |                 |
| Reinsurance receivables   | (5,007)                           | (2,388)         |
| Future policy benefits  | (7,497)                           | 6,834           |
| Policyholder account balances   | (8,100)                           | (18,333)        |
| Income taxes payable and deferred   | 4,515                             | 10,245          |
| Other, net  | (5,174)                           | (2,562)         |
| <b>Net cash provided (used)</b>   | <b>(3,309)</b>                    | <b>6,358</b>    |
| <b>INVESTING ACTIVITIES</b>   |                                   |                 |
| Purchases of investments:   |                                   |                 |
| Fixed maturity securities   | (146,508)                         | (308,218)       |
| Equity securities   | (191)                             | (786)           |
| Mortgage loans  | (122,860)                         | (93,861)        |
| Real estate   | (7,188)                           | (9,669)         |
| Policy loans  | (10,898)                          | (12,872)        |
| Other investments   | -                                 | (644)           |
| Sales of investments:   |                                   |                 |
| Fixed maturity securities   | 61,241                            | 60,470          |
| Equity securities   | 14                                | 585             |
| Other investments   | -                                 | 858             |
| Net sales (purchases) of short-term investments                                   | (24,823)                          | 112,916         |
| Maturities and principal paydowns of investments:                                 |                                   |                 |
| Fixed maturity securities   | 164,752                           | 179,175         |
| Equity securities   | 1,200                             | -               |
| Mortgage loans  | 58,655                            | 28,270          |
| Policy loans  | 13,417                            | 13,838          |
| Net acquisition of property and equipment   | (283)                             | (348)           |
| <b>Net cash used</b>  | <b>(13,472)</b>                   | <b>(30,286)</b> |

*See accompanying Notes to Consolidated Financial Statements (Unaudited)*



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**Kansas City Life Insurance Company**  
**Consolidated Statements of Cash Flows (Continued)**

|  | Nine Months Ended<br>September 30 |           |
|--|-----------------------------------|-----------|
|  | 2011                              | 2010      |
|  | (Unaudited)                       |           |
| <b>FINANCING ACTIVITIES</b>                    |                                   |           |
| Proceeds from borrowings                       | \$ -                              | \$ 8,000  |
| Repayment of borrowings                        | -                                 | (8,000)   |
| Deposits on policyholder account balances      | 181,502                           | 179,450   |
| Withdrawals from policyholder account balances | (149,882)                         | (148,558) |
| Net transfers from separate accounts           | 3,925                             | 5,536     |
| Change in other deposits                       | (4,795)                           | 3,303     |
| Cash dividends to stockholders                 | (9,287)                           | (9,305)   |
| Net acquisition of treasury stock              | (3,719)                           | (3,057)   |
| Net cash provided                              | 17,744                            | 27,369    |
| Increase in cash                               | 963                               | 3,441     |
| Cash at beginning of year                      | 5,445                             | 4,981     |
| Cash at end of period                          | \$ 6,408                          | \$ 8,422  |

*See accompanying Notes to Consolidated Financial Statements (Unaudited)*

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**Kansas City Life Insurance Company**

**Notes to Consolidated Financial Statements (Unaudited)**

***1. Nature of Operations and Significant Accounting Policies***

**Basis of Presentation**

The unaudited interim consolidated financial statements and the accompanying notes to these unaudited interim consolidated financial statements of Kansas City Life Insurance Company include the accounts of the consolidated entity (the Company), which primarily consists of three life insurance companies. Kansas City Life Insurance Company (Kansas City Life) is the parent company. Sunset Life Insurance Company of America (Sunset Life) and Old American Insurance Company (Old American) are wholly-owned subsidiaries.

The unaudited interim consolidated financial statements have been prepared on the basis of accounting principles generally accepted in the United States of America (GAAP) for interim financial reporting and with the instructions to Form 10-Q and Regulations S-K, S-X, and other applicable regulations. Accordingly, they do not include all of the disclosures required by GAAP for complete financial statements. As such, these unaudited interim consolidated financial statements should be read in conjunction with the Company's 2010 Form 10-K as filed with the Securities and Exchange Commission. Management believes that the disclosures are adequate to make the information presented not misleading, and all normal and recurring adjustments necessary to present fairly the financial position as of September 30, 2011 and the results of operations for all periods presented have been made. The results of operations for any interim period are not necessarily indicative of the Company's operating results for a full year.

Significant intercompany transactions have been eliminated in consolidation and certain immaterial reclassifications have been made to the prior period results to conform with the current period's presentation.

The preparation of the unaudited interim consolidated financial statements requires management of the Company to make estimates and assumptions relating to the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities as of the date of the unaudited interim consolidated financial statements, and the reported amounts of revenue and expenses during the period. These estimates are inherently subject to change and actual results could differ from these estimates.

**Significant Accounting Policies**

Please refer to the Company's 2010 Form 10-K for a full discussion of significant accounting policies.

***2. New Accounting Pronouncements and Other Regulatory Activity***

For a full discussion of new accounting pronouncements and other regulatory activity and their impact on the Company, please refer to the Company's 2010 Form 10-K. Following is a discussion of pronouncements issued during 2011 that were either adopted or under consideration by the Company at the time of the preparation of these consolidated financial statements.

**Accounting Pronouncements Issued During 2011, Adopted During 2011**

In April 2011, the Financial Accounting Standards Board (FASB) issued amended guidance concerning creditors' determinations of when a restructuring is considered to be a troubled debt restructuring. In making the determination, a creditor must evaluate and conclude that the restructuring constitutes a concession and that the debtor is experiencing financial difficulties. The amended guidance provides clarifications as to whether a concession has been made and provides additional guidance on a creditor's evaluation of whether a debtor is experiencing financial difficulties. This guidance became effective for the first interim or annual period beginning after June 15, 2011 and retrospective application to the beginning of the annual period of adoption is required. The Company adopted this guidance on July 1, 2011 with retroactive application to January 1, 2011 with no material impact to the consolidated financial statements.

**Accounting Pronouncements Issued During 2011, Not Yet Adopted**

In April 2011, the FASB issued new guidance concerning repurchase agreements. This guidance amends previously provided guidance as to when an entity may or may not recognize a sale upon the transfer of financial assets subject to repurchase agreements. That determination was previously based upon whether the entity has maintained effective control over the transferred financial assets. One of the relevant

considerations for assessing effective control is the transferor s

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**Notes to Consolidated Financial Statements (Unaudited) Continued**

ability to repurchase or redeem financial assets before maturity. This update removes the assessment of effective control. The update is effective for interim or annual periods beginning on or after December 15, 2011. The Company is currently evaluating this new guidance and its materiality to the consolidated financial statements.

In May 2011, the FASB issued new guidance concerning fair value measurements and disclosure. The new guidance is the result of joint efforts by the FASB and the International Accounting Standards Board (IASB) to develop a single, converged fair value framework on how to measure fair value and the necessary disclosures concerning fair value measurements. The guidance is effective for interim and annual periods beginning after December 15, 2011 and early adoption is not permitted. The Company is currently evaluating this new guidance and its materiality to the consolidated financial statements.

In June 2011, the FASB issued new guidance regarding the manner in which entities present comprehensive income in the financial statements. This guidance removes the previous presentation options and provides that entities must report comprehensive income in either a continuous statement of comprehensive income or two separate but consecutive statements. This guidance does not change the items that must be reported in other comprehensive income nor does it require incremental disclosures in addition to those previously required. The guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company is currently evaluating this new guidance and its impact to the presentation within the consolidated financial statements.

In July 2011, the FASB issued new guidance regarding fees paid to the federal government by health insurers. The guidance addresses how health insurers should recognize and classify in their income statements the fees that are mandated by the Patient Protection and Affordable Care Act as amended by the Health Care and Education Reconciliation Act. The guidance is effective for calendar years beginning after December 31, 2013. The Company is currently evaluating this new guidance and its impact to the consolidated financial statements.

***3. Fair Value Measurements***

**Fair Values Hierarchy**

The Company categorizes its financial assets and liabilities measured at fair value into three levels, based on the inputs and assumptions used to determine the fair value. These levels are as follows:

Level 1 Valuations are based upon quoted prices for identical instruments traded in active markets.

Level 2 Valuations are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which significant assumptions are observable in the market. Valuations are obtained from third-party pricing services or inputs that are observable or derived principally from or corroborated by observable market data.

Level 3 Valuations are generated from techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Company's assumptions that market participants would use in pricing the asset or liability. Valuation techniques include the use of discounted cash flow models, spread-based models, and similar techniques, using the best information available in the circumstances.

**Determination of Fair Value**

Under U.S. GAAP, fair value represents the price that would be received to sell an asset (exit price) or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. It is the Company's policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements. Accordingly, the Company utilizes a primary independent third-party pricing service to determine the majority of its fair values on investment securities available for sale.

In the event that the primary pricing service does not provide a price, the Company utilizes the price provided by a second pricing service. The Company reviews prices received from service providers for unusual fluctuations but generally accepts the price identified from the primary pricing service. In the event a price is not available from either third-party pricing service, the Company pursues external pricing from brokers.

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Generally, the Company pursues and utilizes only one broker quote per security. In doing so, the Company solicits only brokers which the Company believes have previously demonstrated knowledge and experience of the subject security. If a broker price is not available, the Company determines a fair value through various valuation techniques that include discounted cash flows, spread-based models or similar techniques, depending upon the specific security to be priced. These techniques are primarily applied to private placement securities. The Company utilizes available market information, wherever possible, to identify inputs into the fair value determination, primarily including prices and spreads on comparable securities.



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**Kansas City Life Insurance Company**

**Notes to Consolidated Financial Statements (Unaudited) Continued**

The Company performs an analysis on the prices received from third-party security pricing services and independent brokers to assess that the prices represent a reasonable estimate of the fair value. The Company corroborates and validates the primary pricing sources through a variety of procedures that include but are not limited to comparison to additional independent third-party pricing services or brokers, where possible, a review of third-party pricing service methodologies, back testing and comparison of prices to actual trades for specific securities where observable data exists. In addition, the Company analyzes the primary third-party pricing service's methodologies and related inputs and also evaluates the various types of securities in its investment portfolio to determine an appropriate fair value hierarchy.

The Company had three instances where it used a price other than identified in its pricing policy as of September 30, 2011.

In the first instance, the Company had two similar issues without prices from either pricing service. The Company received a broker price for each issue. The Company used the average of these prices and the latest liquidation price as its determination of fair value.

In the second instance, the Company received a price from its second pricing service but determined that the price was inconsistent with observable market indications. Accordingly, the Company used the average of the price from the pricing service and a broker price as its determination of fair value.

In the third instance, the Company received a price from its second pricing service but determined that the price was inconsistent with observable market indications. Accordingly, the Company's determination of fair value was derived from internal matrices and calculations.

Fair value measurements for assets and liabilities where there exists limited or no observable market data are calculated using the Company's own estimates. These estimates are based on current interest rates, credit spreads, liquidity premium or discount, the economic and competitive environment, unique characteristics of the asset or liability and other pertinent factors. Therefore, these estimates cannot be determined with precision and may not be realized in an actual sale or immediate settlement of the asset or liability. Additionally, there may be inherent weaknesses in any calculation technique. Further, changes in the underlying assumptions used, including discount rates and estimates of future cash flows, could significantly affect the results of current or future values.

The Company's own estimates of fair value are derived in a number of ways, including but not limited to: 1) pricing provided by brokers, where the price indicates reliability as to value; 2) fair values of comparable securities incorporating a spread adjustment for maturity differences, collateralization, credit quality, liquidity, and other items, if applicable; 3) discounted cash flow models and margin spreads; 4) bond yield curves; 5) observable market prices and exchange transaction information not provided by external pricing services; and 6) statement values provided to the Company by fund managers.

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value and for estimating fair value for financial instruments not recorded at fair value but for which fair value is disclosed.

*Assets*

*Securities Available for Sale*

Fixed maturity and equity securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon unadjusted quoted prices, if available, except as described in the preceding paragraphs. If quoted prices are not available, fair values are determined as described in the preceding paragraphs.

*Short-Term Financial Assets*

Short-term financial assets include cash and other short-term investments and are carried at historical cost. The carrying amount is a reasonable estimate of the fair value because of the relatively short time between the purchase of the instrument and its expected repayment or maturity.

*Loans*

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The Company does not record loans at fair value. As such, valuation techniques discussed herein for loans are primarily for estimating fair value for purpose of disclosure.

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**Notes to Consolidated Financial Statements (Unaudited) Continued**

Fair values of mortgage loans on real estate properties are calculated by discounting contractual cash flows, using discount rates based on current industry pricing or the Company's estimate of an appropriate risk-adjusted discount rate for loans of similar size, type, remaining maturity, likelihood of prepayment and repricing characteristics.

The Company also has loans made to policyholders. These loans cannot exceed the cash surrender value of the policy. Carrying value of policy loans approximates fair value.

*Liabilities*

*Investment-Type Liabilities Included in Policyholder Account Balances and Other Policyholder Funds*

Fair values for liabilities under investment-type insurance contracts are based upon account value. The fair values of investment-type insurance contracts included with policyholder account balances for fixed deferred annuities are estimated to be their cash surrender values. The fair values for supplementary contracts without life contingencies are estimated to be the present value of payments at a market yield. The fair values of deposits with no stated maturity are estimated to be the amount payable on demand at the measurement date.

*Guaranteed Minimum Withdrawal Benefits (GMWB)*

The Company offers a GMWB rider that can be added to new or existing variable annuity contracts. The rider provides an enhanced withdrawal benefit that guarantees a stream of income payments to an owner or annuitant, regardless of the contract account value. Fair value for GMWB rider contracts is a Level 3 valuation, as previously defined. The fair value is determined by using a risk-neutral valuation method and is based on models which utilize significant unobservable inputs. These models require actuarial and financial market assumptions, which reflect the assumptions market participants would use in pricing the contract, including adjustments for volatility, risk and issuer non-performance.

*Notes Payable*

Fair values for short-term notes payable approximate carrying value. The carrying amount is a reasonable estimate of the fair value because of the relatively short time between the origination of the loan and its expected repayment.

**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued***Categories Reported at Fair Value*

The following tables present categories reported at fair value on a recurring basis.

|   | September 30, 2011 |                     |                  |                     |
|---|--------------------|---------------------|------------------|---------------------|
|   | Level 1            | Level 2             | Level 3          | Total               |
| <b>Assets:</b>  |                    |                     |                  |                     |
| U.S. Treasury securities and obligations of U.S. Government               | \$ 12,356          | \$ 116,813          | \$ 3,625         | \$ 132,794          |
| Federal agencies <sup>1</sup>   | -                  | 27,307              | -                | 27,307              |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | -                  | 124,717             | -                | 124,717             |
| <b>Subtotal</b>   | <b>12,356</b>      | <b>268,837</b>      | <b>3,625</b>     | <b>284,818</b>      |
| <b>Corporate obligations:</b>   |                    |                     |                  |                     |
| Industrial  | -                  | 463,222             | 478              | 463,700             |
| Energy  | -                  | 165,379             | 2,244            | 167,623             |
| Communications and technology   | -                  | 199,659             | -                | 199,659             |
| Financial   | -                  | 314,941             | 2,891            | 317,832             |
| Consumer  | -                  | 449,142             | 22,235           | 471,377             |
| Public utilities  | -                  | 309,232             | -                | 309,232             |
| <b>Subtotal</b>   | <b>-</b>           | <b>1,901,575</b>    | <b>27,848</b>    | <b>1,929,423</b>    |
| Corporate private-labeled residential mortgage-backed securities          | -                  | 172,750             | -                | 172,750             |
| Municipal securities  | -                  | 164,298             | 5,144            | 169,442             |
| Other   | -                  | 96,603              | -                | 96,603              |
| Redeemable preferred stocks   | 11,153             | -                   | -                | 11,153              |
| Fixed maturity securities   | 23,509             | 2,604,063           | 36,617           | 2,664,189           |
| Equity securities   | 2,325              | 33,564              | 1,011            | 36,900              |
| <b>Total</b>  | <b>\$ 25,834</b>   | <b>\$ 2,637,627</b> | <b>\$ 37,628</b> | <b>\$ 2,701,089</b> |
| <b>Percent of total</b>   | <b>1%</b>          | <b>98%</b>          | <b>1%</b>        | <b>100%</b>         |
| <b>Liabilities:</b>   |                    |                     |                  |                     |
| <b>Other policyholder funds</b>   |                    |                     |                  |                     |
| Guaranteed minimum withdrawal benefits                                    | \$ -               | \$ -                | \$ 670           | \$ 670              |
| <b>Total</b>  | <b>\$ -</b>        | <b>\$ -</b>         | <b>\$ 670</b>    | <b>\$ 670</b>       |

<sup>1</sup> Federal agency securities are not backed by the full faith and credit of the U.S. Government.



**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

|   | December 31, 2010 |                     |                   |                     |
|---|-------------------|---------------------|-------------------|---------------------|
|   | Level 1           | Level 2             | Level 3           | Total               |
| <b>Assets:</b>  |                   |                     |                   |                     |
| U.S. Treasury securities and obligations of U.S. Government               | \$ 11,544         | \$ 119,624          | \$ 3,974          | \$ 135,142          |
| Federal agencies <sup>1</sup>   | -                 | 26,095              | -                 | 26,095              |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | -                 | 138,056             | -                 | 138,056             |
| <b>Subtotal</b>   | <b>11,544</b>     | <b>283,775</b>      | <b>3,974</b>      | <b>299,293</b>      |
| <b>Corporate obligations:</b>   |                   |                     |                   |                     |
| Industrial  | -                 | 430,283             | 2,235             | 432,518             |
| Energy  | -                 | 176,220             | 2,291             | 178,511             |
| Communications and technology   | -                 | 172,946             | -                 | 172,946             |
| Financial   | -                 | 347,884             | 2,775             | 350,659             |
| Consumer  | -                 | 408,592             | 21,912            | 430,504             |
| Public utilities  | -                 | 324,800             | -                 | 324,800             |
| <b>Subtotal</b>   | <b>-</b>          | <b>1,860,725</b>    | <b>29,213</b>     | <b>1,889,938</b>    |
| Corporate private-labeled residential mortgage-backed securities          | -                 | 195,055             | -                 | 195,055             |
| Municipal securities  | -                 | 146,083             | 5,748             | 151,831             |
| Other   | -                 | 81,136              | 16,866            | 98,002              |
| Redeemable preferred stocks   | 14,769            | -                   | -                 | 14,769              |
| Fixed maturity securities   | 26,313            | 2,566,774           | 55,801            | 2,648,888           |
| Equity securities   | 3,871             | 33,270              | 1,180             | 38,321              |
| <b>Total</b>  | <b>\$ 30,184</b>  | <b>\$ 2,600,044</b> | <b>\$ 56,981</b>  | <b>\$ 2,687,209</b> |
| <b>Percent of total</b>   | <b>1%</b>         | <b>97%</b>          | <b>2%</b>         | <b>100%</b>         |
| <b>Liabilities:</b>   |                   |                     |                   |                     |
| <b>Other policyholder funds</b>   |                   |                     |                   |                     |
| Guaranteed minimum withdrawal benefits                                    | \$ -              | \$ -                | \$ (2,799)        | \$ (2,799)          |
| <b>Total</b>  | <b>\$ -</b>       | <b>\$ -</b>         | <b>\$ (2,799)</b> | <b>\$ (2,799)</b>   |

<sup>1</sup> Federal agency securities are not backed by the full faith and credit of the U.S. Government.

**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

The following table presents the fair value of fixed maturity and equity securities available for sale by pricing source and fair value hierarchy level.

|  | September 30, 2011 |                     |                  | Total               |
|--|--------------------|---------------------|------------------|---------------------|
|  | Level 1            | Level 2             | Level 3          |                     |
| <b>Fixed maturity securities available for sale:</b> |                    |                     |                  |                     |
| Priced from external pricing services                | \$ 23,509          | \$ 2,566,293        | \$ -             | \$ 2,589,802        |
| Priced from independent brokers                      | -                  | 37,770              | -                | 37,770              |
| Priced from internal matrices and calculations       | -                  | -                   | 36,617           | 36,617              |
| <b>Subtotal</b>                                      | <b>23,509</b>      | <b>2,604,063</b>    | <b>36,617</b>    | <b>2,664,189</b>    |
| <b>Equity securities available for sale:</b>         |                    |                     |                  |                     |
| Priced from external pricing services                | 2,325              | 2,426               | -                | 4,751               |
| Priced from independent brokers                      | -                  | -                   | -                | -                   |
| Priced from internal matrices and calculations       | -                  | 31,138              | 1,011            | 32,149              |
| <b>Subtotal</b>                                      | <b>2,325</b>       | <b>33,564</b>       | <b>1,011</b>     | <b>36,900</b>       |
| <b>Total</b>   | <b>\$ 25,834</b>   | <b>\$ 2,637,627</b> | <b>\$ 37,628</b> | <b>\$ 2,701,089</b> |
| Percent of total                                     | 1%                 | 98%                 | 1%               | 100%                |
|  |                    |                     |                  |                     |
|  | December 31, 2010  |                     |                  | Total               |
|  | Level 1            | Level 2             | Level 3          |                     |
| <b>Fixed maturity securities available for sale:</b> |                    |                     |                  |                     |
| Priced from external pricing services                | \$ 26,313          | \$ 2,537,287        | \$ -             | \$ 2,563,600        |
| Priced from independent brokers                      | -                  | 29,487              | -                | 29,487              |
| Priced from internal matrices and calculations       | -                  | -                   | 55,801           | 55,801              |
| <b>Subtotal</b>                                      | <b>26,313</b>      | <b>2,566,774</b>    | <b>55,801</b>    | <b>2,648,888</b>    |
| <b>Equity securities available for sale:</b>         |                    |                     |                  |                     |
| Priced from external pricing services                | 3,871              | 7,125               | -                | 10,996              |
| Priced from independent brokers                      | -                  | -                   | -                | -                   |
| Priced from internal matrices and calculations       | -                  | 26,145              | 1,180            | 27,325              |
| <b>Subtotal</b>                                      | <b>3,871</b>       | <b>33,270</b>       | <b>1,180</b>     | <b>38,321</b>       |
| <b>Total</b>   | <b>\$ 30,184</b>   | <b>\$ 2,600,044</b> | <b>\$ 56,981</b> | <b>\$ 2,687,209</b> |
| Percent of total                                     | 1%                 | 97%                 | 2%               | 100%                |





**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

The changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the third quarter and nine months ended September 30, 2011 and year ended December 31, 2010 are summarized below:

|   | Quarter Ended<br>September 30, 2011                |  |                  |               |
|---|--|--|------------------|---------------|
|   | Assets   |  |                  | Liabilities   |
|   | Fixed maturity<br>securities available<br>for sale | Equity securities<br>available<br>for sale | Total            | GMWB          |
| Beginning balance                                   | \$ 63,819  | \$ 1,085                                   | \$ 64,904        | \$ (2,731)    |
| Included in earnings                                | 15   | -  | 15               | 3,404         |
| Included in other comprehensive income              | 996  | (74)                                       | 922              | -             |
| Purchases, issuances, sales and other dispositions: |  |  |                  |               |
| Purchases   | -  | -  | -                | -             |
| Issuances   | -  | -  | -                | 72            |
| Sales   | -  | -  | -                | -             |
| Other dispositions                                  | (373)  | -  | (373)            | (75)          |
| Transfers into Level 3                              | 1,574  | -  | 1,574            | -             |
| Transfers out of Level 3                            | (29,414)   | -  | (29,414)         | -             |
| <b>Ending balance</b>                               | <b>\$ 36,617</b>                                   | <b>\$ 1,011</b>                            | <b>\$ 37,628</b> | <b>\$ 670</b> |
| Net unrealized gains (losses)                       | \$ 996   | \$ (74)                                    | \$ 922           |               |

|   | Nine Months Ended<br>September 30, 2011                  |   |                  |               |
|---|--|---|------------------|---------------|
|   | Assets   |   |                  | Liabilities   |
|   | Fixed<br>maturity<br>securities<br>available<br>for sale | Equity<br>securities<br>available<br>for sale | Total            | GMWB          |
| Beginning balance                                   | \$ 55,801  | \$ 1,180                                      | \$ 56,981        | \$ (2,799)    |
| Included in earnings                                | 8  | 92  | 100              | 3,335         |
| Included in other comprehensive income              | 1,230  | (61)  | 1,169            | -             |
| Purchases, issuances, sales and other dispositions: |  |   |                  |               |
| Purchases   | -  | -   | -                | -             |
| Issuances   | -  | -   | -                | 86            |
| Sales   | -  | -   | -                | -             |
| Other dispositions                                  | (1,751)  | (200)   | (1,951)          | 48            |
| Transfers into Level 3                              | 430  | -   | 430              | -             |
| Transfers out of Level 3                            | (19,101)   | -   | (19,101)         | -             |
| <b>Ending balance</b>                               | <b>\$ 36,617</b>   | <b>\$ 1,011</b>                               | <b>\$ 37,628</b> | <b>\$ 670</b> |

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|                               |          |    |     |          |
|-------------------------------|----------|----|-----|----------|
| Net unrealized gains (losses) | \$ 1,229 | \$ | (7) | \$ 1,222 |
|-------------------------------|----------|----|-----|----------|

**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

|  | Year Ended<br>December 31, 2010              |                                      |           | Liabilities |
|--|--|--------------------------------------|-----------|-------------|
|  | Assets                                       |                                      | Total     |             |
|  | Fixed maturity securities available for sale | Equity securities available for sale |           |             |
| Beginning balance                      | \$ 52,474                                    | \$ 1,037                             | \$ 53,511 | \$ (1,642)  |
| Included in earnings                   | (4)  | -                                    | (4)       | (1,217)     |
| Included in other comprehensive income | 920  | 143                                  | 1,063     | -           |
| Purchases and dispositions             | (3,159)                                      | -                                    | (3,159)   | 60          |
| Net transfers in                       | 5,570  | -                                    | 5,570     | -           |
| Ending balance                         | \$ 55,801                                    | \$ 1,180                             | \$ 56,981 | \$ (2,799)  |
| Net unrealized gains                   | \$ 922                                       | \$ 143                               | \$ 1,065  |             |

The Company did not exclude any realized or unrealized gains or losses on items transferred into Level 3. Depending upon the availability of Level 1 or Level 2 pricing, specific securities may transfer into or out of Level 3. The Company did not have any significant transfers between Level 1 and Level 2 during the nine months ended September 30, 2011.

The table below is a summary of fair value estimates as of September 30, 2011 and December 31, 2010 for financial instruments. The Company has not included assets and liabilities that are not financial instruments in this disclosure. The total of the fair value calculations presented do not represent, and should not be construed to represent, the underlying value of the Company.

|  | September 30, 2011 |              | December 31, 2010 |              |
|--|--------------------|--------------|-------------------|--------------|
|  | Carrying Value     | Fair Value   | Carrying Value    | Fair Value   |
| <b>Assets:</b>                                     |                    |              |                   |              |
| <b>Investments:</b>                                |                    |              |                   |              |
| Fixed maturity securities available for sale       | \$ 2,664,189       | \$ 2,664,189 | \$ 2,648,888      | \$ 2,648,888 |
| Equity securities available for sale               | 36,900             | 36,900       | 38,321            | 38,321       |
| Mortgage loans                                     | 623,368            | 631,158      | 559,167           | 593,418      |
| Policy loans                                       | 81,762             | 81,762       | 84,281            | 84,281       |
| Cash and short-term investments                    | 46,944             | 46,944       | 21,158            | 21,158       |
| Separate account assets                            | 304,425            | 304,425      | 339,029           | 339,029      |
| <b>Liabilities:</b>                                |                    |              |                   |              |
| Individual and group annuities                     | \$ 1,074,483       | \$ 1,055,109 | \$ 1,037,331      | \$ 1,017,135 |
| Supplementary contracts without life contingencies | 56,701             | 55,360       | 58,012            | 56,514       |
| Separate account liabilities                       | 304,425            | 304,425      | 339,029           | 339,029      |

**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued****4. Investments****Fixed Maturity and Equity Securities Available for Sale***Securities by Asset Class*

The following table provides amortized cost and fair value of securities by asset class as of September 30, 2011.

|   | Amortized<br>Cost | Gross<br>Unrealized |           | Fair<br>Value |
|---|-------------------|---------------------|-----------|---------------|
|   |                   | Gains               | Losses    |               |
| U.S. Treasury securities and obligations of U.S. Government               | \$ 119,377        | \$ 13,443           | \$ 26     | \$ 132,794    |
| Federal agencies <sup>1</sup>   | 23,783            | 3,524               | -         | 27,307        |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | 114,424           | 10,296              | 3         | 124,717       |
| Subtotal  | 257,584           | 27,263              | 29        | 284,818       |
| Corporate obligations:  |                   |                     |           |               |
| Industrial  | 420,105           | 44,453              | 858       | 463,700       |
| Energy  | 149,066           | 18,698              | 141       | 167,623       |
| Communications and technology   | 183,394           | 16,369              | 104       | 199,659       |
| Financial   | 305,805           | 16,588              | 4,561     | 317,832       |
| Consumer  | 428,085           | 43,803              | 511       | 471,377       |
| Public utilities  | 272,967           | 38,448              | 2,183     | 309,232       |
| Subtotal  | 1,759,422         | 178,359             | 8,358     | 1,929,423     |
| Corporate private-labeled residential mortgage-backed securities          | 180,215           | 2,151               | 9,616     | 172,750       |
| Municipal securities  | 150,503           | 19,045              | 106       | 169,442       |
| Other   | 102,301           | 3,682               | 9,380     | 96,603        |
| Redeemable preferred stocks   | 11,735            | 162                 | 744       | 11,153        |
| Fixed maturity securities   | 2,461,760         | 230,662             | 28,233    | 2,664,189     |
| Equity securities   | 35,275            | 1,756               | 131       | 36,900        |
| Total   | \$ 2,497,035      | \$ 232,418          | \$ 28,364 | \$ 2,701,089  |

<sup>1</sup> Federal agency securities are not backed by the full faith and credit of the U.S. Government.

**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

The following table provides amortized cost and fair value of securities by asset class as of December 31, 2010.

|   | Amortized<br>Cost   | Gross<br>Unrealized |                  | Fair<br>Value       |
|---|---------------------|---------------------|------------------|---------------------|
|   |                     | Gains               | Losses           |                     |
| U.S. Treasury securities and obligations of U.S. Government               | \$ 128,280          | \$ 7,180            | \$ 318           | \$ 135,142          |
| Federal agencies <sup>1</sup>   | 24,144              | 1,951               | -                | 26,095              |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | 128,318             | 9,740               | 2                | 138,056             |
| Subtotal  | 280,742             | 18,871              | 320              | 299,293             |
| Corporate obligations:  |                     |                     |                  |                     |
| Industrial  | 409,193             | 26,255              | 2,930            | 432,518             |
| Energy  | 163,237             | 15,498              | 224              | 178,511             |
| Communications and technology   | 164,499             | 9,243               | 796              | 172,946             |
| Financial   | 341,520             | 14,161              | 5,022            | 350,659             |
| Consumer  | 404,152             | 28,725              | 2,373            | 430,504             |
| Public utilities  | 298,626             | 27,640              | 1,466            | 324,800             |
| Subtotal  | 1,781,227           | 121,522             | 12,811           | 1,889,938           |
| Corporate private-labeled residential mortgage-backed securities          | 209,529             | 2,352               | 16,826           | 195,055             |
| Municipal securities  | 153,813             | 1,319               | 3,301            | 151,831             |
| Other   | 100,548             | 5,193               | 7,739            | 98,002              |
| Redeemable preferred stocks   | 14,866              | 343                 | 440              | 14,769              |
| Fixed maturity securities   | 2,540,725           | 149,600             | 41,437           | 2,648,888           |
| Equity securities   | 36,293              | 2,165               | 137              | 38,321              |
| <b>Total</b>  | <b>\$ 2,577,018</b> | <b>\$ 151,765</b>   | <b>\$ 41,574</b> | <b>\$ 2,687,209</b> |

<sup>1</sup> Federal agency securities are not backed by the full faith and credit of the U.S. Government.

*Contractual Maturities*

The following table provides the distribution of maturities for fixed maturity securities available for sale as of September 30, 2011. Expected maturities may differ from these contractual maturities since borrowers may have the right to call or prepay obligations.

|  | September 30, 2011 |               |
|--|--------------------|---------------|
|  | Amortized<br>Cost  | Fair<br>Value |
| Due in one year or less                | \$ 78,295          | \$ 79,757     |
| Due after one year through five years  | 580,004            | 617,339       |
| Due after five years through ten years | 919,640            | 1,023,015     |

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|   |              |              |
|---|--------------|--------------|
| Due after ten years                         | 490,961      | 538,551      |
| Securities with variable principal payments | 381,125      | 394,374      |
| Redeemable preferred stocks                 | 11,735       | 11,153       |
|   | \$ 2,461,760 | \$ 2,664,189 |

**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued***Realized Gains (Losses)*

The following table provides detail concerning realized investment gains and losses for the third quarters and nine months ended September 30, 2011 and 2010.

|   | Quarter Ended<br>September 30 |                 | Nine Months Ended<br>September 30 |                 |
|---|-------------------------------|-----------------|-----------------------------------|-----------------|
|   | 2011                          | 2010            | 2011                              | 2010            |
| <b>Gross gains resulting from:</b>                                |                               |                 |                                   |                 |
| Sales of investment securities                                    | \$ 292                        | \$ 290          | \$ 3,944                          | \$ 1,914        |
| Investment securities called and other                            | 105                           | 75              | 1,355                             | 1,241           |
| <b>Total gross gains</b>  | <b>397</b>                    | <b>365</b>      | <b>5,299</b>                      | <b>3,155</b>    |
| <b>Gross losses resulting from:</b>                               |                               |                 |                                   |                 |
| Sales of investment securities                                    | (76)                          | (19)            | (1,666)                           | (19)            |
| Investment securities called and other                            | (118)                         | (47)            | (297)                             | (202)           |
| Mortgage loans  | -                             | -               | (3)                               | -               |
| <b>Total gross losses</b>   | <b>(194)</b>                  | <b>(66)</b>     | <b>(1,966)</b>                    | <b>(221)</b>    |
| Amortization of DAC and VOBA                                      | 7                             | (36)            | (218)                             | 145             |
| <b>Net realized investment gains, excluding impairment losses</b> | <b>210</b>                    | <b>263</b>      | <b>3,115</b>                      | <b>3,079</b>    |
| <b>Net impairment losses recognized in earnings:</b>              |                               |                 |                                   |                 |
| Total other-than-temporary impairment losses                      | (167)                         | (1,080)         | (674)                             | (4,129)         |
| Portion of loss recognized in other comprehensive income          | 17                            | 170             | 131                               | 309             |
| <b>Net impairment losses recognized in earnings</b>               | <b>(150)</b>                  | <b>(910)</b>    | <b>(543)</b>                      | <b>(3,820)</b>  |
| <b>Realized investment gains (losses)</b>                         | <b>\$ 60</b>                  | <b>\$ (647)</b> | <b>\$ 2,572</b>                   | <b>\$ (741)</b> |

**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued***Proceeds From Sales of Investment Securities*

The table below provides information regarding sales of fixed maturity and equity securities, excluding maturities and calls, for the third quarters and nine months ended September 30, 2011 and 2010.

|                       | Quarter Ended<br>September 30 |           | Nine Months Ended<br>September 30 |           |
|-----------------------|-------------------------------|-----------|-----------------------------------|-----------|
|                       | 2011                          | 2010      | 2011                              | 2010      |
| Proceeds              | \$ 9,714                      | \$ 45,968 | \$ 61,255                         | \$ 61,055 |
| Gross realized gains  | 292                           | 290       | 3,944                             | 1,914     |
| Gross realized losses | (76)                          | (19)      | (1,666)                           | (19)      |

*Unrealized Losses on Investments*

The Company reviews all security investments, with particular attention given to those having unrealized losses. Further, the Company specifically assesses all investments with greater than 10% declines in fair value below amortized cost and, in general, monitors all security investments as to ongoing risk. These risks are fundamentally evaluated through both a qualitative and quantitative analysis of the issuer. The Company also prepares a formal review document no less often than quarterly of all investments where fair value is less than 80% of amortized cost for six months or more and selected investments that have changed significantly from a previous period and that have a decline in fair value greater than 10% of amortized cost.

The Company has a policy and process in place to identify securities that could potentially have an impairment that is other-than-temporary. This process involves monitoring market events and other items that could impact issuers such as:

- Intent and ability to make all principal and interest payments when due;
- Near-term business prospects;
- Cash flow and liquidity;
- Credit ratings;
- Business climate;
- Management changes;
- Litigation and government actions; and
- Other similar factors.

The Company considers relevant facts and circumstances in evaluating whether the impairment of a security is other-than-temporary. Relevant facts and circumstances considered are described in the Valuation of Investments section of Note 1 – Nature of Operations and Significant Accounting Policies of the Company's 2010 Form 10-K.

To the extent the Company determines that a fixed maturity security is deemed to be other-than-temporarily impaired, the portion of the impairment that is deemed to be due to credit is charged to the Consolidated Statements of Income and the cost basis of the underlying investment is reduced. The portion of such impairment that is determined to be non-credit-related is deducted from net realized loss in the Consolidated Statements of Income and reflected in other comprehensive income and accumulated other comprehensive income, which is a component of stockholders' equity in the Consolidated Balance Sheets.

There are a number of significant risks and uncertainties inherent in the process of monitoring impairments, determining if an impairment is other-than-temporary and determining the portion of an other-than-temporary impairment that is due to credit. These risks and uncertainties are described in the Valuation of Investments Section of Note 1 of the Company's 2010 Form 10-K.



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Once a security is determined to have met certain of the criteria for consideration as being other-than-temporarily impaired, further information is gathered and evaluated pertaining to the particular security. If the security is an unsecured obligation, the additional research is a top-down approach with particular emphasis on the likelihood of the issuer to meet the contractual terms of the obligation. If the security is secured by an asset or guaranteed by another party, the value of the underlying secured asset or the financial ability of the third-party guarantor is evaluated as a secondary source of repayment. Such research is based upon a top-down approach, narrowing to the specific estimates of value and cash flow of the underlying secured asset or guarantor. If the security is a collateralized obligation, such as a mortgage-backed or other asset-backed instrument, research is also conducted to obtain and analyze the performance of the collateral relative to expectations at the time of acquisition and with regard to projections for the future. Such analyses are based upon historical results, trends, comparisons to collateral performance of similar securities and analyses performed by third parties. This information is used to develop projected cash flows that are compared to the amortized cost of the security.

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**Kansas City Life Insurance Company**

**Notes to Consolidated Financial Statements (Unaudited) Continued**

If a determination is made that an unsecured security, secured security or security with a guaranty of payment by a third-party is other-than-temporarily impaired, an estimate is developed of the portion of such impairment that is due to credit. The estimate of the portion of impairment due to credit is based upon a comparison of ratings and maturity horizon for the security and relative historical default probabilities from one or more nationally recognized rating organizations. When appropriate for any given security, sector or period in the business cycle, the historical default probability is adjusted to reflect periods or situations of distress by adding to the default probability increments of standard deviations from mean historical results. The credit impairment analysis is supplemented by estimates of potential recovery values for the specific security, including the potential impact of the value of any secured assets, in the event of default. This information is used to determine the Company's best estimate, derived from probability-weighted cash flows.

The Company has less than 5% of its investments in municipal bond securities. The Company's investments in municipal bonds present unique considerations in evaluating other-than-temporary impairments. Judgments regarding whether a municipal debt security is other-than-temporarily impaired include analyzing a number of rather unique characteristics pertaining to the issuer. Municipalities possess unique powers, along with special legal standing and protections. These powers include the sovereign power to tax, access to one-time revenue sources, capacity to issue or restructure debt and the ability to shift spending to other authorities. In addition, state governments often provide secondary support to local governments in times of financial stress and the federal government has also provided assistance to state governments.

The evaluation of loan-backed and similar asset-backed securities, particularly including residential mortgage-backed securities, with significant indications of potential other-than-temporary impairment requires considerable use of estimates and judgment. Specifically, the Company performs discounted future cash flow projections on these securities to evaluate whether the value of the investment is expected to be fully realized. Projections of expected future cash flows is based upon considerations of the performance of the actual underlying assets, including historical delinquencies, defaults, severity of losses incurred, and prepayments, along with the Company's estimates of future results for these factors. The Company's estimates of future results are based upon actual historical performance of the underlying assets relative to historical, current and expected general economic conditions, specific conditions related to the underlying assets, industry data, and other factors that are believed to be relevant. If the present value of the projected expected future cash flows is determined to be below the Company's carrying value, the Company recognizes an other-than-temporary impairment on the portion of the carrying value that exceeds the projected expected future cash flows. To the extent that the loan-backed or other asset-backed securities remain high quality investments and do not otherwise demonstrate characteristics of impairment, the Company performs other initial evaluations to determine whether other-than-temporary cash flow evaluations need to be performed.

The discounted future cash flow calculation typically becomes the primary determinant of whether any portion and to what extent an unrealized loss is due to credit on loan-backed and similar asset-backed securities with significant indications of potential other-than-temporary impairment. Such indications typically include below investment grade ratings and significant unrealized losses for an extended period of time, among other factors. The Company identified 16 and 12 non-U.S. Agency mortgage-backed securities that had such indications as of September 30, 2011 and December 31, 2010, respectively. Discounted future cash flow analysis was performed for each of these securities to determine if any portion of the impairment was due to credit and deemed to be other-than-temporary. The discount rate used in calculating the present value of future cash flows was the investment yield at the time of purchase for each security. The initial default rates were assumed to remain constant over a 24-month time frame and grade down thereafter, reflecting the general perspective of a more stabilized residential housing environment in the future.

For loan-backed and similar asset-backed securities, the determination of any amount of impairment that is due to credit is based upon the present value of projected future cash flows being less than the amortized cost of the security. This amount is recognized as a realized loss in the Company's Consolidated Statements of Income, and the carrying value of the security is written down by the same amount. The portion of an impairment that is determined not to be due to credit is recorded as a component of accumulated other comprehensive income in the Consolidated Balance Sheets.

As part of the required accounting for unrealized gains and losses, the Company also adjusts the deferred acquisition costs (DAC) and value of business acquired (VOBA) assets to recognize the adjustment to those assets as if the unrealized gains and losses from securities classified as available-for-sale actually had been realized.



**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

The following table provides information regarding fixed maturity and equity security investments available for sale with unrealized losses by length of time as of September 30, 2011.

|   | Less Than 12 Months |                   | 12 Months or Longer |                   | Total      |                   |
|---|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury securities and obligations of U.S. Government               | \$ 542              | \$ 1              | \$ 2,027            | \$ 25             | \$ 2,569   | \$ 26             |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | 704                 | 1                 | 295                 | 2                 | 999        | 3                 |
| Subtotal  | 1,246               | 2                 | 2,322               | 27                | 3,568      | 29                |
| Corporate obligations:  |                     |                   |                     |                   |            |                   |
| Industrial  | 26,758              | 858               | -                   | -                 | 26,758     | 858               |
| Energy  | 10,861              | 141               | -                   | -                 | 10,861     | 141               |
| Communications and technology   | 5,652               | 104               | -                   | -                 | 5,652      | 104               |
| Financial   | 42,971              | 1,904             | 17,539              | 2,657             | 60,510     | 4,561             |
| Consumer  | 10,896              | 353               | 3,722               | 158               | 14,618     | 511               |
| Public utilities  | 9,233               | 884               | 7,443               | 1,299             | 16,676     | 2,183             |
| Total corporate obligations   | 106,371             | 4,244             | 28,704              | 4,114             | 135,075    | 8,358             |
| Corporate private-labeled residential mortgage-backed securities          | 22,072              | 155               | 78,796              | 9,461             | 100,868    | 9,616             |
| Municipal securities  | 3,101               | 10                | 3,878               | 96                | 6,979      | 106               |
| Other   | 5,227               | 13                | 49,614              | 9,367             | 54,841     | 9,380             |
| Redeemable preferred stocks   | 2,920               | 134               | 3,071               | 610               | 5,991      | 744               |
| Fixed maturity securities   | 140,937             | 4,558             | 166,385             | 23,675            | 307,322    | 28,233            |
| Equity securities   | 87                  | 86                | 1,040               | 45                | 1,127      | 131               |
| Total   | \$ 141,024          | \$ 4,644          | \$ 167,425          | \$ 23,720         | \$ 308,449 | \$ 28,364         |

<sup>1</sup> Federal agency securities are not backed by the full faith and credit of the U.S. Government.

**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

The following table provides information regarding fixed maturity and equity security investments available for sale with unrealized losses by length of time as of December 31, 2010.

|   | Less Than 12 Months |                   | 12 Months or Longer |                   | Total             |                   |
|---|---------------------|-------------------|---------------------|-------------------|-------------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses |
| U.S. Treasury securities and obligations of U.S. Government               | \$ 7,663            | \$ 286            | \$ 2,206            | \$ 32             | \$ 9,869          | \$ 318            |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | 16                  | 1                 | 281                 | 1                 | 297               | 2                 |
| <b>Subtotal</b>   | <b>7,679</b>        | <b>287</b>        | <b>2,487</b>        | <b>33</b>         | <b>10,166</b>     | <b>320</b>        |
| Corporate obligations:  |                     |                   |                     |                   |                   |                   |
| Industrial  | 76,795              | 2,825             | 3,023               | 105               | 79,818            | 2,930             |
| Energy  | 7,848               | 224               | -                   | -                 | 7,848             | 224               |
| Communications and technology   | 38,762              | 796               | -                   | -                 | 38,762            | 796               |
| Financial   | 50,744              | 900               | 38,170              | 4,122             | 88,914            | 5,022             |
| Consumer  | 67,690              | 1,444             | 14,931              | 929               | 82,621            | 2,373             |
| Public utilities  | 24,165              | 1,204             | 4,394               | 262               | 28,559            | 1,466             |
| <b>Total corporate obligations</b>  | <b>266,004</b>      | <b>7,393</b>      | <b>60,518</b>       | <b>5,418</b>      | <b>326,522</b>    | <b>12,811</b>     |
| Corporate private-labeled residential mortgage-backed securities          | -                   | -                 | 96,581              | 16,826            | 96,581            | 16,826            |
| Municipal securities  | 81,799              | 2,537             | 7,145               | 764               | 88,944            | 3,301             |
| Other   | 5,379               | 182               | 54,488              | 7,557             | 59,867            | 7,739             |
| Redeemable preferred stocks   | 618                 | 8                 | 4,333               | 432               | 4,951             | 440               |
| <b>Fixed maturity securities</b>  | <b>361,479</b>      | <b>10,407</b>     | <b>225,552</b>      | <b>31,030</b>     | <b>587,031</b>    | <b>41,437</b>     |
| <b>Equity securities</b>  | <b>-</b>            | <b>-</b>          | <b>2,034</b>        | <b>137</b>        | <b>2,034</b>      | <b>137</b>        |
| <b>Total</b>  | <b>\$ 361,479</b>   | <b>\$ 10,407</b>  | <b>\$ 227,586</b>   | <b>\$ 31,167</b>  | <b>\$ 589,065</b> | <b>\$ 41,574</b>  |

<sup>1</sup> Federal agency securities are not backed by the full faith and credit of the U.S. Government.

Gross unrealized losses on fixed maturity and equity security investments attributable to securities having gross unrealized losses of 12 months or longer was \$23.7 million as of September 30, 2011, a decrease from \$31.2 million as of December 31, 2010. The unrealized losses in fixed maturity securities at September 30, 2011 were primarily due to wider spreads between the risk-free and corporate and other bond yields in relation to the spreads when they were purchased. However, because the Company does not intend to sell or does not believe that the Company will be required to sell these investments before their anticipated recovery of amortized costs, the Company did not consider these investments to be other-than-temporarily impaired at September 30, 2011.

In addition, the Company also considers as part of its monitoring and evaluation process the length of time the fair value of a security is below amortized cost. As of September 30, 2011, the Company had 88 issues in its investment portfolio of fixed maturity and equity securities with unrealized losses. Included in this total, 48 security issues were below cost for less than one year; 14 security issues were below cost for one year or more and less than three years; and 26 security issues were below cost for three years or more. At December 31, 2010, the Company had 187

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issues in its investment portfolio of fixed maturity and equity securities with unrealized losses. Included in this total, 130 security issues were below cost for less than one year; 18 security issues were below cost for one year or more and less than three years; and 39 security issues were below cost for three years or more.

**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

The following table provides the distribution of maturities for fixed maturity securities available for sale with unrealized losses as of September 30, 2011. Expected maturities may differ from these contractual maturities since borrowers may have the right to call or prepay obligations.

|   | Fair<br>Value | Gross<br>Unrealized<br>Losses |
|---|---------------|-------------------------------|
| Fixed maturity securities available for sale: |               |                               |
| Due in one year or less                       | \$ 854        | \$ 49                         |
| Due after one year through five years         | 44,916        | 1,759                         |
| Due after five years through ten years        | 68,885        | 3,200                         |
| Due after ten years                           | 84,808        | 12,860                        |
| Total   | 199,463       | 17,868                        |
| Securities with variable principal payments   | 101,868       | 9,621                         |
| Redeemable preferred stocks                   | 5,991         | 744                           |
| Total   | \$ 307,322    | \$ 28,233                     |

The following table provides a reconciliation of credit losses recognized in earnings on fixed maturity securities held by the Company for which a portion of the other-than-temporary loss was recognized in accumulated other comprehensive income.

|  | Quarter Ended<br>September 30<br>2011 | Nine Months Ended<br>September 30<br>2011 |
|--|---------------------------------------|---|
| Credit losses on securities held at beginning of period in accumulated other comprehensive income  | \$ 11,952                             | \$ 11,567                                 |
| Additions for credit losses not previously recognized in other-than-temporary impairment   | 28                                    | 35  |
| Additions for increases in the credit loss for which an other-than-temporary impairment previously was recognized and there was no intent to sell the security before recovery of its amortized cost basis | 122                                   | 508                                       |
| Reductions for securities sold during the period (realized)  | -                                     | -   |
| Reductions for securities previously recognized in other comprehensive income because of intent to sell the security before recovery of its amortized cost basis   | -                                     | -   |
| Reductions for increases in cash flows expected to be collected that are recognized over the remaining life of the security  | (4)                                   | (12)                                      |
| Credit losses on securities held at the end of period in accumulated other comprehensive income  | \$ 12,098                             | \$ 12,098                                 |

**Mortgage Loans**

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The Company invests in commercial mortgage loans that are secured by real estate on an ongoing basis. At September 30, 2011, the Company had 17% of its invested assets in commercial mortgage loans, up from 16% at December 31, 2010. In addition to the subject collateral underlying the mortgage, the Company typically requires some amount of recourse from borrowers as another potential source of repayment. The recourse requirement is determined as part of the underwriting requirements of each loan. The Company added 55 new loans to the portfolio during the first nine months of 2011, and 84% of these loans had some amount of recourse requirement. The Company purchased 22 mortgage loans totaling \$72.3 million from another institutional lender during the second quarter of 2011. The purchased loans are seasoned performing loans having characteristics of property type, geographical diversification, term, underwriting and cash flows that are similar to the Company's portfolio of originated loans. During 2011, the Company originated 33 new loans totaling \$44.3 million and 100% of these loans included some amount of recourse. The average loan to value ratio for the overall portfolio was 47% and 49% at September 30, 2011 and December 31, 2010, respectively, based upon the underwriting and appraisal of value at the time the loan was originated or acquired.



**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

The following table summarizes the amount of mortgage loans held by the Company as of September 30, 2011, segregated by year of origination. Purchased loans are shown in the year acquired by the Company, although the individual loans were initially originated in prior years.

|                    | Carrying<br>Amount | %<br>of Total |
|--------------------|--------------------|---------------|
| Prior to 2002      | \$ 31,858          | 5%            |
| 2003               | 44,473             | 7%            |
| 2004               | 32,686             | 5%            |
| 2005               | 57,077             | 9%            |
| 2006               | 48,279             | 8%            |
| 2007               | 35,851             | 6%            |
| 2008               | 44,785             | 7%            |
| 2009               | 55,074             | 9%            |
| 2010               | 145,773            | 23%           |
| 2011               | 130,922            | 21%           |
|                    | 626,778            | 100%          |
| Allowance for loss | (3,410)            |               |
| <b>Total</b>       | <b>\$ 623,368</b>  |               |

The following table identifies mortgage loans by geographic location as of September 30, 2011 and December 31, 2010.

| Geographic region: | September 30<br>2011 |               | December 31<br>2010 |               |
|--------------------|----------------------|---------------|---------------------|---------------|
|                    | Carrying<br>Amount   | %<br>of Total | Carrying<br>Amount  | %<br>of Total |
| Pacific            | \$ 148,691           | 24%           | \$ 134,892          | 24%           |
| West north central | 131,358              | 21%           | 122,228             | 22%           |
| West south central | 104,977              | 17%           | 106,093             | 19%           |
| Mountain           | 79,624               | 13%           | 72,871              | 13%           |
| South atlantic     | 64,192               | 10%           | 50,454              | 9%            |
| East north central | 31,095               | 5%            | 30,905              | 5%            |
| Middle atlantic    | 46,638               | 7%            | 22,975              | 4%            |
| East south central | 20,203               | 3%            | 22,159              | 4%            |
|                    | 626,778              | 100%          | 562,577             | 100%          |
| Allowance for loss | (3,410)              |               | (3,410)             |               |
| <b>Total</b>       | <b>\$ 623,368</b>    |               | <b>\$ 559,167</b>   |               |



**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

The following table identifies mortgage loans by property type as of September 30, 2011 and December 31, 2010. The other category consists of apartment and retail properties.

| Property type:     | September 30<br>2011 |            | December 31<br>2010 |            |
|--------------------|----------------------|------------|---------------------|------------|
|                    | Carrying<br>Amount   | %<br>Total | Carrying<br>Amount  | %<br>Total |
| Industrial         | \$ 262,322           | 42%        | \$ 263,621          | 47%        |
| Office             | 255,089              | 41%        | 227,772             | 41%        |
| Medical            | 47,046               | 7%         | 35,223              | 6%         |
| Other              | 62,321               | 10%        | 35,961              | 6%         |
|                    | 626,778              | 100%       | 562,577             | 100%       |
| Allowance for loss | (3,410)              |            | (3,410)             |            |
| Total              | \$ 623,368           |            | \$ 559,167          |            |

The following table identifies the concentration of mortgage loans by state greater than 5% as of September 30, 2011 and December 31, 2010.

|                    | September 30<br>2011 |               | December 31<br>2010 |               |
|--------------------|----------------------|---------------|---------------------|---------------|
|                    | Carrying<br>Amount   | %<br>of Total | Carrying<br>Amount  | %<br>of Total |
| California         | \$ 124,690           | 20%           | \$ 115,766          | 21%           |
| Texas              | 91,490               | 15%           | 81,903              | 15%           |
| Minnesota          | 66,353               | 11%           | 56,537              | 10%           |
| Florida            | 31,700               | 5%            | 28,770              | 5%            |
| All Others         | 312,545              | 49%           | 279,601             | 49%           |
|                    | 626,778              | 100%          | 562,577             | 100%          |
| Allowance for loss | (3,410)              |               | (3,410)             |               |
| Total              | \$ 623,368           |               | \$ 559,167          |               |

The table below identifies mortgage loans by maturity as of September 30, 2011.

|                             | Carrying<br>Amount | %<br>of Total |
|-----------------------------|--------------------|---------------|
| Mortgage loans by maturity: |                    |               |
| Due in one year or less     | \$ 18,666          | 3%            |

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|  |                |      |
|--|----------------|------|
| Due after one year through five years  | 164,817        | 26%  |
| Due after five years through ten years | 253,581        | 40%  |
| Due after ten years                    | 189,714        | 31%  |
|  | 626,778        | 100% |
| Allowance for loss                     | (3,410)        |      |
| <br>Total                              | <br>\$ 623,368 |      |

The concentration in California, along with other states included in the Pacific Region, exposes the Company to potential losses from a regional economic downturn and certain catastrophes, such as earthquakes and fires that may affect certain areas of the region. The Company requires borrowers to maintain fire insurance coverage to provide reimbursement for losses due to fire. The Company diversifies its commercial mortgage loan portfolio both geographically and by property type to reduce certain catastrophic and economic exposure. However, diversification may not always sufficiently mitigate the risk of such losses. Historically, the delinquency rate of the Company's Pacific Region commercial mortgage loans has been substantially below the industry average and consistent with the Company's experience in other regions. The Company does not require earthquake insurance for properties on which it makes commercial mortgage loans. However, the Company does consider the potential for earthquake loss if the property lies within areas believed by the Company to be seismically active.

**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

submarkets and structural information specific to each property. The Company does not expect catastrophe or earthquake damage or economic downturn in the Pacific Region to have a material adverse effect on its business, financial position, results of operations or cash flows. However, the Company cannot provide assurance that such risks could not have such material adverse effects.

Under the laws of certain states, environmental contamination of a property may result in a lien on the property to secure recovery of the costs of cleanup. In some states, such a lien has priority over the lien of an existing mortgage against such property. As a commercial mortgage lender, the Company customarily conducts environmental assessments prior to making commercial mortgage loans secured by real estate and before taking title on real estate. Based on the Company's environmental assessments, the Company believes that any compliance costs associated with environmental laws and regulations or any remediation of affected properties would not have a material adverse effect on the Company's business, financial position, results of operations or cash flows. However, the Company cannot provide assurance that material compliance costs will not be incurred.

In the normal course of business, the Company commits to fund commercial mortgage loans generally up to 120 days in advance. The Company had commitments to originate mortgage loans of \$3.9 million at September 30, 2011 with fixed interest rates ranging from 5.25% to 6.375%. These commitments generally have fixed expiration dates. A small percentage of commitments expire due to the borrower's failure to deliver the requirements of the commitment by the expiration date. In these cases, the Company will retain the commitment fee.

Prior to 2010, the Company issued two construction-to-permanent loans totaling \$17.8 million. At September 30, 2011, \$17.8 million had been disbursed for the two construction loans, with no remaining commitments. Both projects have been completed and one has been transitioned to permanent loan status. In addition, in the first quarter of 2011, the Company issued a third construction-to-permanent loan in the amount of \$2.8 million. At September 30, 2011, \$1.1 million had been disbursed. At completion and fulfillment of occupancy requirements, the construction loan will convert to a long-term, fixed rate permanent loan.

**5. Financing Receivables**

The Company has financing receivables that have both a specific maturity date, either on demand or on a fixed or determinable date, and are recognized as an asset in the Company's statement of financial position.

The table below identifies the Company's financing receivables by classification amount as of September 30, 2011 and December 31, 2010.

|  | September 30<br>2011 | December 31<br>2010 |
|--|----------------------|---------------------|
| <b>Receivables:</b>                                      |                      |                     |
| Agent receivables, net (allowance \$1,631; \$644 - 2010) | \$ 2,235             | \$ 2,677            |
| <b>Investment-related financing receivables:</b>         |                      |                     |
| Mortgage loans, net (allowance \$3,410; \$3,410 - 2010)  | 623,368              | 559,167             |
| <b>Total financing receivables</b>                       | <b>\$ 625,603</b>    | <b>\$ 561,844</b>   |

**Agent Receivables**

The Company has agent receivables which are classified as financing receivables and which are reduced by an allowance for doubtful accounts. These receivables are long-term in nature, are trade receivables with the Company's sales force, contain specifically agreed contracts and are specifically assessed as to the collectability of each receivable. The Company's gross agent receivables totaled \$3.8 million as of September 30, 2011 and the Company had an allowance for doubtful accounts totaling \$1.6 million. Gross agent receivables totaled \$3.3 million with an allowance for doubtful accounts of \$0.6 million at December 31, 2010. The Company has two types of agent receivables included in this

category as follows:

Agent specific loans. As of September 30, 2011, these loans totaled \$0.8 million with a minimal allowance for doubtful accounts. As of December 31, 2010, agent specific loans totaled \$0.3 million and had a minimal allowance for doubtful accounts.

Various agent commission advances and other commission receivables. Gross agent receivables in this category totaled \$3.0 million, and the Company had an allowance for doubtful accounts of \$1.6 million as of September 30, 2011. Gross agent receivables totaled \$3.0 million and the allowance for doubtful accounts was \$0.6 million as of December 31, 2010.

**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued****Mortgage Loans**

The Company considers its mortgage loan portfolio to be long-term financing receivables. Mortgage loans are stated at cost, net of an allowance for potential future losses. Mortgage loan interest income is recognized on an accrual basis with any premium or discount amortized over the life of the loan. Prepayment and late fees are recorded on the date of collection. Loans in foreclosure, loans considered impaired or loans past due 90 days or more are placed on a non-accrual status.

If a mortgage loan is determined to be in non-accrual status, the Company does not accrue interest income. The loan is independently monitored and evaluated as to potential impairment or foreclosure. This evaluation includes assessing the probability of receiving future cash flows, along with consideration of many of the factors described below. If delinquent payments are made and the loan is brought current, then the Company returns the loan to active status and accrues income accordingly.

Generally, the Company considers its mortgage loans to be a portfolio segment. The Company considers its primary class to be property type. The Company primarily uses loan-to-value as its credit risk quality indicator but also monitors additional secondary risk factors, such as geographic distribution both on a regional and specific state basis. The mortgage loan portfolio segment is presented by property-type in a table in this section. In addition, geographic distributions for both regional and significant state concentrations are also presented in Note 4 - Investments. These measures are also supplemented with various other analytics to provide additional information concerning mortgage loans and management's assessment of financing receivables.

The following table presents an aging schedule for delinquent payments for both principal and interest as of September 30, 2011 and December 31, 2010, by property type.

| September 30, 2011 | Book Value      | Amount of Payments Past Due |             |             | Total        |
|--------------------|-----------------|-----------------------------|-------------|-------------|--------------|
|                    |                 | 30-59 Days                  | 60-89 Days  | > 90 Days   |              |
| Industrial         | \$ -            | \$ -                        | \$ -        | \$ -        | \$ -         |
| Medical            | -               | -                           | -           | -           | -            |
| Office             | 2,980           | 22                          | 7           | -           | 29           |
| Other              | -               | -                           | -           | -           | -            |
| <b>Total</b>       | <b>\$ 2,980</b> | <b>\$ 22</b>                | <b>\$ 7</b> | <b>\$ -</b> | <b>\$ 29</b> |
| December 31, 2010  |                 |                             |             |             |              |
| Industrial         | \$ 1,187        | \$ 11                       | \$ -        | \$ -        | \$ 11        |
| Medical            | -               | -                           | -           | -           | -            |
| Office             | 2,219           | 22                          | -           | -           | 22           |
| Other              | -               | -                           | -           | -           | -            |
| <b>Total</b>       | <b>\$ 3,406</b> | <b>\$ 33</b>                | <b>\$ -</b> | <b>\$ -</b> | <b>\$ 33</b> |

As of September 30, 2011, there was one mortgage loan that was 30 days past due and one 60 days past due. Subsequently, payment has been received on the 30-day delinquent loan and brought current in October 2011. As of December 31, 2010, there were two mortgage loans that were 30 days past due. Subsequently, payment was received on both of these loans and they were brought current in January 2011.

The allowance for losses on mortgage loans is maintained at a level believed by management to be adequate to absorb estimated credit losses. Management's periodic evaluation and assessment of the adequacy of the reserve is based on known and inherent risks in the portfolio, historical and industry data, current economic conditions and other relevant factors. A loan is considered impaired if it is probable that contractual

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amounts due will not be collected. The Company's allowance for credit losses was \$3.4 million at September 30, 2011.

The Company monitors and evaluates the allowance for losses on mortgage loans using a process that includes many factors, as detailed in the Financing Receivables - Mortgage Loans section of Note 3 - Investments of the Company's 2010 Form 10-K.



**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

There are a number of significant risks and uncertainties inherent in the process of monitoring impairments on loans. These risks include but are not limited to:

The risk that the Company's assessment of a borrower to meet all of its contractual obligations will change based on changes in the credit characteristics of the borrower or property;

The risk that the economic outlook will be worse than expected or have more of an impact on the borrower than anticipated;

The risk that the performance of the underlying property could deteriorate in the future;

The risk that fraudulent, inaccurate or misleading information could be provided to the Company;

The risk that the methodology or assumptions used to develop estimates of the portion of the impairment of the loan prove over time to be inaccurate; and

The risk that other facts and circumstances change such that it becomes more likely than not that the Company will not obtain all of its contractual payments.

To the extent the Company's review and valuation determines a loan is impaired, that amount will be charged to the allowance for loss and the loan balance will be reduced. In the event the property is foreclosed upon, the carrying value will be written down to the lesser of the current fair value or book value of the property with a charge to the allowance for loss and a corresponding reduction to the mortgage loan asset.

Over the past three years, the Company has had one mortgage loan default, which occurred in the fourth quarter of 2010. The Company completed the foreclosure on this loan in the fourth quarter of 2010 with no impairment recorded due to the fair value of the property being greater than its book value. Based in part on the factors described above, the Company has determined that it does not have any impairments in its portfolio. The Company had no loans that were restructured or modified in 2011.

The following table details the activity of the collectively evaluated allowance for losses on mortgage loans as of September 30, 2011 and December 31, 2010.

|                   | September 30<br>2011 | December 31<br>2010 |
|-------------------|----------------------|---------------------|
| Beginning of year | \$ 3,410             | \$ 3,410            |
| Additions         | -                    | -                   |
| Deductions        | -                    | -                   |
| End of year       | \$ 3,410             | \$ 3,410            |

**6. Variable Interest Entities**

The Company invests in certain affordable housing and real estate joint ventures which are considered to be variable interest entities (VIEs) and are included in Real Estate in the Consolidated Balance Sheets. The assets held in affordable housing real estate joint venture VIEs are primarily residential real estate properties that are restricted to provide affordable housing under federal or state programs for varying periods of time. The restrictions primarily apply to the rents that may be paid by tenants residing in the properties during the term of an agreement to remain in the affordable housing program. Investments in real estate joint ventures are equity interests in partnerships or limited liability companies that may or may not participate in profits or residual value. In certain cases, the Company may issue fixed-rate senior mortgage loan investments secured by properties controlled by VIEs. These investments are classified as mortgage loans in the Consolidated Balance Sheets, and the income received from such investments is recorded as investment income in the Consolidated Statements of Income.

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Investments in the affordable housing real estate and real estate joint ventures are interests that will absorb portions of the VIE's expected losses or receive portions of expected residual returns of the VIE's net assets exclusive of variable interests. The Company makes an initial assessment of whether it is the primary beneficiary of a VIE at the time of the initial investment and on an ongoing basis thereafter. The Company considers many factors when making this determination based upon a review of the underlying investment agreement and other information related to the specific investment. The first factor is whether the Company has the ability to direct the activities of a VIE that most significantly impact the VIE's economic performance. The power to direct the activities of the VIE is generally vested in the managing general partner or managing member of the VIE, which is not the position held by the Company in these investments. Other factors include the

**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

entity's equity investment at risk, decision-making abilities, obligations to absorb economic risks and the right to receive economic rewards of the entity; and the extent to which the Company shares in the VIE's expected losses and residual returns.

Most of the Company's investment interests in VIEs not in the form of a fixed-rate senior mortgage debt investment are recorded using the equity method, with cash distributions from the VIE and cash contributions to the VIE recorded as decreases or increases, respectively, in the carrying value of the VIE. Certain other equity investments in VIEs, where permitted, are recorded on an amortized cost basis. The operating performance of investments in the VIE is recorded in the Consolidated Statements of Income as investment income or as a component of income tax expense, depending upon the nature and primary design of the investment. The Company evaluates the carrying value of VIEs for impairment on an ongoing basis to assess whether the carrying value is expected to be realized during the anticipated life of the investment. Fixed-rate senior mortgage debt investments secured by properties controlled by VIEs are classified as commercial mortgages, and income received from such investments is recorded as investment income.

The following table presents the carrying amount and maximum exposure to loss relating to VIEs for which the Company holds a variable interest, but is not the primary beneficiary, and which have not been consolidated at September 30, 2011 and December 31, 2010. The table includes investments in 11 real estate joint ventures and 28 affordable housing real estate joint ventures as of September 30, 2011 and investments in 10 real estate joint ventures and 28 affordable housing real estate joint ventures as of December 31, 2010.

|   | September 30<br>2011 |                                | December 31<br>2010 |                                |
|---|----------------------|--------------------------------|---------------------|--------------------------------|
|   | Carrying<br>Amount   | Maximum<br>Exposure<br>to Loss | Carrying<br>Amount  | Maximum<br>Exposure<br>to Loss |
| Real estate joint ventures                    | \$ 36,064            | \$ 36,064                      | \$ 35,089           | \$ 35,089                      |
| Affordable housing real estate joint ventures | 21,031               | 63,323                         | 21,129              | 63,444                         |
| <b>Total</b>                                  | <b>\$ 57,095</b>     | <b>\$ 99,387</b>               | <b>\$ 56,218</b>    | <b>\$ 98,533</b>               |

The maximum exposure to loss relating to the real estate joint ventures and affordable housing real estate joint ventures, as shown in the table above, is equal to the carrying amounts plus any unfunded equity commitments, exposure to potential recapture of tax credits, guarantees of debt or other obligations of the VIE with recourse to the Company. Unfunded equity and loan commitments typically require financial or operating performance by other parties and have not yet become due or payable but which may become due in the future. As of September 30, 2011 and December 31, 2010, the Company had \$6.9 million and \$9.2 million, respectively, in fixed-rate senior mortgage loan commitments outstanding to the benefit of entities that are also real estate joint venture VIEs. The loan commitments are included in the discussion of commitments in the Notes to Consolidated Financial Statements for both periods. The Company also has contingent commitments to fund additional equity contributions and operating support to certain real estate joint venture VIEs, which could result in additional exposure to loss. However, the Company is not able to quantify the amount of these contingent commitments.

In addition, the maximum exposure to loss on affordable housing joint ventures as of September 30, 2011 and December 31, 2010 includes \$14.4 million and \$12.0 million, respectively, of losses which could be realized if the tax credits received by the VIEs were recaptured. Recapture events would cause the Company to reverse some or all of the benefit previously recognized by the Company or third parties to whom the tax credit interests were transferred. A recapture event can occur at any time during a 15-year required compliance period. The principal causes of recapture include financial default and non-compliance with affordable housing program requirements by the properties controlled by the VIE. The potential exposure due to recapture may be mitigated by guarantees from the managing member or managing partner in the VIE, insurance contracts, or changes in the residual value accruing to the Company's interests in the VIEs.

**7. Comprehensive Income**

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Comprehensive income is comprised of net income and other comprehensive income. Other comprehensive income includes the unrealized investment gains or losses on securities available for sale (net of adjustments for realized investment gains or losses) net of adjustments to DAC, VOBA and policyholder account balances. In addition, other comprehensive income includes the change in the liability for benefit plan obligations. Other comprehensive income reflects these items net of tax.

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The table below provides information about comprehensive income for the third quarters and nine months ended September 30, 2011 and 2010.

|   | Quarter Ended<br>September 30 |           | Nine Months Ended<br>September 30 |            |
|---|-------------------------------|-----------|-----------------------------------|------------|
|   | 2011                          | 2010      | 2011                              | 2010       |
| Net unrealized gains (losses) arising during the year                           | \$ 57,584                     | \$ 68,150 | \$ 96,657                         | \$ 182,371 |
| Less:   |                               |           |                                   |            |
| Net realized investment gains (losses), excluding impairment losses             | 204                           | 299       | 3,337                             | 2,934      |
| Other-than-temporary impairment losses recognized in earnings                   | (167)                         | (1,080)   | (674)                             | (4,129)    |
| Other-than-temporary impairment losses recognized in other comprehensive income | 17                            | 170       | 131                               | 309        |
| Net unrealized gains (losses) excluding impairment losses                       | 57,530                        | 68,761    | 93,863                            | 183,257    |
| Effect on DAC and VOBA  | (20,189)                      | (22,405)  | (27,019)                          | (57,306)   |
| Policyholder account balances   | (6,089)                       | (6,948)   | (9,600)                           | (15,598)   |
| Deferred income taxes   | (10,940)                      | (13,792)  | (20,037)                          | (38,623)   |
| Other comprehensive income  | 20,312                        | 25,616    | 37,207                            | 71,730     |
| Net income  | 4,466                         | 4,456     | 20,430                            | 15,479     |
| Comprehensive income  | \$ 24,778                     | \$ 30,072 | \$ 57,637                         | \$ 87,209  |

The following table provides accumulated balances related to each component of accumulated other comprehensive income as of September 30, 2011.

|                            | Net<br>Unrealized<br>Gain (Loss) on<br>Non-Impaired<br>Securities | Net<br>Unrealized<br>Gain (Loss) on<br>Impaired<br>Securities | Benefit<br>Plan<br>Obligations | DAC/<br>VOBA<br>Impact | Policyholder<br>Account<br>Balances | Tax Effect  | Total     |
|----------------------------|---|---|--------------------------------|------------------------|-------------------------------------|-------------|-----------|
| Beginning of year          | \$ 122,422  | \$ (12,231)   | \$ (55,980)                    | \$ (35,538)            | \$ (7,430)                          | \$ (3,436)  | \$ 7,807  |
| Other comprehensive income | 93,774  | 89  | -                              | (27,019)               | (9,600)                             | (20,037)    | 37,207    |
| End of period              | \$ 216,196  | \$ (12,142)   | \$ (55,980)                    | \$ (62,557)            | \$ (17,030)                         | \$ (23,473) | \$ 45,014 |

**8. Notes Payable**

The Company had no notes payable at September 30, 2011 or December 31, 2010.

As a member of the Federal Home Loan Bank of Des Moines (FHLB) with a capital investment of \$4.9 million, the Company has the ability to borrow on a collateralized basis from the FHLB. The Company received dividends on the capital investment of less than \$0.1 million in the third quarter and \$0.1 million for the nine-month period ended September 30, 2011. Dividends received were less than \$0.1 million in the third quarter and \$0.1 million for the nine-month period ended September 30, 2010.

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The Company has unsecured revolving lines of credit of \$60.0 million with two major commercial banks with no balances outstanding and which are at variable interest rates based upon short-term indices. These lines of credit will expire in June of 2012. The Company anticipates renewing these lines as they come due.

### ***9. Income Per Share***

Due to the Company's capital structure and the absence of other potentially dilutive securities, there is no difference between basic and diluted earnings per common share for any of the periods reported. The average numbers of shares outstanding were 11,432,209 and 11,467,605 for the quarters ended September 30, 2011 and 2010, respectively. The average numbers of shares outstanding were 11,453,124 and 11,492,090 for nine months ended September 30, 2011 and 2010, respectively.

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**Kansas City Life Insurance Company**

**Notes to Consolidated Financial Statements (Unaudited) Continued**

***10. Income Taxes***

The third quarter income tax expense was \$3.0 million or 40% of income before tax for 2011, versus \$2.3 million or 34% of income before tax for the prior year period. The income tax expense for the nine months ended September 30, 2011 was \$11.3 million or 36% of income before tax, versus \$10.1 million or 40% of income before tax for the prior year period.

The effective income tax rate in the third quarter of 2011 and for the nine months ended September 30, 2011 was greater than the prevailing corporate federal income tax rate of 35% primarily due to adjustments related to the Company's investments in affordable housing. The affordable housing adjustments resulted in a tax expense of approximately 5% and 1% of income before tax in the third quarter and nine months ended September 30, respectively.

The effective income tax rate in the third quarter of 2010 was less than the prevailing corporate federal income tax rate of 35% primarily due to favorable permanent differences. The permanent differences consisted primarily of the dividends-received deduction and differences between the prior year tax provision and the Company's filed tax returns. The permanent differences resulted in a tax benefit of approximately 7% of income before tax. Additionally, a decrease in the income tax contingency in third quarter 2010 resulted in a benefit of approximately 2% of income before tax. The favorable differences were partially offset in the third quarter of 2010 by expense of approximately 8% of income before tax, related to the Company's investments in affordable housing.

The effective income tax rate in the nine months ended September 30, 2010 exceeded the prevailing corporate federal income tax rate of 35%, primarily due to additional tax expense incurred with respect to affordable housing investments. Affordable housing investments increased the tax rate by \$2.4 million or 10% of income before tax and included tax credit recapture events. Permanent differences, primarily from the dividends-received deduction, and a decrease in the tax contingency partially offset the adjustments related to affordable housing and resulted in a benefit of approximately 5% of income before tax.

The Company did not have any uncertain tax positions at September 30, 2011.

As of September 30, 2011, the Company had a \$1.5 million net current tax liability and a \$73.3 million deferred tax liability. As of December 31, 2010, the Company had a \$0.2 million current tax liability and a \$53.3 million deferred tax liability.

Federal income taxes paid during the first nine months of 2011 and 2010 were \$8.3 million and \$4.0 million, respectively.

***11. Segment Information***

The Company has three reportable business segments, which are defined based on the nature of the products and services offered: Individual Insurance, Group Insurance and Old American. The Individual Insurance segment consists of individual insurance products for both Kansas City Life and Sunset Life. The Individual Insurance segment is marketed through a nationwide sales force of independent general agents and third-party marketing arrangements. The Group segment consists of sales of group life, dental, vision and long-term and short-term disability products. This segment is marketed through a nationwide sales force of independent general agents, group brokers and third-party marketing arrangements. The Old American segment consists of individual insurance products designed largely as final expense products. These products are marketed through a nationwide general agency sales force with exclusive territories, using direct response marketing to supply agents with leads.

Separate investment portfolios are maintained for each of the three life insurance companies. However, investment assets and income are allocated to the Group Insurance segment based upon its cash flows and future policy benefit liabilities. Most home office functions are fully integrated for all segments in order to maximize economies of scale. Therefore, operating expenses are allocated to the segments based upon internal cost studies, which are consistent with industry cost methodologies.

Inter-segment revenues are not material. The Company operates solely in the United States and no individual customer accounts for 10% or more of the Company's revenue.





**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

The following schedule provides the financial performance of each of the three reportable operating segments of the Company.

|                               |      | Individual<br>Insurance | Group<br>Insurance | Old<br>American | Intercompany<br>Eliminations <sup>1</sup> | Consolidated |
|-------------------------------|------|-------------------------|--------------------|-----------------|---|--------------|
| <b>Insurance revenues:</b>    |      |                         |                    |                 |   |              |
| Third quarter:                | 2011 | \$ 28,377               | \$ 12,613          | \$ 17,048       | \$ (135)                                  | \$ 57,903    |
|                               | 2010 | 34,617                  | 11,525             | 16,420          | (133)                                     | 62,429       |
| Nine months:                  | 2011 | 84,651                  | 37,413             | 50,655          | (404)                                     | 172,315      |
|                               | 2010 | 99,957                  | 36,728             | 48,630          | (396)                                     | 184,919      |
| <b>Net investment income:</b> |      |                         |                    |                 |   |              |
| Third quarter:                | 2011 | \$ 40,031               | \$ 133             | \$ 2,929        | \$ -                                      | \$ 43,093    |
|                               | 2010 | 40,842                  | 149                | 3,129           | -   | 44,120       |
| Nine months:                  | 2011 | 123,798                 | 420                | 9,159           | -   | 133,377      |
|                               | 2010 | 121,014                 | 456                | 9,226           | -   | 130,696      |
| <b>Net income (loss):</b>     |      |                         |                    |                 |   |              |
| Third quarter:                | 2011 | \$ 3,083                | \$ 299             | \$ 1,084        | \$ -                                      | \$ 4,466     |
|                               | 2010 | 4,413                   | (758)              | 801             | -   | 4,456        |
| Nine months:                  | 2011 | 20,333                  | (461)              | 558             | -   | 20,430       |
|                               | 2010 | 15,651                  | (1,630)            | 1,458           | -   | 15,479       |

<sup>1</sup> Elimination entries to remove intercompany transactions for life and accident and health insurance that the Company purchases for its employees and agents were as follows: insurance revenues from the Group Insurance segment and operating expenses from the Individual Insurance segment to arrive at Consolidated Statements of Income.

**12. Pensions and Other Postretirement Benefits**

The following tables provide the components of net periodic benefit cost for the third quarters and nine months ended September 30, 2011 and 2010:

|                                    | Pension Benefits              |                 | Other Benefits                |               |
|------------------------------------|-------------------------------|-----------------|-------------------------------|---------------|
|                                    | Quarter Ended<br>September 30 |                 | Quarter Ended<br>September 30 |               |
|                                    | 2011                          | 2010            | 2011                          | 2010          |
| Service cost                       | \$ -                          | \$ 473          | \$ 161                        | \$ 205        |
| Interest cost                      | 1,871                         | 1,819           | 387                           | 460           |
| Expected return on plan assets     | (2,342)                       | (2,159)         | (9)                           | (11)          |
| Amortization of:                   |                               |                 |                               |               |
| Unrecognized actuarial gain (loss) | 896                           | 1,034           | 4                             | (57)          |
| Unrecognized prior service cost    | -                             | (142)           | (68)                          | (59)          |
| <b>Net periodic benefit cost</b>   | <b>\$ 425</b>                 | <b>\$ 1,025</b> | <b>\$ 475</b>                 | <b>\$ 538</b> |



**Table of Contents****Kansas City Life Insurance Company****Notes to Consolidated Financial Statements (Unaudited) Continued**

|                                    | Pension Benefits                  |                 | Other Benefits                    |                 |
|------------------------------------|-----------------------------------|-----------------|-----------------------------------|-----------------|
|                                    | Nine Months Ended<br>September 30 |                 | Nine Months Ended<br>September 30 |                 |
|                                    | 2011                              | 2010            | 2011                              | 2010            |
| Service cost                       | \$ -                              | \$ 1,418        | \$ 482                            | \$ 615          |
| Interest cost                      | 5,613                             | 5,456           | 1,162                             | 1,377           |
| Expected return on plan assets     | (7,025)                           | (6,477)         | (28)                              | (34)            |
| Amortization of:                   |                                   |                 |                                   |                 |
| Unrecognized actuarial gain (loss) | 2,687                             | 3,103           | 13                                | (170)           |
| Unrecognized prior service cost    | -                                 | (425)           | (204)                             | (178)           |
| <b>Net periodic benefit cost</b>   | <b>\$ 1,275</b>                   | <b>\$ 3,075</b> | <b>\$ 1,425</b>                   | <b>\$ 1,610</b> |

The Kansas City Life Cash Balance Pension Plan was amended effective December 31, 2010 to provide that participants' accrued benefits will be frozen as of, and that no further benefits or accruals will be earned after, December 31, 2010. The postretirement plan disclosures included herein do not include the potential impact from the Medicare Act (the Act) that became law in December 2003. The Act introduced a new federal subsidy to sponsors of certain retiree healthcare plans that provide a benefit that is at least actuarially equivalent to Medicare. Since the Company does not provide benefits that are actuarially equivalent to Medicare, the Act did not impact the Company's disclosures.

**13. Share-Based Payment**

The Company has a long-term incentive plan for senior management that provides a cash award to participants for the increase in the share price of the Company's common stock through units (phantom shares) assigned by the Board of Directors. The cash award is calculated over a three-year interval on a calendar year basis. At the conclusion of each three-year interval, participants will receive a cash award based on the increase in the share price during a defined measurement period, times the number of units. The increase in the share price will be determined based on the change in the share price from the beginning to the end of the three-year interval. Dividends are accrued and paid at the end of each three-year interval to the extent that they exceed negative stock price appreciation. Plan payments are contingent on the continued employment of the participant unless termination is due to a qualifying event such as death, disability or retirement. The Company does not make payments in shares, warrants or options.

No payments were made under this plan during the first nine months ended September 30, 2011 and 2010.

At each reporting period, an estimate of the share-based compensation expense is accrued, utilizing the share price at the period end. The changes in accrual for share-based compensation that increased operating expense in the third quarters of 2011 and 2010 were each \$0.1 million, net of tax. The changes in accrual for share-based compensation that increased operating expense in the first nine months of 2011 and 2010 were each \$0.1 million, net of tax.

**14. Separate Accounts**

Separate account assets and liabilities arise from the sale of variable universal life insurance and variable annuity products. The separate account represents funds segregated for the benefit of certain policyholders who assume the investment risk. The assets are legally segregated and are not subject to claims which may arise from any other business of the Company. The separate account assets and liabilities, which are equal, are recorded at fair value based upon net asset value (NAV). Policyholder account deposits and withdrawals, investment income and realized investment gains and losses are excluded from the amounts reported in the Consolidated Statements of Income. Revenues to the Company from separate accounts consist principally of contract charges, which include maintenance charges, administrative fees and mortality and risk charges.

The Company has a guaranteed minimum withdrawal benefit (GMWB) rider that can be added to new or existing variable annuity contracts. The rider provides an enhanced withdrawal benefit that guarantees a stream of income payments to an owner or annuitant, regardless of the contract account value. The value of variable annuity separate accounts with the GMWB rider was \$82.0 million at September 30, 2011 (December 31,

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2010 - \$80.3 million) and the guarantee liability was \$0.7 million at September 30, 2011, a \$3.5 million change from December 31, 2010. The value of the GMWB rider is

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**Kansas City Life Insurance Company**

**Notes to Consolidated Financial Statements (Unaudited) Continued**

recorded at fair value. The change in this value is included in policyholder benefits in the Consolidated Statements of Income. The value of variable annuity separate accounts with the GMWB rider is recorded in separate account liabilities and the value of the rider is included in other policyholder funds in the Consolidated Balance Sheets. The determination of fair value of the GMWB liability requires models that use actuarial and financial market assumptions, which reflect the assumptions market participants would use in pricing the contract, including adjustments for risk and issuer non-performance.

Guarantees are offered under variable universal life and variable annuity contracts: a guaranteed minimum death benefit (GMDB) rider is available on certain variable universal life contracts and GMDB are provided on all variable annuities. The GMDB rider for variable universal life and variable annuity contracts guarantees the death benefit for specified periods of time, regardless of investment performance, provided cumulative premium requirements are met. The total reserve held for the variable annuity GMDB at September 30, 2011 was \$0.2 million, virtually unchanged from December 31, 2010.

***15. Commitments***

In the normal course of business, the Company has open purchase and sale commitments. At September 30, 2011, the Company's commitments included purchase commitments to fund mortgage loans and other investments of \$11.1 million. At September 30, 2011, the Company also had a commitment to fund one construction-to-permanent loan of \$1.7 million that is subject to the borrower's performance.

Subsequent to September 30, 2011, the Company entered into a commitment to fund an additional mortgage loan of \$4.8 million. The Company has also funded \$0.5 million of the remaining commitment on the construction-to-permanent loan that was outstanding as of September 30, 2011.

***16. Contingent Liabilities***

The Company is occasionally involved in litigation, both as a defendant and as a plaintiff. The life insurance industry, including the Company and its subsidiaries, has been subject to an increase in litigation in recent years. Such litigation has been pursued on behalf of purported classes of insurance purchasers, often questioning the conduct of insurers in the marketing of their products. In addition, state regulatory bodies, the SEC, FINRA, and other regulatory bodies regularly make inquiries and conduct examinations or investigations concerning the Company's compliance with laws in relation to, but not limited to, insurance, securities and activities of broker-dealers.

The Company's retail broker-dealer subsidiary is in an industry that involves substantial risks of liability. In recent years, litigation and arbitration proceedings involving actions against registered representatives and securities products (including mutual funds, variable annuities, and alternative investments such as real estate investment products, oil and gas investments, etc.) have continued to increase. Given the significant decline in the major market indices beginning in 2008, and the generally poor performance of investments that have historically been considered safe and conservative, there is the potential for an increase in the number of proceedings to which a broker-dealer may be named as a party.

In addition to the above, the Company and its subsidiaries are defendants in, or subject to, other claims or legal actions related to insurance and investment products. Some of these claims and legal actions are in jurisdictions where juries are given substantial latitude in assessing damages, including punitive damages.

Although no assurances can be given and no determinations can be made at this time, management believes that the ultimate liability, if any, with respect to these other claims and legal actions would not have a material effect on the Company's business, results of operations or financial position.

In accordance with applicable accounting guidelines, the Company has established an accrued liability for litigation and regulatory matters when those matters present loss contingencies that are both probable and estimable. As a litigation or regulatory matter develops, it is evaluated on an ongoing basis, in conjunction with outside counsel, as to whether the matter presents a loss contingency that meets conditions indicating the need for accrual and/or disclosure. If and when a loss contingency related to litigation or regulatory matters is deemed to be both probable and

estimable, the Company establishes an accrued liability. This accrued liability is then monitored for further developments that may affect the amount of the accrued liability.

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**Kansas City Life Insurance Company**

**Notes to Consolidated Financial Statements (Unaudited) Continued**

***17. Guarantees and Indemnifications***

The Company is subject to various indemnification obligations issued in conjunction with certain transactions, primarily assumption reinsurance agreements, stock purchase agreements, mortgage servicing agreements, tax credit assignment agreements, construction and lease guarantees and borrowing agreements whose terms range in duration and often are not explicitly defined. Generally, a maximum obligation is not explicitly stated. Therefore, the overall maximum amount of the obligation under the indemnifications cannot be reasonably estimated. The Company is unable to estimate with certainty the ultimate legal and financial liability with respect to these indemnifications. The Company believes that the likelihood is remote that material payments would be required under such indemnifications and therefore such indemnifications would not result in a material adverse effect on the financial position or results of operations.

***18. Subsequent Events***

On October 24, 2011, the Board of Directors declared a quarterly dividend of \$0.27 per share that will be paid November 9, 2011 to stockholders of record as of November 3, 2011.

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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 is intended to provide in narrative form the perspective of the management of Kansas City Life Insurance Company (the Company) on its financial condition, results of operations, liquidity and certain other factors that may affect its future results. The following is a discussion and analysis of the results of operations for the third quarters and nine months ended September 30, 2011 and 2010 and the financial condition of the Company as of September 30, 2011. This discussion should be read in conjunction with the consolidated financial statements and accompanying notes included in this document, as well as the Company's 2010 Form 10-K. Amounts are stated in thousands, except share data, or as otherwise noted.

**Overview**

Kansas City Life Insurance Company is a financial services company that is predominantly focused on the underwriting, sales, and administration of life and annuity insurance products. The consolidated entity (the Company) primarily consists of three life insurance companies. Kansas City Life Insurance Company (Kansas City Life) is the parent company. Sunset Life Insurance Company of America (Sunset Life) and Old American Insurance Company (Old American) are wholly-owned subsidiaries.

Kansas City Life markets individual insurance products, including traditional, interest sensitive and variable products through a nationwide sales force of independent general agents and third-party marketing arrangements. Kansas City Life also markets group insurance products, which include life, dental, vision and disability products through its sales force of independent general agents, group brokers and third-party marketing arrangements. Kansas City Life operates in 48 states and the District of Columbia.

Sunset Life is a life insurance company that maintains its current block of business, but does not solicit new sales. Sunset Life is included in the Individual Insurance segment and its individual insurance products include traditional and interest sensitive products. Sunset Life operates in 43 states and the District of Columbia.

Old American focuses on selling final expense life insurance products to the senior market. Old American markets its products nationwide through a general agency system, with exclusive territories, using direct response marketing to supply agents with leads. Old American's administrative and accounting operations are part of the Company's home office but it operates and maintains a separate marketing function and independent field force. Old American operates in 47 states and the District of Columbia.

The Company offers investment products and broker dealer services through its subsidiary Sunset Financial Services, Inc. (SFS) for both proprietary and non-proprietary variable insurance products, mutual funds and other securities.

The Company operates in the life insurance sector of the financial services industry in the United States. This industry is highly competitive with respect to pricing, selection of products and quality of service. No single competitor or any small group of competitors dominates any of the markets in which the Company operates.

The Company earns revenues primarily from premiums received from the sale of life insurance, immediate annuity and accident and health policies, from earnings on its investment portfolio and from the sale of investment assets. Revenues from the sale of traditional life insurance, immediate annuity products and accident and health products are reported as premium income for financial statement purposes. Considerations for supplementary contracts with life contingencies are reported as part of other revenues. However, deposits received from the sale of interest sensitive products, namely universal life insurance products, fixed deferred annuities, variable universal life, variable annuities and supplementary contracts without life contingencies, are not reported as premium revenues. These are instead reported as additions to the policyholders' account balances and are reflected as deposits in the Consolidated Statements of Cash Flows. Accordingly, revenues on these products are recognized over time in the form of contract charges assessed against policyholder account balances, charges assessed on the early surrender of policyholder account balances and other charges deducted from policyholders' balances.

The Company's profitability depends on many factors, which include but are not limited to:

- The sale of life, annuity, and accident and health products;
- The rate of mortality, lapse and surrenders of future policy benefits and policyholder account balances;
- The rate of morbidity, disability and incurrence of other policyholder benefits;
- Persistency of existing insurance policies;





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Interest rates credited to policyholders;  
The effectiveness of reinsurance programs;  
The amount of investment assets under management;  
Investment spreads earned on policyholder account balances;  
The ability to maximize investment returns and minimize risks such as interest rate risk, credit risk and equity risk;  
Timely and cost-effective access to liquidity; and  
Management of distribution costs and operating expenses.

Strong sales competition, highly competitive products and a challenging economic environment present significant challenges to the Company from a new sales perspective. The Company's primary emphasis is on expanding sales of individual life insurance products. The Company's continued focus is on delivering competitive products for a reasonable cost, prompt customer service, excellent financial strength and effective sales and marketing support to the field force.

The Company generates cash largely through premiums collected from the sale of insurance products, deposits through the sale of universal life-type and deposit-type products and through investment activity. The principal uses of cash are for the insurance operations, including the purchase of investments, payment of insurance benefits and withdrawals from policyholder accounts, operating expenses, premium taxes, and costs related to acquiring new business. In addition, cash is used to pay income taxes and stockholder dividends, as well as to fund potential acquisition opportunities.

General economic conditions may affect future results. Interim results are not necessarily indicative of results for the entire year and should be read in conjunction with the Company's 2010 Form 10-K. Market fluctuations, often extreme in nature, have significantly impacted the financial markets and the Company's investments, revenues, and policyholder benefits. The interest rate and credit environments have presented significant challenges to the financial markets as a whole and specifically to companies invested in fixed maturity and equity securities. These conditions continue and the stressed economic and market environment may persist into the future.

## **Cautionary Statement on Forward-Looking Information**

This report reviews the Company's financial condition and results of operations, and historical information is presented and discussed. Where appropriate, factors that may affect future financial performance are also identified and discussed. Certain statements made in this report include forward-looking statements that fall within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include any statement that may predict, forecast, indicate or imply future results, performance or achievements rather than historical facts and may contain words like believe, expect, estimate, project, forecast, anticipate, plan, will, shall, and other words, phrases or similar meaning.

Actual results may differ materially from those included in the forward-looking statements as a result of risks and uncertainties. Those risks and uncertainties include, but are not limited to, the risk factors listed in Item 1A. Risk Factors and Cautionary Factors that may Affect Future Results as filed in the Company's 2010 Form 10-K.

## **Consolidated Results of Operations**

### ***Summary of Results***

The Company's net income in the third quarter of 2011 was \$4.5 million, the same as the third quarter of 2010. Net income per share was \$0.39 per share in both the third quarters of 2011 and 2010. Net income for the first nine months of 2011 was \$20.4 million, an increase of \$5.0 million or 32% compared to last year. Net income per share was \$1.78, an increase of \$0.43 per share versus the same period one year earlier.

Results for the third quarter of 2011 reflected a \$7.8 million decrease in policyholder benefits and a \$0.7 million increase in net realized investment gains. Partially offsetting these improvements were a \$3.3 million decrease in net premiums, a \$2.9 million increase in the amortization of DAC, a \$1.2 million decline in contract charges, and lower net investment income of \$1.0 million.

Contributing to the higher net income for the nine months were increases in realized investment gains of \$3.3 million and net investment income of \$2.7 million. Decreases in policyholder benefits of \$14.1 million and interest credited to policyholder account balances of \$1.9 million also contributed to the increase in net income. Partially offsetting these favorable items were decreases in net premiums of \$8.0 million and contract charges of \$4.6 million.



**Table of Contents****Sales**

The Company measures sales in terms of new premiums and deposits. Sales of traditional life insurance, immediate annuities and accident and health products are reported as premium income for financial statement purposes. Deposits received from the sale of interest sensitive products, including universal life insurance, fixed deferred annuities, variable universal life, variable annuities and supplementary contracts without life contingencies are reflected as deposits in the Consolidated Statements of Cash Flows.

The Company's marketing plan for individual products primarily focuses on three main aspects: providing financial security with respect to life insurance; the accumulation of long-term value; and future retirement income needs. The primary emphasis is on the growth of individual life insurance business, including new premiums for individual life products and new deposits for universal life and variable universal life products.

Sales are primarily made through the Company's existing sales force. The Company emphasizes growth of the sales force with the addition of new general agents and agents. The Company believes that increased sales will result through both the number and productivity of general agents and agents. In addition, the Company has placed an emphasis on training and direct support to the field force to assist new agents in their start-up phase, support existing agents to stay abreast of the ever-changing regulatory environment, and introduce agents to new products and enhanced features of existing products. On occasion, the Company may also selectively utilize third-party marketing arrangements to enhance its sales objectives. This allows the Company flexibility to identify niches or pursue unique avenues in the existing market environment and to react quickly to take advantage of opportunities when they occur.

The Company also markets a series of group products. These products include group life, dental, disability, and vision products. The primary growth strategies for these products include increased productivity of the existing group representatives, planned expansion of the group distribution system and also to selectively utilize third-party marketing arrangements. Further, growth is to be supported by the addition of new products to the portfolio, particularly voluntary-type products.

The following tables present gross premiums by new and renewal business, less reinsurance ceded, as included in insurance revenues, for the third quarters and nine months ended September 30, 2011 and 2010. New premiums are detailed by product.

|                                     | 2011             | % Change    | Quarter Ended<br>September 30<br>2010 | % Change    |
|-------------------------------------|------------------|-------------|---------------------------------------|-------------|
| <b>New premiums:</b>                |                  |             |                                       |             |
| Individual life insurance           | \$ 4,249         | 1           | \$ 4,201                              | 15          |
| Immediate annuities                 | 1,903            | (72)        | 6,689                                 | (38)        |
| Group life insurance                | 516              | (5)         | 545                                   | 52          |
| Group accident and health insurance | 3,301            | 13          | 2,920                                 | 6           |
| <b>Total new premiums</b>           | <b>9,969</b>     | <b>(31)</b> | <b>14,355</b>                         | <b>(18)</b> |
| <b>Renewal premiums</b>             | <b>37,079</b>    | <b>7</b>    | <b>34,813</b>                         | <b>(3)</b>  |
| <b>Total premiums</b>               | <b>47,048</b>    | <b>(4)</b>  | <b>49,168</b>                         | <b>(8)</b>  |
| <b>Reinsurance ceded</b>            | <b>(14,572)</b>  | <b>9</b>    | <b>(13,382)</b>                       | <b>(4)</b>  |
| <b>Premiums, net</b>                | <b>\$ 32,476</b> | <b>(9)</b>  | <b>\$ 35,786</b>                      | <b>(9)</b>  |

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|                                     | Nine Months Ended<br>September 30 |          |            |          |
|-------------------------------------|-----------------------------------|----------|------------|----------|
|                                     | 2011                              | % Change | 2010       | % Change |
| <b>New premiums:</b>                |                                   |          |            |          |
| Individual life insurance           | \$ 12,973                         | 6        | \$ 12,229  | 18       |
| Immediate annuities                 | 5,649                             | (66)     | 16,637     | (1)      |
| Group life insurance                | 1,463                             | (13)     | 1,672      | 47       |
| Group accident and health insurance | 10,292                            | 9        | 9,454      | 25       |
| <br>                                |                                   |          |            |          |
| Total new premiums                  | 30,377                            | (24)     | 39,992     | 12       |
| Renewal premiums                    | 109,034                           | 3        | 105,356    | (2)      |
| <br>                                |                                   |          |            |          |
| Total premiums                      | 139,411                           | (4)      | 145,348    | 2        |
| Reinsurance ceded                   | (42,509)                          | 5        | (40,414)   | 2        |
| <br>                                |                                   |          |            |          |
| Premiums, net                       | \$ 96,902                         | (8)      | \$ 104,934 | 1        |

Consolidated total premiums decreased \$2.1 million or 4% in the third quarter of 2011 versus the same period in the prior year. This includes a decrease in total new premiums of \$4.4 million or 31% and an increase in total renewal premiums of \$2.3 million or 7%. The decrease in new premiums was due to a \$4.8 million or 72% decrease in immediate annuities. This decrease was largely the result of elevated sales of this product in 2010 due to the demand of guaranteed benefits by consumers at that time. Immediate annuity receipts can have sizable fluctuations, as receipts from policyholders result from significant one-time premiums rather than recurring premiums. The decrease in new immediate annuity sales can also be attributed to lower interest rates and increased competition from alternative products. New individual life insurance premiums increased 1%, primarily reflecting a 5% increase in new premiums in the Old American segment. The increase in new premiums from the Old American segment primarily reflects greater field force productivity and the expansion of targeted geographic distribution opportunities. New group accident and health premiums increased \$0.4 million or 13%, primarily due to increased sales of short-term disability products. The Group segment has expanded the use of a third-party marketing organization, specifically in the short-term disability market, which has resulted in increased new sales of this product. The increase in renewal premiums was primarily due to a \$1.2 million increase in renewal group accident and health premiums, largely in the dental line. Also contributing to the increase in renewal premiums was a \$1.0 million or 4% increase in individual life sales from both the Individual Insurance and Old American segments.

Consolidated total premiums decreased \$5.9 million or 4% for the first nine months of 2011 versus the same period in the prior year, reflecting an \$11.0 million or 66% decrease in new immediate annuity sales. However, total renewal premiums increased \$3.7 million or 3% in the nine months. The decrease in new immediate annuities was largely the result of elevated sales of this product in 2010 due to the demand of guaranteed benefits by consumers at that time. The decrease in new immediate annuity sales can also be attributed to lower interest rates and increased competition from alternative products. New individual life insurance premiums increased \$0.7 million or 6%, primarily reflecting a 10% increase in new premiums in the Old American segment. The increase in new premiums from the Old American segment primarily reflects the continued results of greater field force productivity and targeted geographic distribution opportunities. New group accident and health premiums increased \$0.8 million or 9%, primarily due to increased sales of short-term disability products. The Group segment expanded the use of a third-party marketing organization in 2011, specifically in the short-term disability market, which has resulted in increased new sales of this product. However, the segment has also significantly reinsured the risk associated with this product. The increase in renewal premiums included a \$1.6 million or 2% increase in individual life sales, reflecting increases from both the Old American and Individual Insurance segments. Also contributing to the increase in renewal premiums was a \$1.6 million or 6% increase in group accident and health premiums from both short-term disability and dental products.

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The following tables reconcile deposits with the Consolidated Statements of Cash Flows and provide detail by new and renewal deposits for the third quarters and nine months ended September 30, 2011 and 2010. New deposits are also detailed by product.

|                                   | Quarter Ended<br>September 30 |             |                  |           |
|-----------------------------------|-------------------------------|-------------|------------------|-----------|
|                                   | 2011                          | % Change    | 2010             | % Change  |
| <b>New deposits:</b>              |                               |             |                  |           |
| Universal life insurance          | \$ 2,391                      | (39)        | \$ 3,920         | 85        |
| Variable universal life insurance | 183                           | (43)        | 320              | 82        |
| Fixed deferred annuities          | 15,368                        | (42)        | 26,562           | 37        |
| Variable annuities                | 4,119                         | 44          | 2,870            | (14)      |
| <b>Total new deposits</b>         | <b>22,061</b>                 | <b>(34)</b> | <b>33,672</b>    | <b>35</b> |
| Renewal deposits                  | 37,459                        | 6           | 35,260           | 3         |
| <b>Total deposits</b>             | <b>\$ 59,520</b>              | <b>(14)</b> | <b>\$ 68,932</b> | <b>17</b> |

|                                   | Nine Months Ended<br>September 30 |            |                   |             |
|-----------------------------------|-----------------------------------|------------|-------------------|-------------|
|                                   | 2011                              | % Change   | 2010              | % Change    |
| <b>New deposits:</b>              |                                   |            |                   |             |
| Universal life insurance          | \$ 8,953                          | (14)       | \$ 10,418         | 71          |
| Variable universal life insurance | 676                               | (11)       | 760               | (13)        |
| Fixed deferred annuities          | 48,285                            | (1)        | 49,005            | (24)        |
| Variable annuities                | 14,098                            | (2)        | 14,387            | 30          |
| <b>Total new deposits</b>         | <b>72,012</b>                     | <b>(3)</b> | <b>74,570</b>     | <b>(10)</b> |
| Renewal deposits                  | 109,490                           | 4          | 104,880           | 6           |
| <b>Total deposits</b>             | <b>\$ 181,502</b>                 | <b>1</b>   | <b>\$ 179,450</b> | <b>(1)</b>  |

Total new deposits decreased \$11.6 million or 34% in the third quarter of 2011 compared with the prior year. New fixed annuity deposits decreased \$11.2 million or 42% and new universal life deposits decreased \$1.5 million or 39%. This was partially offset by a \$1.2 million or 44% increase in new variable annuity deposits. The decrease in new fixed deferred annuity deposits can be largely attributed to lower interest rates and increased competition from alternative products. Total renewal deposits increased \$2.2 million or 6% in the third quarter of 2011 compared with the same period one year earlier.

Total new deposits decreased \$2.6 million or 3% in the first nine months of 2011 compared with the prior year. This decrease reflected declines in new universal life deposits of \$1.5 million or 14%; new fixed deferred annuity deposits of \$0.7 million or 1%; and new variable annuity deposits of \$0.3 million or 2%. Total renewal deposits increased \$4.6 million or 4% in the first nine months of 2011.

**Insurance Revenues**

Insurance revenues consist of premiums, net of reinsurance, and contract charges. In the third quarter of 2011, total insurance revenues decreased \$4.5 million or 7%, reflecting a \$3.3 million or 9% decrease in net premiums and a \$1.2 million or 5% decrease in contract charges. Total immediate annuity premiums decreased \$4.8 million or 72%. However, total individual life premiums and total accident and health premiums increased \$1.2 million and \$1.5 million, respectively, versus the prior year. In addition, reinsurance ceded increased \$1.2 million or 9% in the third quarter, largely from new short-term disability sales.

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Insurance revenues for the first nine months of 2011 decreased \$12.6 million or 7%, largely from a decrease in immediate annuity sales of \$10.7 million or 64% and a decrease in contract charges of \$4.6 million or 6% compared to the first nine months of 2010. Total individual life premiums increased \$2.6 million or 3%, primarily reflecting an increase from the Old American segment. Accident and health premiums increased \$2.2 million or 6%, largely driven from disability sales from the Group segment. Partially offsetting these increases was an increase in reinsurance ceded of \$2.1 million, principally resulting from an increase in new short-term disability sales.

Contract charges consist of cost of insurance, expense loads, amortization of unearned revenues, and surrender charges. Certain contract charges for universal life, deposit or investment products are not recognized in income immediately but are deferred and amortized into income in proportion to the expected future gross profits of the business in a manner similar to

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DAC. Profit expectations are based upon assumptions of future interest spreads, mortality margins, expense margins and policy and premium persistency experience. At least annually, a review is performed of the assumptions related to profit expectations. If it is determined the assumptions should be revised, the impact is recorded as a change in the revenue reported in the current period as an unlocking adjustment.

Contract charges are impacted by the sales of new products and the persistency of both existing and closed blocks of business. The closed blocks of business reflect policies and companies that have been purchased but to which the Company is not actively pursuing marketing efforts to generate new sales and has the intent of holding and servicing long-term. Total contract charges on these closed blocks were approximately one-third of total consolidated contract charges for both the third quarter and first nine months of both periods presented.

Total contract charges on all blocks of business decreased \$1.2 million or 5% in the third quarter of 2011 compared to the third quarter of 2010. Contract charges on closed blocks of business decreased \$0.3 million or 3% and contract charges on ongoing blocks of business decreased \$0.9 million or 5%. Cost of insurance charges declined due to the runoff of the closed blocks. Surrender charges declined due to reduced surrenders of universal life and variable universal life insurance products on the ongoing blocks of business.

Total contract charges decreased \$4.6 million or 6% in the first nine months of 2011 compared to the same period in 2010. Contract charges on closed blocks of business decreased \$1.3 million or 4% and contract charges on ongoing blocks of business decreased \$3.3 million or 6%. Cost of insurance charges declined largely due to the runoff of the closed blocks. The decline in surrender charges reflected reduced surrenders on universal life and variable universal life products in the ongoing blocks of business. Deferred revenue declined primarily due to the unlocking described in the Company's Form 10-Q for the quarter ended June 30, 2011.

The Company uses reinsurance as a means to mitigate its risks and to reduce the earnings volatility from claims. Reinsurance ceded premiums increased \$1.2 million or 9% in the third quarter and \$2.1 million or 5% in the first nine months, as compared to the same periods in 2010. Reinsurance ceded premiums for the Individual Insurance segment increased \$0.6 million or 6% in the third quarter and \$0.4 million or 1% in the nine months. The Group segment experienced a \$0.7 million or 30% increase in reinsurance ceded in the third quarter and \$2.0 million or 30% in the nine months, largely due to increased disability sales from a third-party arrangement where the risk is 100% reinsured. Reinsurance ceded for the Old American segment declined 12% in both the third quarter and first nine months of 2011, reflecting the continued runoff of a large closed block of reinsured business.

***Investment Revenues***

Gross investment income is largely composed of interest, dividends and other earnings on fixed maturity securities, equity securities, short-term investments, mortgage loans, real estate and policy loans. Gross investment income decreased \$0.8 million or 2% in the third quarter of 2011, compared with the same period in 2010. Gross investment income for the nine months increased \$3.3 million or 2% versus 2010. The lower investment income from the third quarter of 2011 was largely due to lower yields earned and a \$1.2 million decline in the market value of an alternative investment fund. Partially offsetting this, average invested assets increased, largely due to increased mortgage loan holdings in 2011. The increase in investment income for the first nine months of 2011 resulted from both an increase in average invested assets and higher yields earned.

Fixed maturity securities provided a majority of the Company's investment income during the third quarter and nine months ended September 30, 2011. Income on these investments declined \$1.9 million in the third quarter and \$2.3 million in the nine months, reflecting both rate and average volume declines.

Investment income from mortgage loans increased \$2.5 million in the third quarter and \$5.5 million during the first nine months of 2011 compared to the same periods in 2010. These improvements were largely the result of higher mortgage loan portfolio holdings in 2011 compared to 2010, as the Company increased mortgage loan holdings through purchases made during the second through fourth quarters of 2010 and in the second quarter of 2011. During 2010, the Company purchased approximately \$84.6 million in mortgage loans, and the Company purchased another \$72.3 million in mortgage loans during the second quarter of 2011. The purchased loans are seasoned performing loans having characteristics of property type, geographical diversification, term, underwriting and cash flows that are similar to the Company's portfolio of originated loans.

In addition, the market value declined on an alternative investment fund, which reduced investment income of \$1.2 million in the third quarter of 2011 compared to the prior year and \$0.4 million for the first nine months of 2011 versus the prior year.



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Net investment income is stated net of investment expenses. Investment expenses increased \$0.2 million or 9% in the third quarter of 2011 compared to the same period in 2010 and increased \$0.6 million in the first nine months of 2011 versus the same period of the prior year. These variances can largely be attributed to real estate expenses.

The following table provides detail concerning realized investment gains and losses for the third quarters and nine months ended September 30, 2011 and 2010.

|   | Quarter Ended<br>September 30 |                 | Nine Months Ended<br>September 30 |                 |
|---|-------------------------------|-----------------|-----------------------------------|-----------------|
|   | 2011                          | 2010            | 2011                              | 2010            |
| <b>Gross gains resulting from:</b>                                |                               |                 |                                   |                 |
| Sales of investment securities                                    | \$ 292                        | \$ 290          | \$ 3,944                          | \$ 1,914        |
| Investment securities called and other                            | 105                           | 75              | 1,355                             | 1,241           |
| <b>Total gross gains</b>  | <b>397</b>                    | <b>365</b>      | <b>5,299</b>                      | <b>3,155</b>    |
| <b>Gross losses resulting from:</b>                               |                               |                 |                                   |                 |
| Sales of investment securities                                    | (76)                          | (19)            | (1,666)                           | (19)            |
| Investment securities called and other                            | (118)                         | (47)            | (297)                             | (202)           |
| Mortgage loans  | -                             | -               | (3)                               | -               |
| <b>Total gross losses</b>   | <b>(194)</b>                  | <b>(66)</b>     | <b>(1,966)</b>                    | <b>(221)</b>    |
| Amortization of DAC and VOBA                                      | 7                             | (36)            | (218)                             | 145             |
| <b>Net realized investment gains, excluding impairment losses</b> | <b>210</b>                    | <b>263</b>      | <b>3,115</b>                      | <b>3,079</b>    |
| <b>Net impairment losses recognized in earnings:</b>              |                               |                 |                                   |                 |
| Total other-than-temporary impairment losses                      | (167)                         | (1,080)         | (674)                             | (4,129)         |
| Portion of loss recognized in other comprehensive income          | 17                            | 170             | 131                               | 309             |
| <b>Net impairment losses recognized in earnings</b>               | <b>(150)</b>                  | <b>(910)</b>    | <b>(543)</b>                      | <b>(3,820)</b>  |
| <b>Realized investment gains (losses)</b>                         | <b>\$ 60</b>                  | <b>\$ (647)</b> | <b>\$ 2,572</b>                   | <b>\$ (741)</b> |

The Company recorded net realized investment gains of less than \$0.1 million in the third quarter of 2011, compared with a \$0.6 million net realized investment loss in the third quarter of 2010. During the third quarter of 2011, investment losses of \$0.1 million were recorded due to write-downs of investment securities that were considered other-than-temporarily impaired. These were offset by \$0.3 million in gains from the sale of investment securities and \$0.1 million in gains from investment securities called and other. In the above table, investment securities called and other includes, but is not limited to, principal paydowns and sinking funds.

Net realized investment gains for the first nine months totaled \$2.6 million in 2011, compared to a \$0.7 million net realized investment loss in 2010. Investment losses of \$0.5 million were due to write-downs of investment securities that were considered other-than-temporarily impaired during the nine months, including \$0.1 million from the third quarter, \$0.2 million from the second quarter and \$0.2 million from the first quarter of 2011. In addition, the Company had realized losses of \$1.7 million from sales of investment securities. These were offset by \$3.9 million in gains from the sale of investment securities and \$1.4 million in gains from investment securities called and other.

The Company's analysis of securities for the third quarter ended September 30, 2011 resulted in the determination that seven fixed-maturity securities had other-than-temporary impairments and were written down by a combined \$0.1 million due to credit impairments. All of the securities with other-than-temporary impairments in both the third quarter and nine months were residential mortgage-backed securities that had incremental losses, reflecting deterioration in the present value of expected future cash flows. The additional losses from these residential mortgage-backed securities totaled \$0.3 million in the first quarter, \$0.2 million in the second quarter and \$0.2 million in the third quarter of 2011. These impairment losses included \$0.1 million in both the first and second quarters of 2011 and less than \$0.1 million in the third quarter of

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2011 that were determined to be non-credit and recognized in other comprehensive income. The total fair value of the affected securities after the write-downs was \$52.1 million.

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The following tables summarize securities with other-than-temporary impairments recognized in earnings by business segment during the first three quarters and nine months of 2011 and 2010 by asset class:

|   | Quarter Ended<br>March 31<br>2011 | Quarter Ended<br>June 30<br>2011 | Quarter Ended<br>September 30<br>2011 | Nine<br>Months<br>Ended<br>September 30<br>2011 |
|---|-----------------------------------|----------------------------------|---------------------------------------|---|
| <b>Bonds:</b>   |                                   |                                  |                                       |   |
| Corporate private-labeled residential mortgage-backed securities: |                                   |                                  |                                       |   |
| Individual Insurance  | \$ 188                            | \$ 164                           | \$ 141                                | \$ 493  |
| Old American  | 23                                | 18                               | 9                                     | 50  |
| <b>Total</b>  | <b>\$ 211</b>                     | <b>\$ 182</b>                    | <b>\$ 150</b>                         | <b>\$ 543</b>                                   |
| <b>Segment detail:</b>  |                                   |                                  |                                       |   |
| Individual Insurance  | \$ 188                            | \$ 164                           | \$ 141                                | \$ 493  |
| Old American  | 23                                | 18                               | 9                                     | 50  |
| <b>Consolidated total</b>   | <b>\$ 211</b>                     | <b>\$ 182</b>                    | <b>\$ 150</b>                         | <b>\$ 543</b>                                   |

|   | Quarter<br>Ended<br>March 31<br>2010 | Quarter<br>Ended<br>June 30<br>2010 | Quarter<br>Ended<br>September 30<br>2010 | Nine Months<br>Ended<br>September 30<br>2010 |
|---|--------------------------------------|-------------------------------------|--|--|
| <b>Bonds:</b>   |                                      |                                     |  |  |
| Corporate private-labeled residential mortgage-backed securities: |                                      |                                     |  |  |
| Individual Insurance  | \$ 737                               | \$ 366                              | \$ 256                                   | \$ 1,359                                     |
| Old American  | 109                                  | 18                                  | 34                                       | 161  |
| <b>Other:</b>   |                                      |                                     |  |  |
| Individual Insurance  | 740                                  | 807                                 | 579                                      | 2,126  |
| Old American  | -                                    | 133                                 | 41                                       | 174  |
| <b>Total</b>  | <b>1,586</b>                         | <b>1,324</b>                        | <b>910</b>                               | <b>3,820</b>                                 |
| <b>Segment detail:</b>  |                                      |                                     |  |  |
| Individual Insurance  | 1,477                                | 1,173                               | 835                                      | 3,485  |
| Old American  | 109                                  | 151                                 | 75                                       | 335  |
| <b>Consolidated total</b>   | <b>\$ 1,586</b>                      | <b>\$ 1,324</b>                     | <b>\$ 910</b>                            | <b>\$ 3,820</b>                              |

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The following table provides detail regarding nine individual investment securities that were written down through earnings during the first nine months of 2011 by business segment, none of which exceeded \$0.5 million on a consolidated basis.

| Security             | Impairment Loss      |              |              | Description |
|----------------------|----------------------|--------------|--------------|-------------|
|                      | Individual Insurance | Old American | Consolidated |             |
| Other - 9 securities | \$ 493               | \$ 50        | \$ 543       |             |
| Total                | \$ 493               | \$ 50        | \$ 543       |             |

The following table provides detail regarding 12 individual investment securities that were written down through earnings during the first nine months of 2010 by business segment.

| Security   | Impairment Loss      |              |              | Description  |
|--|----------------------|--------------|--------------|--|
|  | Individual Insurance | Old American | Consolidated |  |
| Securitization of U.S. government guaranteed student loans | \$ 964               | \$ -         | \$ 964       | Liquidation of the security by the trustees, at the direction of a majority of bondholders.  |
| Mortgage-backed security                                   | 423                  | 159          | 582          | Decline in the subprime and non-conforming mortgage markets and the specific performance of the underlying collateral caused cash flow projections to be less than the amortized cost of the security. |
| Other - 10 securities                                      | 2,098                | 176          | 2,274        |  |
| Total  | \$ 3,485             | \$ 335       | \$ 3,820     |  |

**Investment Accounting Policy and Analysis of Investments**

The Company seeks to protect policyholders' benefits and achieve a desired level of organizational profitability by optimizing risk and return on an ongoing basis through managing asset and liability cash flows, monitoring credit risk, avoiding high levels of investments that may be redeemed by the issuer, maintaining sufficiently liquid investments and avoiding undue asset concentrations through diversification, among other things. The Company has three primary sources of investment risk:

Credit risk, relating to the uncertainty associated with the continued ability of a given obligor to make timely payments of principal and interest;

Interest rate risk, relating to the market price and/or cash flow associated with changes in market yields and curves; and

Liquidity risk, relating to the risk that investments cannot be converted into cash when needed or that the terms for conversion have a negative effect on the Company.

The Company's ability to manage these risks is essential to the success of the organization. In particular, the Company devotes considerable resources to both the credit analysis of each new investment and to ongoing credit positions. The majority of the Company's investments are exposed to varying degrees of credit risk. Credit risk is the risk that the value of the investment may decline due to deterioration in the financial strength of the issuer and that the timely or ultimate payment of principal or interest might not occur. A default by an issuer usually involves some loss of principal to the investor. Losses can be mitigated by timely sales of affected securities or by active involvement in a restructuring process. However, there can be no assurance that the efforts of an investor will lead to favorable outcomes in a bankruptcy or restructuring. Credit risk is managed primarily through industry, issuer, and structure diversification.



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The following table provides information regarding fixed maturity and equity securities by asset class as of September 30, 2011.

|   | Total<br>Fair<br>Value | %<br>of Total | Fair Value<br>of Securities<br>with Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Gains | Fair Value<br>of Securities<br>with Gross<br>Unrealized<br>Losses | Gross<br>Unrealized<br>Losses |
|---|------------------------|---------------|--|------------------------------|---|-------------------------------|
| U.S. Treasury securities and obligations of U.S. Government               | \$ 132,794             | 5%            | \$ 130,225   | \$ 13,443                    | \$ 2,569  | \$ 26                         |
| Federal agencies <sup>1</sup>   | 27,307                 | 1%            | 27,307   | 3,524                        | -   | -                             |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | 124,717                | 5%            | 123,718  | 10,296                       | 999   | 3                             |
| Subtotal  | 284,818                | 11%           | 281,250  | 27,263                       | 3,568   | 29                            |
| Corporate obligations:  |                        |               |  |                              |   |                               |
| Industrial  | 463,700                | 17%           | 436,942  | 44,453                       | 26,758  | 858                           |
| Energy  | 167,623                | 6%            | 156,762  | 18,698                       | 10,861  | 141                           |
| Communications and technology   | 199,659                | 7%            | 194,007  | 16,369                       | 5,652   | 104                           |
| Financial   | 317,832                | 12%           | 257,322  | 16,588                       | 60,510  | 4,561                         |
| Consumer  | 471,377                | 18%           | 456,759  | 43,803                       | 14,618  | 511                           |
| Public utilities  | 309,232                | 12%           | 292,556  | 38,448                       | 16,676  | 2,183                         |
| Subtotal  | 1,929,423              | 72%           | 1,794,348  | 178,359                      | 135,075   | 8,358                         |
| Corporate private-labeled residential mortgage-backed securities          | 172,750                | 6%            | 71,882   | 2,151                        | 100,868   | 9,616                         |
| Municipal securities  | 169,442                | 6%            | 162,463  | 19,045                       | 6,979   | 106                           |
| Other   | 96,603                 | 4%            | 41,762   | 3,682                        | 54,841  | 9,380                         |
| Redeemable preferred stocks   | 11,153                 | -             | 5,162  | 162                          | 5,991   | 744                           |
| Fixed maturity securities   | 2,664,189              | 99%           | 2,356,867  | 230,662                      | 307,322   | 28,233                        |
| Equity securities   | 36,900                 | 1%            | 35,773   | 1,756                        | 1,127   | 131                           |
| Total   | \$ 2,701,089           | 100%          | \$ 2,392,640   | \$ 232,418                   | \$ 308,449  | \$ 28,364                     |

<sup>1</sup> Federal agency securities are not backed by the full faith and credit of the U.S. Government.

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The following table provides information regarding fixed maturity and equity securities by asset class as of December 31, 2010.

|   | Total<br>Fair<br>Value | %<br>of Total | Fair Value<br>of Securities<br>with Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Gains | Fair Value<br>of Securities<br>with Gross<br>Unrealized<br>Losses | Gross<br>Unrealized<br>Losses |
|---|------------------------|---------------|--|------------------------------|---|-------------------------------|
| U.S. Treasury securities and obligations of U.S. Government               | \$ 135,142             | 5%            | \$ 125,273   | \$ 7,180                     | \$ 9,869  | \$ 318                        |
| Federal agencies <sup>1</sup>   | 26,095                 | 1%            | 26,095   | 1,951                        | -   | -                             |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | 138,056                | 5%            | 137,759  | 9,740                        | 297   | 2                             |
| Subtotal  | 299,293                | 11%           | 289,127  | 18,871                       | 10,166  | 320                           |
| Corporate obligations:  |                        |               |  |                              |   |                               |
| Industrial  | 432,518                | 16%           | 352,700  | 26,255                       | 79,818  | 2,930                         |
| Energy  | 178,511                | 7%            | 170,663  | 15,498                       | 7,848   | 224                           |
| Communications and technology   | 172,946                | 6%            | 134,184  | 9,243                        | 38,762  | 796                           |
| Financial   | 350,659                | 13%           | 261,745  | 14,161                       | 88,914  | 5,022                         |
| Consumer  | 430,504                | 16%           | 347,883  | 28,725                       | 82,621  | 2,373                         |
| Public utilities  | 324,800                | 12%           | 296,241  | 27,640                       | 28,559  | 1,466                         |
| Subtotal  | 1,889,938              | 70%           | 1,563,416  | 121,522                      | 326,522   | 12,811                        |
| Corporate private-labeled residential mortgage-backed securities          | 195,055                | 7%            | 98,474   | 2,352                        | 96,581  | 16,826                        |
| Municipal securities  | 151,831                | 6%            | 62,887   | 1,319                        | 88,944  | 3,301                         |
| Other   | 98,002                 | 4%            | 38,135   | 5,194                        | 59,867  | 7,739                         |
| Redeemable preferred stocks   | 14,769                 | 1%            | 9,818  | 342                          | 4,951   | 440                           |
| Fixed maturity securities   | 2,648,888              | 99%           | 2,061,857  | 149,600                      | 587,031   | 41,437                        |
| Equity securities   | 38,321                 | 1%            | 36,287   | 2,165                        | 2,034   | 137                           |
| Total   | \$ 2,687,209           | 100%          | \$ 2,098,144   | \$ 151,765                   | \$ 589,065  | \$ 41,574                     |

<sup>1</sup> Federal agency securities are not backed by the full faith and credit of the U.S. Government.

As of December 31, 2010, the Company had \$41.6 million in gross unrealized losses on investment securities which were offset by \$151.8 million in gross unrealized gains. As of September 30, 2011, the Company's unrealized losses on investment securities had decreased to \$28.4 million and were offset by \$232.4 million in gross unrealized gains. As of September 30, 2011, 29% of the gross unrealized losses were in the category of corporate obligations. The financial sector was the single largest contributor to this category, reflecting the direct and indirect impact of the troubled residential real estate and mortgage markets. In addition, 34% of the gross unrealized losses were in the category of corporate private-labeled residential mortgage-backed securities, also due to the troubled residential real estate and mortgage markets. As of September 30, 2011, 89% of the total fair value of the fixed maturities portfolio had unrealized gains, up from 78% at December 31, 2010.

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The following table identifies fixed maturity securities available for sale by rating.

| Equivalent S&P Rating               | September 30, 2011  |             | December 31, 2010   |             |
|-------------------------------------|---------------------|-------------|---------------------|-------------|
|                                     | Fair Value          | % of Total  | Fair Value          | % of Total  |
| AAA                                 | \$ 183,738          | 7%          | \$ 511,854          | 19%         |
| AA                                  | 596,806             | 22%         | 278,850             | 11%         |
| A                                   | 787,151             | 30%         | 780,919             | 30%         |
| BBB                                 | 901,243             | 34%         | 905,540             | 34%         |
| <b>Total investment grade</b>       | <b>2,468,938</b>    | <b>93%</b>  | <b>2,477,163</b>    | <b>94%</b>  |
| BB                                  | 65,573              | 2%          | 56,973              | 2%          |
| B and below                         | 129,678             | 5%          | 114,752             | 4%          |
| <b>Total below investment grade</b> | <b>195,251</b>      | <b>7%</b>   | <b>171,725</b>      | <b>6%</b>   |
|                                     | <b>\$ 2,664,189</b> | <b>100%</b> | <b>\$ 2,648,888</b> | <b>100%</b> |

As of September 30, 2011, 93% of all fixed maturity securities were investment grade. This is a decline from 94% at December 31, 2010.

**Analysis of Unrealized Losses on Securities**

The Company reviews all security investments, and particular attention is given to those having unrealized losses. Further, the Company specifically assesses all investments with greater than 10% declines in fair value below amortized cost and, in general, monitors all security investments as to ongoing risk. These risks are fundamentally evaluated through both a qualitative and quantitative analysis of the issuer. The Company also prepares a formal review document no less often than quarterly of all investments where fair value is less than 80% of amortized cost for six months or more, as well as selected investments that have experienced significant changes in fair value from a previous period and that have a decline in fair value greater than 10% of amortized cost.

The Company has a policy and process in place to identify securities that could potentially have an impairment that is other-than-temporary. This process involves monitoring market events and other items that could impact issuers such as:

- Intent and ability to make all principal and interest payments when due;
- Near-term business prospects;
- Cash flow and liquidity;
- Credit ratings;
- Business climate;
- Management changes;
- Litigation and government actions; and
- Other similar factors.

This process also involves monitoring several factors including late payments, downgrades by rating agencies, asset quality, key financial ratios, financial statements, revenue forecasts and cash flow projections as indicators of credit issues.

All securities are reviewed to determine whether other-than-temporary impairments should be recorded. This process includes an assessment of the credit quality of each investment in the entire securities portfolio. Additional reporting and review procedures are conducted for those securities where fair value is less than 90% of amortized cost. Further, detailed analysis is performed for each issue or issues having experienced a formal restructuring or where the security has experienced material deterioration in fair value or where the fair value is less than 80% of amortized cost for six months or more.

The Company considers relevant facts and circumstances in evaluating whether the impairment of a security is other-than-temporary. Relevant facts and circumstances considered include but are not limited to:



The current fair value of the security as compared to cost;

The credit rating of the security;

The extent and the length of time the fair value has been below amortized cost;

The financial position of the issuer, including the current and future impact of any specific events, material declines in the issuer's revenues, margins, cash positions, liquidity issues, asset quality, debt levels and income results;

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Significant management or organizational changes;  
Significant uncertainty regarding the issuer's industry;  
Violation of financial covenants;  
Consideration of information or evidence that supports timely recovery;  
The Company's intent and ability to hold an equity security until it recovers in value;  
Whether the Company intends to sell a debt security and whether it is more likely than not that the Company will be required to sell a debt security before recovery of the amortized cost basis; and  
Other business factors related to the issuer's industry.

To the extent the Company determines that a fixed maturity security is deemed to be other-than-temporarily impaired, the portion of the impairment that is deemed to be due to credit is charged to the Consolidated Statements of Income and the cost basis of the underlying investment is reduced. The portion of such impairment that is determined to be non-credit-related is deducted from net realized loss in the Consolidated Statements of Income and reflected in other comprehensive income and accumulated other comprehensive income, which is a component of stockholders' equity in the Consolidated Balance Sheets.

There are a number of significant risks and uncertainties inherent in the process of monitoring impairments, determining if an impairment is other-than-temporary and determining the portion of an other-than-temporary impairment that is due to credit. These risks and uncertainties include but are not limited to:

The risk that the Company's assessment of an issuer's ability to meet all of its contractual obligations will change based on changes in the credit characteristics of that issuer;  
The risk that the economic outlook will be worse than expected or have more of an impact on the issuer than anticipated;  
The risk that the performance of the underlying collateral for securities could deteriorate in the future and the Company's credit enhancement levels and recovery values do not provide sufficient protection to the Company's contractual principal and interest;  
The risk that fraudulent, inaccurate or misleading information could be provided to the Company's credit, investment and accounting professionals who determine the fair value estimates and accounting treatment for securities;  
The risk that actions of trustees, custodians or other parties with interests in the security may have an unforeseen adverse impact on the Company's investments;  
The risk that new information obtained by the Company or changes in other facts and circumstances may lead the Company to change its intent to sell the security before it recovers in value;  
The risk that the facts and circumstances change such that it becomes more likely than not that the Company will be required to sell the investment before recovery of the amortized cost basis; and  
The risk that the methodology or assumptions used to develop estimates of the portion of impairments due to credit prove, over time, to be inaccurate or insufficient.

Any of these situations could result in a charge to income in a future period.

The Company may selectively determine that it no longer intends to hold a specific issue to its maturity. If the Company makes this determination and the fair value is less than the cost basis, the investment is written down to the fair value and an other-than-temporary impairment is recorded on this particular position. Subsequently, the Company seeks to obtain the best possible outcome available for this specific issue and records an investment gain or loss at the disposal date.

The Company has less than 5% of its investments in municipal bond securities. The Company's investments in municipal bonds present unique considerations in evaluating other-than-temporary impairments. Judgments regarding whether a municipal debt security is other-than-temporarily impaired include analyzing a number of rather unique characteristics pertaining to the issuer. Municipalities possess unique powers, along with special legal standing and protections. These powers include the sovereign power to tax, access to one-time revenue sources, capacity to issue or restructure debt and the ability to shift spending to other authorities. In addition, state governments often provide secondary support to local governments in times of financial stress and the federal government has also provided assistance to state governments.

The evaluation of loan-backed and similar asset-backed securities, particularly including residential mortgage-backed securities, with significant indications of potential other-than-temporary impairment requires considerable use of estimates and judgment. Specifically, the Company performs discounted cash flow projections on these securities to evaluate whether the value of the investment is expected to be fully realized. Projections of expected future cash flows are based upon



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considerations of the performance of the actual underlying assets, including historical delinquencies, defaults, severity of losses incurred, and prepayments, along with the Company's estimates of future results for these factors. The Company's estimates of future results are based upon actual historical performance of the underlying assets relative to historical, current and expected general economic conditions, specific conditions related to the underlying assets, industry data, and other factors that are believed to be relevant. If the present value of the projected expected future cash flows is determined to be below the Company's carrying value, the Company recognizes an other-than-temporary impairment on the portion of the carrying value that exceeds the projected expected future cash flows. To the extent that the loan-backed or other asset-backed securities remain high quality investments and do not otherwise demonstrate characteristics of impairment, the Company performs other initial evaluations to determine whether other-than-temporary cash flow evaluations need to be performed.

The discounted future cash flow calculation typically becomes the primary determinant of whether any portion and to what extent an unrealized loss is due to credit on loan-backed and similar asset-backed securities with significant indications of potential other-than-temporary impairment. Such indications typically include below investment grade ratings and significant unrealized losses for an extended period of time, among other factors. The Company identified 16 and 12 non-U.S. Agency mortgage-backed securities that had such indications as of September 30, 2011 and December 31, 2010, respectively. Discounted future cash flow analysis was performed for each of these securities to determine if any portion of the impairment was due to credit and deemed to be other-than-temporary. The discount rate used in calculating the present value of future cash flows was the investment yield at the time of purchase for each security. The initial default rates were assumed to remain constant over a 24-month time frame and grade down thereafter, reflecting the general perspective of a more stabilized residential housing environment in the future.

The following tables present the range of significant assumptions used in projecting the future cash flows as of September 30, 2011 and December 31, 2010, respectively. The Company believes that the assumptions below are reasonable because they are based upon the actual results of the underlying security collateral.

| Vintage | September 30, 2011   |       |                       |      |                  |       |
|---------|----------------------|-------|-----------------------|------|------------------|-------|
|         | Initial Default Rate |       | Initial Severity Rate |      | Prepayment Speed |       |
|         | Low                  | High  | Low                   | High | Low              | High  |
| 2003    | 2.8%                 | 2.8%  | 40%                   | 40%  | 18.0%            | 18.0% |
| 2004    | 4.3%                 | 7.7%  | 40%                   | 57%  | 10.0%            | 12.0% |
| 2005    | 4.0%                 | 13.8% | 43%                   | 65%  | 6.0%             | 12.0% |
| 2006    | 3.9%                 | 12.0% | 57%                   | 90%  | 8.0%             | 14.0% |
| 2007    | 8.4%                 | 8.4%  | 66%                   | 66%  | 8.0%             | 8.0%  |

| Vintage | December 31, 2010    |       |                       |      |                  |       |
|---------|----------------------|-------|-----------------------|------|------------------|-------|
|         | Initial Default Rate |       | Initial Severity Rate |      | Prepayment Speed |       |
|         | Low                  | High  | Low                   | High | Low              | High  |
| 2004    | 4.6%                 | 4.6%  | 45%                   | 45%  | 10.0%            | 10.0% |
| 2005    | 4.9%                 | 12.3% | 46%                   | 69%  | 6.0%             | 11.0% |
| 2006    | 18.0%                | 18.0% | 84%                   | 84%  | 8.0%             | 8.0%  |
| 2007    | 8.7%                 | 8.7%  | 60%                   | 60%  | 8.0%             | 8.0%  |

For loan-backed and similar asset-backed securities, the determination of any amount of impairment that is due to credit is based upon the present value of projected future cash flows being less than the amortized cost of the security. This amount is recognized as a realized loss in the Company's Consolidated Statements of Income and the carrying value of the security is written down by the same amount. The portion of an impairment that is determined not to be due to credit is recorded as a component of accumulated other comprehensive income in the Consolidated Balance Sheets.

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Following is a summary of the results of the analysis of present values of projected cash flows for non-U.S. Agency mortgage-backed securities as part of the analysis of potential other-than-temporary-impairment (OTTI) of securities as of September 30, 2011 and December 31, 2010. Also presented is the cumulative non-credit impairment recorded in accumulated other comprehensive income (AOCI) in the Consolidated Balance Sheets.

|                  | Amortized Cost as<br>of September 30, 2011<br>After OTTI | OTTI<br>Recognized<br>During<br>2011 | Cumulative<br>OTTI<br>Recognized | Cumulative<br>Non-Credit<br>Impairment<br>Recorded in<br>AOCI as of<br>September 30, 2011 |
|------------------|--|--------------------------------------|----------------------------------|---|
| Written down     | \$ 84,089  | \$ 543                               | \$ 17,476                        | \$ 13,607   |
| Not written down | \$ 119,692   | \$ -                                 | \$ -                             | \$ (1,636)  |

|                  | Amortized Cost<br>as<br>of December<br>31, 2010<br>After OTTI | OTTI<br>Recognized<br>During 2010 | Cumulative<br>OTTI<br>Recognized | Cumulative<br>Non-Credit<br>Impairment<br>Recorded in<br>AOCI as of<br>December 31,<br>2010 |
|------------------|---|-----------------------------------|----------------------------------|---|
| Written down     | \$ 68,274   | \$ 1,936                          | \$ 16,802                        | \$ 13,476   |
| Not written down | \$ 167,044  | \$ -                              | \$ -                             | \$ 6,046  |

Significant unrealized losses on securities can continue for extended periods of time, particularly for certain individual securities. While this can be an indication of potential credit impairments, it can also be an indication of illiquidity in a particular sector or security. In addition, the fair value of an individual security can be heavily influenced by the complexities of varying market sentiment or uncertainty regarding the prospects for an individual security. This has been the situation in the non-U.S. Agency mortgage-backed securities market in recent periods. Based upon the process described above, the Company is best able to determine if and to what extent credit impairment may exist in these securities by performing present value calculations of projected future cash flows at the conclusion of each reporting period. By reviewing the most recent data available regarding the security and other relevant industry and market factors, the Company can modify assumptions used in the cash flow projections and determine the best estimate of the portion of any impairment that is due to credit at the conclusion of each period.

The Company closely monitors its investments in securities classified as subprime. Subprime securities include all bonds or portions of bonds where the underlying collateral is made up of home equity loans or first mortgage loans to borrowers whose credit scores at the time of origination were lower than the level recognized in the market as prime. The Company's classification of subprime does not include Alt-A or jumbo loans, unless the collateral otherwise meets the preceding definition. As of September 30, 2011, the fair value of investments with subprime residential mortgage exposure was \$18.1 million with a related \$4.1 million unrealized loss. As of December 31, 2010, the Company had investments with subprime residential mortgage exposure of \$19.6 million and a related \$4.9 million unrealized loss. This exposure amounted to less than 1% of the Company's invested assets as of both September 30, 2011 and December 31, 2010. These investments are included in the Company's process for evaluation of other-than-temporarily impaired securities.

The Company has a significant level of non-U.S. Agency structured securities. Structured securities include asset-backed, residential mortgage-backed securities, along with collateralized debt obligations, collateralized mortgage obligations and other collateralized obligations. The Company monitors these securities through a combination of an analysis of vintage, credit ratings and other means.

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Identified below are tables that divide these investment types among vintage and credit ratings as of September 30, 2011.

|   | Fair Value | Amortized Cost | Unrealized Gains (Losses) |
|---|------------|----------------|---------------------------|
| <b><u>Residential &amp; Non-agency MBS</u></b> <sup>1</sup> |            |                |                           |
| Investment Grade:   |            |                |                           |
| Vintage 2003 and earlier                                    | \$ 37,453  | \$ 36,459      | \$ 994                    |
| 2004  | 30,401     | 29,461         | 940                       |
| 2005  | -          | -              | -                         |
| 2006  | -          | -              | -                         |
| 2007  | -          | -              | -                         |
| Total investment grade                                      | 67,854     | 65,920         | 1,934                     |
| Below Investment Grade:                                     |            |                |                           |
| Vintage 2003 and earlier                                    | -          | -              | -                         |
| 2004  | 35,926     | 36,149         | (223)                     |
| 2005  | 76,822     | 89,026         | (12,204)                  |
| 2006  | 7,015      | 7,462          | (447)                     |
| 2007  | 4,192      | 5,223          | (1,031)                   |
| Total below investment grade                                | 123,955    | 137,860        | (13,905)                  |
| <b><u>Other Structured Securities:</u></b>                  |            |                |                           |
| Investment grade  | 60,031     | 58,762         | 1,269                     |
| Below investment grade                                      | 16,360     | 18,579         | (2,219)                   |
| Total other   | 76,391     | 77,341         | (950)                     |
| Total structured securities                                 | \$ 268,200 | \$ 281,121     | \$ (12,921)               |

<sup>1</sup> This chart accounts for all vintages owned by the Company.

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Identified below are tables that divide these investment types among vintage and credit ratings as of December 31, 2010.

|  | Fair Value | Amortized Cost | Unrealized Gains (Losses) |
|--|------------|----------------|---------------------------|
| <b>Residential &amp; Non-agency MBS <sup>1</sup></b> |            |                |                           |
| Investment Grade:                                    |            |                |                           |
| Vintage 2003 and earlier                             | \$ 57,811  | \$ 55,929      | \$ 1,882                  |
| 2004   | 72,031     | 74,725         | (2,694)                   |
| 2005   | 4,107      | 4,559          | (452)                     |
| 2006   | -          | -              | -                         |
| 2007   | -          | -              | -                         |
| Total investment grade                               | 133,949    | 135,213        | (1,264)                   |
| Below Investment Grade:                              |            |                |                           |
| Vintage 2003 and earlier                             | -          | -              | -                         |
| 2004   | -          | -              | -                         |
| 2005   | 70,721     | 86,382         | (15,661)                  |
| 2006   | 6,314      | 8,079          | (1,765)                   |
| 2007   | 4,812      | 5,644          | (832)                     |
| Total below investment grade                         | 81,847     | 100,105        | (18,258)                  |
| Other Structured Securities:                         |            |                |                           |
| Investment grade                                     | 55,189     | 53,347         | 1,842                     |
| Below investment grade                               | 20,143     | 19,229         | 914                       |
| Total other  | 75,332     | 72,576         | 2,756                     |
| Total structured securities                          | \$ 291,128 | \$ 307,894     | \$ (16,766)               |

<sup>1</sup> This chart accounts for all vintages owned by the Company.

Total unrealized losses on non-U.S. Agency structured securities totaled \$12.9 million as of September 30, 2011, compared to \$16.8 million as of December 31, 2010. Total unrealized losses on these securities as a percent of total amortized cost totaled 5% as of September 30, 2011 and year-end 2010.

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The following table provides information regarding fixed maturity and equity security investments available for sale with unrealized losses by length of time, as of September 30, 2011.

|   | Less Than 12 Months |                   | 12 Months or Longer |                   | Total      |                   |
|---|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury securities and obligations of U.S. Government               | \$ 542              | \$ 1              | \$ 2,027            | \$ 25             | \$ 2,569   | \$ 26             |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | 704                 | 1                 | 295                 | 2                 | 999        | 3                 |
| Subtotal  | 1,246               | 2                 | 2,322               | 27                | 3,568      | 29                |
| Corporate obligations:  |                     |                   |                     |                   |            |                   |
| Industrial  | 26,758              | 858               | -                   | -                 | 26,758     | 858               |
| Energy  | 10,861              | 141               | -                   | -                 | 10,861     | 141               |
| Communications and technology   | 5,652               | 104               | -                   | -                 | 5,652      | 104               |
| Financial   | 42,971              | 1,904             | 17,539              | 2,657             | 60,510     | 4,561             |
| Consumer  | 10,896              | 353               | 3,722               | 158               | 14,618     | 511               |
| Public utilities  | 9,233               | 884               | 7,443               | 1,299             | 16,676     | 2,183             |
| Total corporate obligations   | 106,371             | 4,244             | 28,704              | 4,114             | 135,075    | 8,358             |
| Corporate private-labeled residential mortgage-backed securities          | 22,072              | 155               | 78,796              | 9,461             | 100,868    | 9,616             |
| Municipal securities  | 3,101               | 10                | 3,878               | 96                | 6,979      | 106               |
| Other   | 5,227               | 13                | 49,614              | 9,367             | 54,841     | 9,380             |
| Redeemable preferred stocks   | 2,920               | 134               | 3,071               | 610               | 5,991      | 744               |
| Fixed maturity securities   | 140,937             | 4,558             | 166,385             | 23,675            | 307,322    | 28,233            |
| Equity securities   | 87                  | 86                | 1,040               | 45                | 1,127      | 131               |
| Total   | \$ 141,024          | \$ 4,644          | \$ 167,425          | \$ 23,720         | \$ 308,449 | \$ 28,364         |

<sup>1</sup> Federal agency securities are not backed by the full faith and credit of the U.S. Government.



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The following table provides information regarding fixed maturity and equity security investments available for sale with unrealized losses by length of time, as of December 31, 2010.

|   | Less Than 12 Months |                   | 12 Months or Longer |                   | Total      |                   |
|---|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury securities and obligations of U.S. Government               | \$ 7,663            | \$ 286            | \$ 2,206            | \$ 32             | \$ 9,869   | \$ 318            |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | 16                  | 1                 | 281                 | 1                 | 297        | 2                 |
| Subtotal  | 7,679               | 287               | 2,487               | 33                | 10,166     | 320               |
| Corporate obligations:  |                     |                   |                     |                   |            |                   |
| Industrial  | 76,795              | 2,825             | 3,023               | 105               | 79,818     | 2,930             |
| Energy  | 7,848               | 224               | -                   | -                 | 7,848      | 224               |
| Communications and technology   | 38,762              | 796               | -                   | -                 | 38,762     | 796               |
| Financial   | 50,744              | 900               | 38,170              | 4,122             | 88,914     | 5,022             |
| Consumer  | 67,690              | 1,444             | 14,931              | 929               | 82,621     | 2,373             |
| Public utilities  | 24,165              | 1,204             | 4,394               | 262               | 28,559     | 1,466             |
| Total corporate obligations   | 266,004             | 7,393             | 60,518              | 5,418             | 326,522    | 12,811            |
| Corporate private-labeled residential mortgage-backed securities          | -                   | -                 | 96,581              | 16,826            | 96,581     | 16,826            |
| Municipal securities  | 81,799              | 2,537             | 7,145               | 764               | 88,944     | 3,301             |
| Other   | 5,379               | 182               | 54,488              | 7,557             | 59,867     | 7,739             |
| Redeemable preferred stocks   | 618                 | 8                 | 4,333               | 432               | 4,951      | 440               |
| Fixed maturity securities   | 361,479             | 10,407            | 225,552             | 31,030            | 587,031    | 41,437            |
| Equity securities   | -                   | -                 | 2,034               | 137               | 2,034      | 137               |
| Total   | \$ 361,479          | \$ 10,407         | \$ 227,586          | \$ 31,167         | \$ 589,065 | \$ 41,574         |

<sup>1</sup> Federal agency securities are not backed by the full faith and credit of the U.S. Government.

Gross unrealized losses on fixed maturity and equity security investments attributable to securities having gross unrealized losses of 12 months or longer was \$23.7 million as of September 30, 2011, a decrease from \$31.2 million as of December 31, 2010. The largest component of this decrease was from the corporate private-labeled residential mortgage-backed securities category, which decreased \$7.4 million during the first nine months of 2011.

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The following tables summarize the Company's investments in securities available for sale with unrealized losses as of September 30, 2011 and December 31, 2010.

|   | September 30, 2011 |                |                               |
|---|--------------------|----------------|-------------------------------|
|   | Amortized<br>Cost  | Fair<br>Value  | Gross<br>Unrealized<br>Losses |
| <b>Securities owned without realized impairment:</b>  |                    |                |                               |
| Unrealized losses of 10% or less                      | \$ 183,798         | \$ 178,458     | \$ 5,340                      |
| Unrealized losses of 20% or less and greater than 10% | 53,996             | 46,667         | 7,329                         |
| <b>Subtotal</b>                                       | <b>237,794</b>     | <b>225,125</b> | <b>12,669</b>                 |
| <b>Unrealized losses greater than 20%:</b>            |                    |                |                               |
| <b>Investment grade</b>                               |                    |                |                               |
| Less than twelve months                               | -                  | -              | -                             |
| Twelve months or greater                              | 908                | 530            | 378                           |
| <b>Total investment grade</b>                         | <b>908</b>         | <b>530</b>     | <b>378</b>                    |
| <b>Below investment grade</b>                         |                    |                |                               |
| Less than twelve months                               | 7,012              | 5,003          | 2,009                         |
| Twelve months or greater                              | -                  | -              | -                             |
| <b>Total below investment grade</b>                   | <b>7,012</b>       | <b>5,003</b>   | <b>2,009</b>                  |
| <b>Unrealized losses greater than 20%</b>             | <b>7,920</b>       | <b>5,533</b>   | <b>2,387</b>                  |
| <b>Subtotal</b>                                       | <b>245,714</b>     | <b>230,658</b> | <b>15,056</b>                 |
| <b>Securities owned with realized impairment:</b>     |                    |                |                               |
| Unrealized losses of 10% or less                      | 23,820             | 22,204         | 1,616                         |
| Unrealized losses of 20% or less and greater than 10% | 42,789             | 37,039         | 5,750                         |
| <b>Subtotal</b>                                       | <b>66,609</b>      | <b>59,243</b>  | <b>7,366</b>                  |
| <b>Unrealized losses greater than 20%:</b>            |                    |                |                               |
| <b>Investment grade</b>                               |                    |                |                               |
| Less than twelve months                               | -                  | -              | -                             |
| Twelve months or greater                              | -                  | -              | -                             |
| <b>Total investment grade</b>                         | <b>-</b>           | <b>-</b>       | <b>-</b>                      |
| <b>Below investment grade</b>                         |                    |                |                               |
| Less than twelve months                               | 13,443             | 9,970          | 3,473                         |
| Twelve months or greater                              | 11,047             | 8,578          | 2,469                         |
| <b>Total below investment grade</b>                   | <b>24,490</b>      | <b>18,548</b>  | <b>5,942</b>                  |
| <b>Unrealized losses greater than 20%</b>             | <b>24,490</b>      | <b>18,548</b>  | <b>5,942</b>                  |

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|          |            |            |           |
|----------|------------|------------|-----------|
| Subtotal | 91,099     | 77,791     | 13,308    |
| Total    | \$ 336,813 | \$ 308,449 | \$ 28,364 |

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|   | December 31, 2010 |                   |                               |
|---|-------------------|-------------------|-------------------------------|
|   | Amortized<br>Cost | Fair<br>Value     | Gross<br>Unrealized<br>Losses |
| <b>Securities owned without realized impairment:</b>  |                   |                   |                               |
| Unrealized losses of 10% or less                      | \$ 480,498        | \$ 465,414        | \$ 15,084                     |
| Unrealized losses of 20% or less and greater than 10% | 71,101            | 61,718            | 9,383                         |
| <b>Subtotal</b>                                       | <b>551,599</b>    | <b>527,132</b>    | <b>24,467</b>                 |
| <b>Unrealized losses greater than 20%:</b>            |                   |                   |                               |
| <b>Investment grade</b>                               |                   |                   |                               |
| Less than twelve months                               | -                 | -                 | -                             |
| Twelve months or greater                              | 5,908             | 4,458             | 1,450                         |
| <b>Total investment grade</b>                         | <b>5,908</b>      | <b>4,458</b>      | <b>1,450</b>                  |
| <b>Below investment grade</b>                         |                   |                   |                               |
| Less than twelve months                               | -                 | -                 | -                             |
| Twelve months or greater                              | -                 | -                 | -                             |
| <b>Total below investment grade</b>                   | <b>-</b>          | <b>-</b>          | <b>-</b>                      |
| <b>Unrealized losses greater than 20%</b>             | <b>5,908</b>      | <b>4,458</b>      | <b>1,450</b>                  |
| <b>Subtotal</b>                                       | <b>557,507</b>    | <b>531,590</b>    | <b>25,917</b>                 |
| <b>Securities owned with realized impairment:</b>     |                   |                   |                               |
| Unrealized losses of 10% or less                      | 5,642             | 5,217             | 425                           |
| Unrealized losses of 20% or less and greater than 10% | 16,073            | 14,009            | 2,064                         |
| <b>Subtotal</b>                                       | <b>21,715</b>     | <b>19,226</b>     | <b>2,489</b>                  |
| <b>Unrealized losses greater than 20%:</b>            |                   |                   |                               |
| <b>Investment grade</b>                               |                   |                   |                               |
| Less than twelve months                               | -                 | -                 | -                             |
| Twelve months or greater                              | -                 | -                 | -                             |
| <b>Total investment grade</b>                         | <b>-</b>          | <b>-</b>          | <b>-</b>                      |
| <b>Below investment grade</b>                         |                   |                   |                               |
| Less than twelve months                               | 13,366            | 10,629            | 2,737                         |
| Twelve months or greater                              | 38,051            | 27,620            | 10,431                        |
| <b>Total below investment grade</b>                   | <b>51,417</b>     | <b>38,249</b>     | <b>13,168</b>                 |
| <b>Unrealized losses greater than 20%</b>             | <b>51,417</b>     | <b>38,249</b>     | <b>13,168</b>                 |
| <b>Subtotal</b>                                       | <b>73,132</b>     | <b>57,475</b>     | <b>15,657</b>                 |
| <b>Total</b>  | <b>\$ 630,639</b> | <b>\$ 589,065</b> | <b>\$ 41,574</b>              |



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The following table provides information on fixed maturity securities with gross unrealized losses by rating as of September 30, 2011.

| Equivalent S&P Rating               | Fair Value        | % of Total  | Gross Unrealized Losses | % of Total  |
|-------------------------------------|-------------------|-------------|-------------------------|-------------|
| AAA                                 | \$ 33,864         | 11%         | \$ 4,283                | 16%         |
| AA                                  | 18,501            | 6%          | 1,454                   | 5%          |
| A                                   | 45,233            | 15%         | 2,210                   | 8%          |
| BBB                                 | 50,404            | 16%         | 2,083                   | 7%          |
| <b>Total investment grade</b>       | <b>148,002</b>    | <b>48%</b>  | <b>10,030</b>           | <b>36%</b>  |
| BB                                  | 41,811            | 14%         | 2,639                   | 9%          |
| B and below                         | 117,509           | 38%         | 15,564                  | 55%         |
| <b>Total below investment grade</b> | <b>159,320</b>    | <b>52%</b>  | <b>18,203</b>           | <b>64%</b>  |
|                                     | <b>\$ 307,322</b> | <b>100%</b> | <b>\$ 28,233</b>        | <b>100%</b> |

The following table provides information on fixed maturity securities with gross unrealized losses by rating as of December 31, 2010.

| Equivalent S&P Rating               | Fair Value        | % of Total  | Gross Unrealized Losses | % of Total  |
|-------------------------------------|-------------------|-------------|-------------------------|-------------|
| AAA                                 | \$ 101,883        | 17%         | \$ 5,105                | 12%         |
| AA                                  | 99,017            | 17%         | 4,260                   | 10%         |
| A                                   | 113,304           | 19%         | 4,486                   | 11%         |
| BBB                                 | 156,809           | 27%         | 6,881                   | 17%         |
| <b>Total investment grade</b>       | <b>471,013</b>    | <b>80%</b>  | <b>20,732</b>           | <b>50%</b>  |
| BB                                  | 16,456            | 3%          | 1,399                   | 3%          |
| B and below                         | 99,562            | 17%         | 19,306                  | 47%         |
| <b>Total below investment grade</b> | <b>116,018</b>    | <b>20%</b>  | <b>20,705</b>           | <b>50%</b>  |
|                                     | <b>\$ 587,031</b> | <b>100%</b> | <b>\$ 41,437</b>        | <b>100%</b> |

As of September 30, 2011, 48% of the fair value of fixed maturity securities with gross unrealized losses was investment grade compared to 80% at December 31, 2010. In addition, 36% of gross unrealized losses on fixed maturity securities with unrealized losses were from investment grade securities as of September 30, 2011, compared to 50% as of December 31, 2010. Unrealized losses have been decreasing throughout 2011, primarily due to falling yields across the entire yield curve. Of the investment grade fixed maturity securities that were in an unrealized loss position at December 31, 2010, only 23% remained in an unrealized loss position as of September 30, 2011. Of the below investment grade fixed maturity securities that were in an unrealized loss position as of December 31, 2010, 85% remained in an unrealized loss position as of September 30, 2011. The count of below investment grade securities increased from 29 issues at December 31, 2010 to 34 issues at September 30, 2011.

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The following table provides the distribution of maturities for fixed maturity securities available for sale with unrealized losses as of September 30, 2011. Expected maturities may differ from these contractual maturities since borrowers may have the right to call or prepay obligations.

|  | Fair<br>Value  | Gross<br>Unrealized<br>Losses |
|--|----------------|-------------------------------|
| <b>Fixed maturity securities available for sale:</b> |                |                               |
| Due in one year or less                              | \$ 854         | \$ 49                         |
| Due after one year through five years                | 44,916         | 1,759                         |
| Due after five years through ten years               | 68,885         | 3,200                         |
| Due after ten years                                  | 84,808         | 12,860                        |
| <br>Total  | <br>199,463    | <br>17,868                    |
| Securities with variable principal payments          | 101,868        | 9,621                         |
| Redeemable preferred stocks                          | 5,991          | 744                           |
| <br>Total  | <br>\$ 307,322 | <br>\$ 28,233                 |

The following is a discussion of all non-residential mortgage-backed securities whose fair value had been less than 80% of amortized cost for at least six consecutive months as of September 30, 2011. The Company has considered a wide variety of factors to determine that these positions were not other-than-temporarily impaired.

| Security                       | Description  |
|--------------------------------|--|
| Financial institution          | Institution impacted by housing and mortgage crisis. The security continues to perform within contractual obligations.   |
| Collateralized debt obligation | Impacted by delinquencies and foreclosures in subprime and Alt-A markets and extreme declines in market valuations regardless of individual security performance. There continues to be overcollateralization within the structure and the investment continues to perform within contractual obligations. |

The Company has written down certain investments in previous periods. Securities written down and continuing to be owned as of September 30, 2011 had a fair value of \$84.5 million with a net unrealized loss of \$12.1 million.

The Company evaluated the current status of all investments previously written-down to determine whether the Company believes that these investments continue to be credit-impaired to the extent previously recorded. The Company's evaluation process is similar to its impairment evaluation process. If evidence exists or the Company believes that it will receive all or a materially greater portion of its contractual maturities from securities previously written down, the accretion of income is adjusted. The Company did not change its evaluation of any investments under this process during the first nine months of 2011 or 2010.

The Company does not have a material amount of direct or indirect guarantees for the securities in its investment portfolio. The Company did not have any direct exposure to financial guarantors as of September 30, 2011. The Company's indirect exposure to financial guarantors totaled \$39.0 million, which was 1% of the Company's investment assets as of September 30, 2011. The unrealized gains on these investments totaled \$1.6 million as of September 30, 2011.

**Other Revenues**

Other revenues consist of supplementary contract considerations, policyholder dividends left with the Company to accumulate, income received on the sale of low income housing tax credits (LIHTC), investments by a subsidiary of the Company and fees charged on products and sales from the Company's broker dealer subsidiary. Other revenues were flat in the third quarter and increased \$0.4 million in the first nine months of

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2011 compared to the same periods one year earlier. The increase in the nine months was primarily due to increased revenues from the broker dealer subsidiary.



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**Table of Contents*****Policyholder Benefits***

Policyholder benefits consist of death benefits (mortality), immediate annuity benefits, accident and health benefits, surrenders, interest, other benefits and the associated increase or decrease in reserves for future policy benefits. The largest component of policyholder benefits was death benefits for the periods presented. Death benefits reflect mortality results, after consideration of the impact of reinsurance. Mortality will fluctuate from period-to-period, however it has generally remained within pricing expectations for the periods presented.

Policyholder benefits decreased \$7.8 million or 17% in the third quarter of 2011 compared to the same period one year earlier. The largest factor in this decrease was a \$3.7 million decline in benefit and contract reserves. This change can be attributed to several factors. First was a \$4.8 million decrease in sales of immediate annuities. Reserves are established on a nearly one-for-one basis with immediate annuity sales. A decrease in sales year-over-year will result in a fluctuation in reserves established on a comparative basis. The second factor was refinements in estimates that resulted from the implementation of a new actuarial valuation system on traditional life insurance products. The new system offers enhancements to product valuation methodologies and improved handling of reinsurance capabilities. Refinements made during the third quarter of 2011 impacted the methods used to calculate the amortization of deferred acquisition costs and the calculation of reserves for certain traditional life insurance contracts. These refinements resulted in a \$2.2 million decrease in benefit and contract reserves. Partially offsetting these factors, the change in the fair value of the GMWB rider resulted in a \$3.4 million increase in benefit and contract reserves. Also contributing to the decline in policyholder benefits, other benefits decreased \$2.3 million, primarily due to an increase in reinsurance ceded benefits on short-term and long-term disability products.

Policyholder benefits decreased \$14.1 million or 10% in the first nine months of 2011 versus the prior year. This reduction was largely due to a decrease in benefit and contract reserves, which declined \$15.5 million compared to the same period one year earlier. This decrease was primarily due to a reduction in sales of immediate annuities, reserves released on increased net death benefits, and the refinements in estimates discussed above. Death benefits, net of reinsurance ceded, increased \$3.7 million versus the prior year and immediate annuity sales declined \$10.7 million. Partially offsetting these factors, the change in the fair value of the GMWB rider resulted in a \$3.5 million increase in benefit and contract reserves. In addition, other benefits decreased \$2.8 million, largely due to an increase in reinsurance ceded benefits on short-term and long-term disability products.

The Company has a GMWB rider for variable annuity contracts that is considered to be a financial derivative and, as such, is accounted for at fair value. The Company determines the fair value of the GMWB rider using a risk-neutral valuation method. The value of the riders will fluctuate depending on market conditions. As of September 30, 2011, the fair value of the liability increased \$3.5 million compared to the fair value as of December 31, 2010. Compared to the change in fair value during the first nine months of the prior year, the impact of the change in fair value during the first nine months of 2011 was an increase in liability of \$3.0 million. These fluctuations are the result of unfavorable returns in the capital markets, declines in risk-free swap rates and increased market volatility that were partially offset by increases in issuer discount spreads. In addition, the Company has a guaranteed minimum death benefit (GMDB) on certain products. The benefit reserve for GMDB was \$0.2 million as of September 30, 2011, down slightly from December 31, 2010.

***Interest Credited to Policyholder Account Balances***

Interest is credited to policyholder account balances according to terms of the policies or contracts. Interest is credited to policyholder account balances for universal life, fixed deferred annuities and other investment-type products. There are minimum levels of interest crediting assumed in certain policies or contracts, as well as allowances for adjustments to be made to reflect current market conditions in certain policies or contracts. Accordingly, the Company reviews and adjusts crediting rates as necessary and appropriate. Amounts credited are a function of account balances and current period crediting rates. As account balances fluctuate, so will the amount of interest credited to policyholder account balances. Interest credited to policyholder account balances decreased \$0.4 million or 2% in the third quarter of 2011 compared with the same period one year earlier. Interest credited to policyholder account balances decreased \$1.9 million or 3% for the nine months versus the prior year. The decline in interest credited for both periods was due to reduced crediting rates.

***Amortization of Deferred Acquisition Costs***

Deferred acquisition costs (DAC), principally agent commissions and other selling, selection and issue costs, which vary with and are directly related to the production of new business, are capitalized as incurred. At least annually, the Company reviews its DAC capitalization policy and the specific items which are capitalized with existing guidance. These deferred costs for life insurance products are generally deferred and amortized over the premium-paying period. Policy acquisition costs that relate to interest sensitive and variable insurance products are deferred and amortized with interest in relation to the estimated gross profits to be realized over the lives of the contracts.



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DAC is reviewed on an ongoing basis to determine that the unamortized portion does not exceed the expected recoverable amounts. If it is determined from emerging experience that the premium margins or expected gross profits are insufficient to amortize deferred acquisition costs, then the asset will be adjusted downward, or unlocked, with the adjustment recorded as an expense in the current period. The Company may also consider refinements in estimates due to improved capabilities resulting from administrative or actuarial system upgrades. The Company considers such enhancements to determine whether and to what extent they are associated with prior periods or simply improvements in the projection of future expected gross profits due to improved functionality. To the extent they represent such improvements, these items are applied to the appropriate financial statement line items in a manner similar to unlocking adjustments.

The amortization of DAC increased \$2.9 million or 34% in the third quarter and \$2.1 million or 11% in the first nine months of 2011 compared to one year ago. The increase in the third quarter was primarily the result of refinements in estimates made during the third quarter of 2011 as described in the policyholder benefits section, above. These refinements resulted in an increase in the amortization of DAC of \$2.4 million. The increase in the nine months can be attributed to the refinements mentioned above. In addition, the Company unlocked assumptions and had a software enhancement in the second quarter of 2011 that impacted the results for the first nine months of 2011. The unlocking resulted in an increase in the DAC asset of \$8.2 million. Also, the Company had an adjustment in the amortization of DAC associated with the actuarial system upgrade that occurred during 2010, discussed below, in the second quarter of 2011 resulting in a decrease in the DAC asset and an increase in DAC amortization of \$0.5 million. The Company had an unlocking in the second quarter of 2010 that resulted in an increase to the DAC asset and a corresponding decrease in the amortization of DAC in the amount of \$5.8 million. Also in the second quarter of 2010, the Company refined its estimate as a result of the implementation of an actuarial system upgrade for universal life and variable universal life products. The effect of the change in estimate was an increase in the DAC asset and a decrease in current period DAC amortization of \$1.1 million.

***Operating Expenses***

Operating expenses consist of incurred commission expense from the sale of insurance products, net of the deferral of certain commissions and certain expenses directly associated with the attainment of new business, expenses from the Company's operations, the amortization of value of business acquired, and other expenses. Capitalized commissions consist primarily of commissions and non-recurring expenses related to the successful sales of certain products. As such, not all commissions are capitalized and recognized as an expense in the period. Commissions in excess of capitalized commissions were \$1.8 million and \$5.1 million in the third quarter and nine months of 2011 compared with \$2.0 million and \$4.7 million in 2010, respectively. Home office operating expenses were flat in the third quarter of 2011 compared to last year. This reflected increases in legal expenses and agent meeting and support expenses that were partially offset by decreases in salaries and benefits. Home office operating expenses in the first nine months of 2011 were flat compared to the same period in the prior year. Decreases in salaries and benefits were offset by agent benefits, including a \$0.9 million increase in an allowance for doubtful accounts on agent receivables. In addition, reductions in taxes, licenses and fees were offset by increases in legal expenses and agent meeting expenses.

The amortization of VOBA is included in operating expenses. VOBA is amortized in concert with each purchased block of business. Generally, as policies run off, the amortization will decline over time. In addition, VOBA is evaluated on an ongoing basis for unlocking adjustments. If necessary, adjustments are made in the current period VOBA amortization. The amortization of VOBA in the third quarter and nine months of 2011 increased \$0.2 million or 11% and \$0.8 million or 17%, respectively. The Company had an unlocking adjustment on certain interest sensitive products which increased the amortization of VOBA \$0.9 million in the nine months. The unlocking adjustment reflected changes in interest rates, premiums and persistency of the closed block of business. There were no VOBA unlocking adjustments in the third quarter or nine months of 2010.

***Income Taxes***

The third quarter income tax expense was \$3.0 million or 40% of income before tax for 2011, versus \$2.3 million or 34% of income before tax for the prior year period. The income tax expense for the nine months ended September 30, 2011 was \$11.3 million or 36% of income before tax, versus \$10.1 million or 40% of income before tax for the prior year period.

The effective income tax rate in the third quarter of 2011 and for the nine months ended September 30, 2011 was greater than the prevailing corporate federal income tax rate of 35% primarily due to adjustments related to the Company's investments in affordable housing. The affordable housing adjustments resulted in a tax expense of approximately 5% and 1% of income before tax in the third quarter and nine months ended September 30, 2011 respectively.

The effective income tax rate in the third quarter of 2010 was less than the prevailing corporate federal income tax rate of 35% primarily due to favorable permanent differences. The permanent differences consisted primarily of the dividends-



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received deduction and differences between the prior year tax provision and the Company's filed tax returns. The permanent differences resulted in a tax benefit of approximately 7% of income before tax. Additionally, a decrease in the income tax contingency in third quarter 2010 resulted in a benefit of approximately 2% of income before tax. The favorable differences were partially offset in third quarter 2010 by expense of approximately 8% of income before tax related to the Company's investments in affordable housing.

The effective income tax rate in the nine months ended September 30, 2010 exceeded the prevailing corporate federal income tax rate of 35%, primarily due to additional tax expense incurred with respect to affordable housing investments. Affordable housing investments increased the tax rate by \$2.4 million or 10% of income before tax and included tax credit recapture events. Permanent differences, primarily from the dividends-received deduction, and a decrease in the tax contingency partially offset the adjustments related to affordable housing and resulted in a benefit of approximately 5% of income before tax.

## **Operating Results by Segment**

The Company has three reportable business segments, which are defined based on the nature of the products and services offered: Individual Insurance, Group Insurance and Old American. The Individual Insurance segment consists of individual insurance products for both Kansas City Life and Sunset Life. The Individual Insurance segment is marketed through a nationwide sales force of independent general agents and third-party marketing arrangements. The Group Insurance segment consists of sales of group life, group disability, dental, and vision products. This segment is marketed through a nationwide sales force of independent general agents, group brokers and third-party marketing arrangements. Old American consists of individual insurance products designed largely as final expense products. These products are marketed through a nationwide general agency sales force with exclusive territories, using direct response marketing to supply agents with leads. For more information, refer to Note 11 - Segment Information in the Notes to Consolidated Financial Statements (Unaudited).

**Table of Contents****Individual Insurance**

The following table presents financial data of the Individual Insurance business segment for the third quarters and nine months ended September 30, 2011 and 2010:

|   | Quarter Ended |          | Nine Months Ended |           |
|---|---------------|----------|-------------------|-----------|
|   | 2011          | 2010     | 2011              | 2010      |
| <b>Insurance revenues:</b>  |               |          |                   |           |
| Premiums, net   | \$ 2,950      | \$ 7,974 | \$ 9,238          | \$ 19,972 |
| Contract charges  | 25,427        | 26,643   | 75,413            | 79,985    |
| Total insurance revenues  | 28,377        | 34,617   | 84,651            | 99,957    |
| <b>Investment revenues:</b>   |               |          |                   |           |
| Net investment income   | 40,031        | 40,842   | 123,798           | 121,014   |
| Realized investment gains, excluding impairment losses                | 209           | 206      | 3,149             | 2,513     |
| <b>Net impairment losses recognized in earnings:</b>                  |               |          |                   |           |
| Total other-than-temporary impairment losses                          | (157)         | (984)    | (607)             | (3,828)   |
| Portion of impairment losses recognized in other comprehensive income | 16            | 149      | 114               | 343       |
| Net impairment losses recognized in earnings                          | (141)         | (835)    | (493)             | (3,485)   |
| Total investment revenues   | 40,099        | 40,213   | 126,454           | 120,042   |
| Other revenues  | 2,176         | 2,185    | 7,162             | 6,793     |
| Total revenues  | 70,652        | 77,015   | 218,267           | 226,792   |
| <b>Policyholder benefits</b>  |               |          |                   |           |
| Policyholder benefits   | 21,775        | 27,870   | 66,799            | 79,483    |
| Interest credited to policyholder account balances                    | 21,119        | 21,561   | 62,366            | 64,301    |
| Amortization of deferred acquisition costs                            | 8,267         | 5,439    | 11,750            | 10,440    |
| Operating expenses  | 14,267        | 15,537   | 45,874            | 46,848    |
| Total benefits and expenses   | 65,428        | 70,407   | 186,789           | 201,072   |
| Income before income tax expense                                      | 5,224         | 6,608    | 31,478            | 25,720    |
| Income tax expense  | 2,141         | 2,195    | 11,145            | 10,069    |
| Net income  | \$ 3,083      | \$ 4,413 | \$ 20,333         | \$ 15,651 |

Net income for this segment was \$3.1 million in the third quarter of 2011, a decrease of \$1.3 million from the third quarter of 2010. Contributing to this decrease were a \$5.0 million decrease in net premiums, a \$2.8 million increase in the amortization of DAC, a \$1.2 million decrease in contract charges and a \$0.8 million decrease in net investment income. These were partially offset by a \$6.0 million decrease in policyholder benefits, a \$1.3 million decrease in operating expenses, and a \$0.7 million increase in net realized investment gains.

Net income for this segment was \$20.3 million in the first nine months of 2011, an increase of \$4.7 million from the first nine months of 2010. Contributing to this improvement were increases in realized investment gains of \$3.6 million and net investment income of \$2.8 million, and decreases in policyholder benefits of \$12.7 million, interest credited to policyholder account balances of \$1.9 million and operating expenses of \$1.0 million. Partially offsetting these favorable items were decreases in net premiums of \$10.7 million and contract charges of \$4.6 million, and

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an increase in the amortization of deferred acquisition costs of \$1.3 million.

Total insurance revenues for this segment decreased \$6.2 million or 18% in the third quarter of 2011 compared with the same period in the prior year. Total premiums, net of reinsurance, decreased \$5.0 million or 63%, reflecting a \$4.8 million or 72% decline in immediate annuity premiums in the third quarter of 2011 versus the same period last year. Contract charges decreased \$1.2 million or 5%, largely due to the runoff of the closed blocks.

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Insurance revenues for this segment decreased \$15.3 million or 15% for the nine months, primarily due to two factors. First, sales of immediate annuities declined \$10.7 million compared to the prior year. Second, contract charges declined \$4.6 million or 6% in the first nine months of 2011 compared to the same period in 2010. Contract charges on closed blocks of business decreased \$1.3 million or 4% and contract charges on ongoing blocks of business decreased \$3.3 million or 6%. Cost of insurance charges declined largely due to the runoff of the closed blocks. The decline in surrender charges reflected reduced surrenders on universal life and variable universal life products in the ongoing blocks of business. Deferred revenue declined largely due to the impact of the unlocking that occurred during the second quarter of 2011.

The following tables present gross premiums by new and renewal business, less reinsurance ceded, as included in insurance revenues, for the third quarters and nine months ended September 30, 2011 and 2010. New premiums are detailed by product.

|                           | Quarter Ended<br>September 30 |             |                 |             |
|---------------------------|-------------------------------|-------------|-----------------|-------------|
|                           | 2011                          | % Change    | 2010            | % Change    |
| <b>New premiums:</b>      |                               |             |                 |             |
| Individual life insurance | \$ 1,194                      | (7)         | \$ 1,286        | (6)         |
| Immediate annuities       | 1,903                         | (72)        | 6,689           | (38)        |
| <b>Total new premiums</b> | <b>3,097</b>                  | <b>(61)</b> | <b>7,975</b>    | <b>(35)</b> |
| Renewal premiums          | 10,970                        | 4           | 10,513          | (2)         |
| <b>Total premiums</b>     | <b>14,067</b>                 | <b>(24)</b> | <b>18,488</b>   | <b>(19)</b> |
| Reinsurance ceded         | (11,117)                      | 6           | (10,514)        | (2)         |
| <b>Premiums, net</b>      | <b>\$ 2,950</b>               | <b>(63)</b> | <b>\$ 7,974</b> | <b>(35)</b> |

|                           | Nine Months Ended<br>September 30 |             |                  |            |
|---------------------------|-----------------------------------|-------------|------------------|------------|
|                           | 2011                              | % Change    | 2010             | % Change   |
| <b>New premiums:</b>      |                                   |             |                  |            |
| Individual life insurance | \$ 3,783                          | (2)         | \$ 3,874         | (4)        |
| Immediate annuities       | 5,649                             | (66)        | 16,637           | (1)        |
| <b>Total new premiums</b> | <b>9,432</b>                      | <b>(54)</b> | <b>20,511</b>    | <b>(2)</b> |
| Renewal premiums          | 31,998                            | 2           | 31,268           | -          |
| <b>Total premiums</b>     | <b>41,430</b>                     | <b>(20)</b> | <b>51,779</b>    | <b>(1)</b> |
| Reinsurance ceded         | (32,192)                          | 1           | (31,807)         | 2          |
| <b>Premiums, net</b>      | <b>\$ 9,238</b>                   | <b>(54)</b> | <b>\$ 19,972</b> | <b>(4)</b> |

Total new premiums for this segment decreased \$4.9 million or 61% in the third quarter of 2011 compared to the same period one year earlier. This decline was the result of a \$4.8 million or 72% decrease in new immediate annuity sales. This decrease was largely the result of elevated sales of this product in 2010, due to the demand of guaranteed benefits by consumers at that time. Immediate annuity receipts can have sizable fluctuations, as receipts from policyholders result from significant one-time premiums rather than recurring premiums. The decrease in new immediate annuity sales can also be attributed to lower interest rates and increased competition from alternative products. Total renewal premiums increased \$0.5 million or 4% compared to last year, reflecting an increase in individual life premiums.

Total new premiums for this segment decreased \$11.1 million or 54% for the first nine months of 2011 compared to the same period last year. This decline was driven by an \$11.0 million or 66% decrease in immediate annuity sales. Total renewal premiums increased \$0.7 million or 2% compared to one year earlier, reflecting increases in individual life and immediate annuity premiums.





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The following tables provide detail by new and renewal deposits for the third quarters and nine months ended September 30, 2011 and 2010. New deposits are also detailed by product.

|                                   | Quarter Ended<br>September 30 |             |                  |           |
|-----------------------------------|-------------------------------|-------------|------------------|-----------|
|                                   | 2011                          | % Change    | 2010             | % Change  |
| <b>New deposits:</b>              |                               |             |                  |           |
| Universal life insurance          | \$ 2,391                      | (39)        | \$ 3,920         | 85        |
| Variable universal life insurance | 183                           | (43)        | 320              | 82        |
| Fixed deferred annuities          | 15,368                        | (42)        | 26,562           | 37        |
| Variable annuities                | 4,119                         | 44          | 2,870            | (14)      |
| <b>Total new deposits</b>         | <b>22,061</b>                 | <b>(34)</b> | <b>33,672</b>    | <b>35</b> |
| Renewal deposits                  | 37,459                        | 6           | 35,260           | 3         |
| <b>Total deposits</b>             | <b>\$ 59,520</b>              | <b>(14)</b> | <b>\$ 68,932</b> | <b>17</b> |

|                                   | Nine Months Ended<br>September 30 |            |                   |             |
|-----------------------------------|-----------------------------------|------------|-------------------|-------------|
|                                   | 2011                              | % Change   | 2010              | % Change    |
| <b>New deposits:</b>              |                                   |            |                   |             |
| Universal life insurance          | \$ 8,953                          | (14)       | \$ 10,418         | 71          |
| Variable universal life insurance | 676                               | (11)       | 760               | (13)        |
| Fixed deferred annuities          | 48,285                            | (1)        | 49,005            | (24)        |
| Variable annuities                | 14,098                            | (2)        | 14,387            | 30          |
| <b>Total new deposits</b>         | <b>72,012</b>                     | <b>(3)</b> | <b>74,570</b>     | <b>(10)</b> |
| Renewal deposits                  | 109,490                           | 4          | 104,880           | 6           |
| <b>Total deposits</b>             | <b>\$ 181,502</b>                 | <b>1</b>   | <b>\$ 179,450</b> | <b>(1)</b>  |

Total new deposits decreased \$11.6 million or 34% in the third quarter of 2011 compared with the prior year. This decrease was due to an \$11.2 million or 42% decrease in new fixed deferred annuity deposits and a \$1.5 million or 39% decrease in new universal life deposits. Partially offsetting these declines, new variable annuity deposits increased \$1.2 million or 44%. The decrease in new fixed deferred annuity deposits can be largely attributed to lower interest rates and increased competition from alternative products. Total renewal deposits increased \$2.2 million or 6% in the third quarter of 2011 compared with the same period one year ago.

Total new deposits decreased \$2.6 million or 3% in the first nine months of 2011 compared with the prior year. This decrease reflected a \$1.5 million or 14% decline in new universal life deposits, a \$0.7 million or 1% decrease in new fixed deferred annuity deposits and a \$0.3 million or 2% decrease in new variable annuity deposits. Total renewal deposits increased \$4.6 million or 4% in the first nine months of 2011.

Net investment income decreased \$1.0 million or 2% in the third quarter of 2011 compared to the third quarter of 2010. This decline largely resulted from lower yields earned and a decline in the market value of an alternative investment fund. These were partially offset by an increase in average invested assets, largely due to increased mortgage loan holdings during 2011. This segment experienced a net realized investment gain of \$0.1 million in the third quarter of 2011, an increase compared to a net realized investment loss of \$0.6 million in the third quarter of 2010.

This segment experienced a \$2.8 million or 2% increase in net investment income for the first nine months of 2011 versus the same period one year ago. This increase was the result of both higher yields earned on investments and an increase in the average invested assets. In addition, this segment had net realized investment gains of \$2.7 million in the first nine months of 2011, an improvement compared to a net realized investment loss of \$1.0 million one year earlier.

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The Company's analysis of securities for the quarter ended September 30, 2011 resulted in the determination that seven fixed-maturity securities had other-than-temporary impairments affecting the Individual Insurance segment and were written down by a combined \$0.1 million due to credit impairments. All of these securities were residential mortgage-backed securities having been previously written down, and incremental credit impairments were recognized. The incremental credit impairments reflected deterioration in the present value of projected future cash flows. The additional losses from these residential mortgage-backed securities were \$0.2 million in the third quarter of 2011, including less than \$0.1 million that was determined to be non-credit and was recognized in other comprehensive income. The total fair value of the affected securities after the write-downs was \$47.7 million.

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Please see Consolidated Results of Operations in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations for a table that provides securities that were written down through earnings by business segment for the first three quarters of 2011 and 2010. This section also contains a table that provides detail regarding individual investment securities by business segment that were written down through earnings during the first nine months of 2011 and 2010.

Other revenues were flat in the third quarter and increased \$0.4 million or 5% in and the first nine months of 2011 compared to the same periods one year earlier. Increased revenue from the broker dealer subsidiary was the primary reason for the increase that occurred in the nine months.

Policyholder benefits decreased \$6.1 million or 22% in the third quarter of 2011 compared to the prior year. The largest factor in this decline was a \$4.0 million decrease in benefit and contract reserves. This change can be attributed to several factors including a \$4.8 million decrease in sales of immediate annuities and refinements in estimates that impacted the methods used to calculate the amortization of deferred acquisition costs and the calculation of reserves for certain traditional life insurance contracts. These refinements resulted in a \$2.2 million decrease in benefit and contract reserves. Partially offsetting these factors, the change in the fair value of the GMWB rider resulted in a \$3.4 million increase in benefit and contract reserves.

Policyholder benefits decreased \$12.7 million or 16% in the first nine months of 2011 compared to one year earlier. This decline was primarily attributable to a \$15.4 million decrease in benefit and contract reserves. This decrease was primarily due to a reduction in sales of immediate annuities, reserves released on increased net death benefits, and the refinements in estimates discussed above. Death benefits, net of reinsurance ceded, increased \$1.9 million versus the prior year and immediate annuity sales declined \$10.7 million. Partially offsetting these, the change in the fair value of the GMWB rider resulted in a \$3.5 million increase in benefit and contract reserves.

The Company has a GMWB rider for variable annuity contracts that is considered to be a financial derivative and, as such, is accounted for at fair value. The Company determines the fair value of the GMWB rider using a risk-neutral valuation method. The value of the riders will fluctuate depending on market conditions. As of September 30, 2011, the fair value of the liability increased \$3.5 million compared to the fair value as of December 31, 2010. Compared to the change in fair value during the first nine months of the prior year, the impact of the change in fair value during the first nine months of 2011 was an increase in liability of \$3.0 million. These fluctuations are the result of unfavorable returns in the capital markets, declines in risk-free swap rates and increased market volatility that were partially offset by increases in issuer discount spreads. In addition, the Company has a guaranteed minimum death benefit (GMDB) on certain products. The benefit reserve for GMDB was \$0.2 million as of September 30, 2011, down slightly from December 31, 2010.

Interest credited to policyholder account balances declined \$0.4 million or 2% in the third quarter and \$1.9 million or 3% in the first nine months of 2011 compared to one year ago. While total policyholder account balances increased over the preceding 12 months, this was offset by declines in crediting rates.

The amortization of DAC increased \$2.8 million or 52% in the third quarter and \$1.3 million or 13% in the first nine months of 2011 compared to one year ago. The increase in the third quarter was primarily the result of the refinements in estimates made during the third quarter of 2011 as discussed earlier. The increase in the nine months can be attributed to the refinements mentioned above as well as unlocking of the Company's assumptions on certain universal life and deposit-type products that occurred during the second quarter of 2011. The Company's unlocking and refinements resulted in an increase in the DAC asset of \$7.7 million in the second quarter of 2011. The Company also had an unlocking in the second quarter of 2010 that resulted in an increase to the DAC asset and a corresponding decrease in the amortization of DAC during the second quarter 2010 in the amount of \$5.8 million. Also in the second quarter of 2010, the Company refined its estimate as a result of the implementation of an actuarial system upgrade. The effect of the change in estimate was an increase in the DAC asset and a decrease in current period DAC amortization of \$1.1 million.

Operating expenses consist of incurred commissions, net of the capitalization of commissions, expenses from the Company's operations, the amortization of VOBA, and other expenses. Capitalized commissions consist primarily of commissions and non-recurring expenses related to the sale of new policies. The Segment's operating expenses decreased \$1.3 million in the third quarter of 2011 compared with the prior year, primarily reflecting a decrease in commissions, net of capitalization. Home office operating expenses were flat as decreases in salaries and benefits and software and depreciation costs were partially offset by an increase in legal expenses.

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Operating expenses decreased \$1.0 million in the nine months compared with one year earlier. This increase was largely the result of a decrease in commissions, net of capitalization. Home office operating expenses were flat as decreases in salaries and benefits were partially offset by agent benefits, including a \$0.9 million increase in an allowance for doubtful accounts on agent receivables. In addition, reductions in taxes, licenses and fees and software and depreciation costs were offset by increases in legal expenses.

The amortization of VOBA is included in operating expenses. VOBA is amortized in concert with each purchased block of business. Generally, as policies run off, the amortization will decline over time. In addition, VOBA is evaluated on an ongoing basis for unlocking adjustments. If necessary, adjustments are made in the current period VOBA amortization. The amortization of VOBA decreased \$0.1 million in the third quarter and increased \$1.1 million in the first nine months of 2011 compared to the same periods one year earlier. The primary reason for the increase in the nine months was an unlocking adjustment on certain interest sensitive products which increased the amortization of VOBA \$0.9 million in the second quarter of 2011. There were no VOBA unlocking adjustments in the first nine months of 2010.

**Table of Contents****Group Insurance**

The following table presents financial data of the Group Insurance business segment for the third quarters and nine months ended September 30, 2011 and 2010:

|  | Quarter Ended<br>September 30 |                 | Nine Months Ended<br>September 30 |                   |
|--|-------------------------------|-----------------|-----------------------------------|-------------------|
|  | 2011                          | 2010            | 2011                              | 2010              |
| <b>Insurance revenues:</b>                           |                               |                 |                                   |                   |
| Premiums, net  | \$ 12,613                     | \$ 11,525       | \$ 37,413                         | \$ 36,728         |
| <b>Total insurance revenues</b>                      | <b>12,613</b>                 | <b>11,525</b>   | <b>37,413</b>                     | <b>36,728</b>     |
| <b>Investment revenues:</b>                          |                               |                 |                                   |                   |
| Net investment income                                | 133                           | 149             | 420                               | 456               |
| Other revenues                                       | 38                            | 38              | 113                               | 117               |
| <b>Total revenues</b>                                | <b>12,784</b>                 | <b>11,712</b>   | <b>37,946</b>                     | <b>37,301</b>     |
| <br>   |                               |                 |                                   |                   |
| Policyholder benefits                                | 6,289                         | 7,874           | 21,373                            | 24,648            |
| Operating expenses                                   | 6,035                         | 5,003           | 17,283                            | 15,160            |
| <br>   |                               |                 |                                   |                   |
| Total benefits and expenses                          | 12,324                        | 12,877          | 38,656                            | 39,808            |
| <br>   |                               |                 |                                   |                   |
| Income (loss) before income tax expense<br>(benefit) | 460                           | (1,165)         | (710)                             | (2,507)           |
| <br>   |                               |                 |                                   |                   |
| Income tax expense (benefit)                         | 161                           | (407)           | (249)                             | (877)             |
| <br>   |                               |                 |                                   |                   |
| <b>Net income (loss)</b>                             | <b>\$ 299</b>                 | <b>\$ (758)</b> | <b>\$ (461)</b>                   | <b>\$ (1,630)</b> |

Net income for this segment totaled \$0.3 million in the third quarter of 2011 compared to a \$0.8 million net loss in the prior year. The net loss for the first nine months of 2011 was \$0.5 million compared to a \$1.6 million net loss for the first nine months of 2010. The improvement in this segment's results for the third quarter and nine months is attributable to increased insurance revenues and decreased policyholder benefits. These were partially offset by increases in operating expenses.

The following tables present premiums included in insurance revenues and provide detail by new and renewal business for the third quarters and nine months ended September 30, 2011 and 2010. New premiums are also detailed by product.

|                            | Quarter Ended<br>September 30 |          | Quarter Ended<br>September 30 |          |
|----------------------------|-------------------------------|----------|-------------------------------|----------|
|                            | 2011                          | % Change | 2010                          | % Change |
| <b>New premiums:</b>       |                               |          |                               |          |
| Group life insurance       | \$ 516                        | (5)      | \$ 545                        | 52       |
| Group dental insurance     | 834                           | (54)     | 1,799                         | 3        |
| Group disability insurance | 2,425                         | 118      | 1,114                         | 11       |
| Other group insurance      | 42                            | 500      | 7                             | (30)     |

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|                    |           |    |           |     |
|--------------------|-----------|----|-----------|-----|
| Total new premiums | 3,817     | 10 | 3,465     | 11  |
| Renewal premiums   | 11,672    | 14 | 10,267    | (8) |
| Total premiums     | 15,489    | 13 | 13,732    | (4) |
| Reinsurance ceded  | (2,876)   | 30 | (2,207)   | (8) |
| Premiums, net      | \$ 12,613 | 9  | \$ 11,525 | (3) |

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|                            | Nine Months Ended<br>September 30 |          |                  |           |
|----------------------------|-----------------------------------|----------|------------------|-----------|
|                            | 2011                              | % Change | 2010             | % Change  |
| <b>New premiums:</b>       |                                   |          |                  |           |
| Group life insurance       | \$ 1,463                          | (13)     | \$ 1,672         | 47        |
| Group dental insurance     | 3,213                             | (47)     | 6,039            | 14        |
| Group disability insurance | 6,967                             | 110      | 3,314            | 53        |
| Other group insurance      | 112                               | 11       | 101              | 23        |
| <b>Total new premiums</b>  | <b>11,755</b>                     | <b>6</b> | <b>11,126</b>    | <b>28</b> |
| Renewal premiums           | 34,166                            | 6        | 32,145           | (5)       |
| <b>Total premiums</b>      | <b>45,921</b>                     | <b>6</b> | <b>43,271</b>    | <b>2</b>  |
| Reinsurance ceded          | (8,508)                           | 30       | (6,543)          | 8         |
| <b>Premiums, net</b>       | <b>\$ 37,413</b>                  | <b>2</b> | <b>\$ 36,728</b> | <b>1</b>  |

Net premiums increased \$1.0 million or 9% in the third quarter and \$0.7 million or 2% in the first nine months of 2011 compared with the prior year. These increases were primarily the result of increases in net premiums from the short-term disability product due to a growing third-party marketing arrangement. Partially offsetting this growth in net premiums were lower net premiums from dental product sales. The Company is purposefully being less aggressive in acquiring new dental business while implementation of a new pricing methodology is established. The revised methodology is based upon increased information about local market pricing and service utilization, and it is expected to improve financial performance of the product line. The Company is implementing the new pricing methodology throughout 2011.

Total new premiums increased \$0.4 million or 10% in the third quarter and \$0.6 million or 6% in the nine months, while total renewal premiums increased \$1.4 million or 14% in the third quarter and \$2.0 million or 6% in the nine months. New disability premiums increased \$1.3 million or 118% in the third quarter and \$3.7 million or 110% in the nine months. These were partially offset by decreases in new dental premiums of \$1.0 million or 54% in the third quarter and \$2.8 million or 47% in the nine months. The improvement in new group disability premiums continues to reflect results from the expanded distribution from a third-party arrangement pertaining primarily to short-term disability products. This arrangement accounted for 58% and 54% of total new premiums in the third quarter and first nine months of 2011, respectively, of total new premiums. The increase in renewal premiums for the third quarter was primarily driven by renewals from the dental product, while the increase in renewal premiums for the nine months largely reflected increases in the disability and dental products.

Policyholder benefits consist of death benefits (mortality), accident and health benefits and the associated increase or decrease in reserves for future policy benefits. Policyholder benefits declined \$1.6 million or 20% in the third quarter and \$3.3 million or 13% in the nine months compared to the prior year. These improvements were largely due to a reduction in the claims for the dental product line. This segment monitors claims ratios as a means of tracking the success of active management of the product lines. Claims ratios reflect benefits as a percentage of revenues. These ratios improved during the third quarter and nine months of 2011 as this segment has sought to retain more profitable business through price control and assessment of results.

Operating expenses consist of commissions, fees to third-party marketing and administrative organizations, and expenses from the Company's operations. Operating expenses increased \$1.0 million or 21% in the third quarter and \$2.1 million or 14% in the nine months. Higher commission expenses associated with increased sales of the short-term disability product and an increase in payments to third-party administrators resulted in the increased operating expenses for both periods. This segment has also focused on operating expense management, seeking a blend of internal administration of product support with selected and targeted use of third-party administrators that effectively manage high volume benefit payments but require less underwriting and assessment. Results have been favorable but payments to third-party administrators have increased.

Improvement efforts for this segment in 2011 will continue to be focused on increased sales of disability products, improved profitability of the dental product line, and improvements in administrative efficiency.



**Table of Contents****Old American**

The following table presents financial data for the Old American business segment for the third quarters and nine months ended September 30, 2011 and 2010:

|   | Quarter Ended<br>September 30 |               | Nine Months Ended<br>September 30 |               |
|---|-------------------------------|---------------|-----------------------------------|---------------|
|   | 2011                          | 2010          | 2011                              | 2010          |
| <b>Insurance revenues:</b>  |                               |               |                                   |               |
| Premiums, net   | \$ 17,048                     | \$ 16,420     | \$ 50,655                         | \$ 48,630     |
| <b>Total insurance revenues</b>                                       | <b>17,048</b>                 | <b>16,420</b> | <b>50,655</b>                     | <b>48,630</b> |
| <b>Investment revenues:</b>   |                               |               |                                   |               |
| Net investment income   | 2,929                         | 3,129         | 9,159                             | 9,226         |
| Realized investment gains (losses), excluding impairment losses       | 1                             | 57            | (34)                              | 566           |
| <b>Net impairment losses recognized in earnings:</b>                  |                               |               |                                   |               |
| Total other-than-temporary impairment losses                          | (10)                          | (96)          | (67)                              | (301)         |
| Portion of impairment losses recognized in other comprehensive income | 1                             | 21            | 17                                | (34)          |
| Net impairment losses recognized in earnings                          | (9)                           | (75)          | (50)                              | (335)         |
| <b>Total investment revenues</b>                                      | <b>2,921</b>                  | <b>3,111</b>  | <b>9,075</b>                      | <b>9,457</b>  |
| Other revenues  | 1                             | -             | 14                                | 3             |
| <b>Total revenues</b>   | <b>19,970</b>                 | <b>19,531</b> | <b>59,744</b>                     | <b>58,090</b> |
| <br>  |                               |               |                                   |               |
| Policyholder benefits   | 10,476                        | 10,630        | 34,507                            | 32,657        |
| Amortization of deferred acquisition costs                            | 3,310                         | 3,213         | 10,116                            | 9,337         |
| Operating expenses  | 4,426                         | 4,345         | 14,203                            | 13,721        |
| <b>Total benefits and expenses</b>                                    | <b>18,212</b>                 | <b>18,188</b> | <b>58,826</b>                     | <b>55,715</b> |
| <br>  |                               |               |                                   |               |
| Income before income tax expense                                      | 1,758                         | 1,343         | 918                               | 2,375         |
| <b>Income tax expense</b>   | <b>674</b>                    | <b>542</b>    | <b>360</b>                        | <b>917</b>    |
| <br>  |                               |               |                                   |               |
| Net income  | \$ 1,084                      | \$ 801        | \$ 558                            | \$ 1,458      |

Net income for this segment was \$1.1 million in the third quarter of 2011 compared to \$0.8 million in the prior year. The increase in net income for the third quarter was primarily the result of a \$0.6 million increase in insurance revenues that was partially offset by a \$0.2 million decrease in net investment income. Net income for the first nine months of 2011 was \$0.6 million versus \$1.5 million for the first nine months of 2010. The decline in net income reflected a \$1.9 million increase in policyholder benefits, a \$0.8 million increase in the amortization of DAC and a \$0.5 million increase in operating expenses. These were partially offset by a \$2.0 million increase in insurance revenues.

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The following tables present gross premiums by new and renewal business, less reinsurance ceded, as included in insurance revenues, for the third quarters and nine months ended September 30, 2011 and 2010.

|                              | Quarter Ended<br>September 30 |             |                  |             |
|------------------------------|-------------------------------|-------------|------------------|-------------|
|                              | 2011                          | %<br>Change | 2010             | %<br>Change |
| New individual life premiums | \$ 3,055                      | 5           | \$ 2,915         | 28          |
| Renewal premiums             | 14,572                        | 3           | 14,166           | -           |
| <b>Total premiums</b>        | <b>17,627</b>                 | <b>3</b>    | <b>17,081</b>    | <b>4</b>    |
| Reinsurance ceded            | (579)                         | (12)        | (661)            | (14)        |
| <b>Premiums, net</b>         | <b>\$ 17,048</b>              | <b>4</b>    | <b>\$ 16,420</b> | <b>5</b>    |

|                              | Nine Months Ended<br>September 30 |             |                  |             |
|------------------------------|-----------------------------------|-------------|------------------|-------------|
|                              | 2011                              | %<br>Change | 2010             | %<br>Change |
| New individual life premiums | \$ 9,190                          | 10          | \$ 8,355         | 32          |
| Renewal premiums             | 43,274                            | 2           | 42,339           | (1)         |
| <b>Total premiums</b>        | <b>52,464</b>                     | <b>3</b>    | <b>50,694</b>    | <b>4</b>    |
| Reinsurance ceded            | (1,809)                           | (12)        | (2,064)          | (14)        |
| <b>Premiums, net</b>         | <b>\$ 50,655</b>                  | <b>4</b>    | <b>\$ 48,630</b> | <b>5</b>    |

Total insurance revenues increased 4% in both the third quarter and nine months compared with the prior year. Total new premiums increased \$0.1 million or 5% in the third quarter and \$0.8 million or 10% in the nine months, while total renewal premiums increased \$0.4 million or 3% in the third quarter and \$0.9 million or 2% in the nine months. The increase in new premiums reflects a combination of expanded geographic distribution efforts and improved agency productivity. Old American continues to experience favorable results from a focus on the recruitment and development of new agencies and agents, along with improved production from existing agencies and agents.

Net investment income declined \$0.2 million or 6% in the third quarter and \$0.1 million or 1% in the nine months compared with 2010. These declines were largely due to a reduction in yields available in the market.

Old American had a net realized investment loss of less than \$0.1 million in both the third quarter and nine months of 2011. This compares to a net realized investment loss of less than \$0.1 million in the third quarter and a \$0.2 million net realized investment gain in the nine months of 2010.

The Company's analysis of securities for the quarter ended September 30, 2011 resulted in the determination that two fixed-maturity securities had other-than-temporary impairments affecting the Old American segment, and these securities were written down by less than \$0.1 million. The total fair value of the affected securities after the write-down was \$4.4 million.

Please see Consolidated Results of Operations in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations for a table that provides securities that were written down through earnings by business segment for the first three quarters of 2011 and 2010. This section also contains a table that provides detail regarding individual investment securities by business segment that were written down through earnings during the first nine months of 2011 and 2010.

Policyholder benefits decreased \$0.2 million or 1% in the third quarter compared to last year. The decrease was primarily due to a decrease in death benefits compared with the prior year. Policyholder benefits for the nine months increased \$1.9 million or 6% compared to a year earlier. The increase was primarily due to an increase in death benefits compared with the prior year. Mortality fluctuations occur each period. The Company monitors these fluctuations in relation to its pricing expectations. While death benefits decreased during the third quarter and increased

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in the first nine months of 2011, the results remained within expectations.

Amortization of deferred acquisition costs increased \$0.1 million or 3% in the third quarter and \$0.8 million or 8% in the nine months compared to a year ago. The increase for the nine months was due in part to an increase in the number of policy terminations experienced in the first quarter of 2011 and due to the increase in sales.

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Operating expenses consist of commissions, net of the capitalization of commissions, expenses from the Company's operations, the amortization of value of business acquired, and other expenses. Capitalized commissions consist primarily of commissions and non-recurring expenses related to the sale of new policies. Operating expenses increased \$0.1 million or 2% in the third quarter and \$0.5 million or 4% in the nine months compared to a year ago. These increases were primarily due to increased agent meeting expenses and other agent-related support costs.

## **Liquidity and Capital Resources**

### ***Liquidity***

Statements made in the Company's 2010 Form 10-K remain pertinent, as the Company's liquidity position is materially unchanged from year-end 2010.

Management believes that the Company has sufficient sources of liquidity and capital resources to satisfy operational requirements and to finance expansion plans and strategic initiatives for 2011. Primary sources of cash flow are premiums, other insurance considerations and deposits, receipts for policyholder accounts, investment sales and maturities, and investment income. In addition, the Company has access to credit facilities that are available for additional working capital needs or investment opportunities. The principal uses of cash are for the insurance operations, including the purchase of investments, payment of insurance benefits, operating expenses, policyholder dividends, income taxes, withdrawals from policyholder accounts, and costs related to acquiring new business. There can be no assurance that the Company will continue to generate cash flows at or above current levels or that the ability to borrow under the current credit facilities will be maintained.

The Company performs cash flow testing and adds various levels of stress testing to potential surrender and policy loan levels in order to assess current and near-term cash and liquidity needs. In the event of increased surrenders and other cash needs, the Company has several sources of cash flow, as mentioned above, to meet these needs.

Net cash used by operating activities was \$3.3 million for the nine months ended September 30, 2011, compared to net cash provided of \$6.4 million for the same period in 2010. This reflected a decrease in premium receipts and increases in claim payments and federal income taxes paid. These were partially offset by an increase in investment income and a decrease in expenses paid.

Net cash used for investing activities for the nine months ended September 30, 2011 was \$13.5 million, down from net cash used of \$30.3 million for the same period in 2010. The Company's new investments in fixed maturity and equity securities were \$146.7 million for the nine months, a 53% decrease from \$309.0 million in the prior year. New investments in mortgage loans were \$122.9 million, compared with \$93.9 million last year. Purchases of real estate totaled \$7.2 million, down from \$9.7 million in 2010. Sales and maturities of fixed maturity and equity securities totaled \$227.2 million for the first nine months of 2011, a 5% decrease versus \$240.2 million a year ago. Mortgage loan maturities and principal paydowns totaled \$58.7 million, compared to \$28.3 million last year.

Net cash provided by financing activities was \$17.7 million for the first nine months of 2011, compared with net cash provided of \$27.4 million a year ago. This change was primarily the result of three items. First, net transfers from separate accounts provided \$3.9 million in 2011, compared with \$5.5 million during the same period in 2010. Second, other deposits used \$4.8 million in 2011, compared with cash provided by other deposits of \$3.3 million in the prior year. Third, the Company's net acquisition of treasury stock was \$3.7 million, compared to \$3.1 million through the first nine months of 2010. Partially offsetting the impact of these three items, deposits net of related withdrawals from policyholder account balances provided \$31.6 million in 2011 compared with \$30.9 million during the same period in 2010.

The above information excludes net proceeds from variable insurance products. These proceeds are segregated into separate accounts and are not held in the Company's general investments because the policyholders, rather than the Company, assume the underlying investment risks.

### ***Debt and Short-term Borrowing***

The Company and certain subsidiaries have access to borrowing capacity through their membership affiliation with the Federal Home Loan Bank of Des Moines (FHLB). As of September 30, 2011, there were no outstanding balances with the FHLB, and there were no outstanding balances at year-end 2010. The Company has access to unsecured revolving lines of credit of \$60.0 million with two major commercial banks with no balances outstanding. These lines of credit will expire on June 30, 2012. The Company anticipates renewing these lines of credit as they come due.



**Table of Contents*****Capital Resources***

The Company considers existing capital resources to be adequate to support the current level of business activities. In addition, the Company's statutory equity exceeds the minimum capital deemed necessary to support its insurance business, as determined by the risk-based capital calculations and guidelines established by the National Association of Insurance Commissioners. The Company believes these statutory limitations impose no practical restrictions on its dividend payment plans.

The following table shows the capital adequacy for the Company.

|  | September 30<br>2011 | December 31<br>2010 |
|--|----------------------|---------------------|
| Total assets, excluding separate accounts                            | \$ 4,073,617         | \$ 3,994,073        |
| Total stockholders' equity   | 724,103              | 679,472             |
| Ratio of stockholders' equity to assets, excluding separate accounts | 18%                  | 17%                 |

The ratio of equity to assets less separate accounts increased from 17% to 18% through the nine months ended September 30, 2011. Unrealized investment gains on available for sale securities, which are included as a part of stockholders' equity (net of securities losses, related taxes, policyholder account balances and deferred acquisition costs), totaled \$80.9 million as of September 30, 2011. This represents an increase of \$37.2 million in net unrealized gains from the \$43.7 million in net unrealized investment gains at year-end 2010. Stockholders' equity increased \$44.6 million from year-end 2010 during the first nine months of 2011. This improvement was largely due to unrealized investment gains and growth in retained earnings.

In January 2011, the stock repurchase program was extended by the Board of Directors through January 2012 to permit the purchase of up to one million of the Company's shares on the open market. During the nine months ended September 30, 2011, the Company purchased 121,241 shares of stock under this plan for \$3.7 million. Through the nine months ended September 30, 2010, the Company purchased 96,931 shares under the stock repurchase program for \$3.0 million.

During the nine months ended September 30, 2011, the employee stock ownership plan purchased 723 shares of treasury stock and sold 1,060 shares for a net change in treasury stock of less than \$0.1 million. The employee stock ownership plan held 27,890 shares of the Company's stock as of September 30, 2011.

On October 24, 2011, the Board of Directors declared a quarterly dividend of \$0.27 per share, unchanged from the prior year. This dividend will be paid on November 9, 2011 to stockholders of record as of November 3, 2011. Total stockholder dividends paid were \$9.3 million for both nine-month periods ended September 30, 2011 and 2010.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

In the most recent reporting period, financial markets have experienced increased volatility and decreased liquidity. This deterioration has been broad-based, and is reflective of heightened economic concerns on a global basis. Periods of increasing volatility and market uncertainty represent a heightened risk for all financial institutions. Such events could negatively affect the Company and policyholder activity, such as a reduction in sales, reduced investment income, increased policyholder reserves, increased policy surrenders, increased policy loans and reduced earnings. The Company has factored these risks into its risk management processes and its disclosures of financial condition.

Please refer to the Company's 2010 Form 10-K for a more complete discussion of quantitative and qualitative disclosures about market risk.

**Item 4. Controls and Procedures**

As required by Exchange Act Rule 13a-15(b), Kansas City Life Insurance Company management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation as of the end of the period covered by this report, of the effectiveness of the Company's disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report. As required by Exchange Act Rule 13a-15(d), Kansas City Life Insurance Company management, including the Chief Executive Officer

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and Chief Financial Officer, also conducted an evaluation of the Company's internal control over financial reporting to determine whether any changes

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occurred during the period covered by this report materially affected, or are reasonably likely to materially affect the Company's internal control over financial reporting. Based on that evaluation, there has been no such change during the period covered by this report.



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**Part II: Other Information**

**Item 1. Legal Proceedings**

The life insurance industry, including the Company and its subsidiaries, has been subject to an increase in litigation in recent years. Such litigation has been pursued on behalf of purported classes of insurance purchasers, often questioning the conduct of insurers in the marketing of their products.

Similarly, the Company's retail broker-dealer subsidiary is in an industry that also involves substantial risks of liability. In recent years, litigation and arbitration proceedings involving actions against registered representatives and securities products (including mutual funds, variable annuities, and alternative investments such as real estate investment products, oil and gas investments, etc.) have continued to increase. Given the significant decline in the major market indices beginning in 2008, and the generally poor performance of investments that have historically been considered safe and conservative, there is the potential for an increase in the number of proceedings to which a broker-dealer may be named as a party.

In addition to the above, the Company and its subsidiaries are defendants in, or subject to, other claims or legal actions related to insurance and investment products. Some of these claims and legal actions are in jurisdictions where juries are given substantial latitude in assessing damages, including punitive damages.

Although no assurances can be given and no determinations can be made at this time, management believes that the ultimate liability, if any, with respect to these other claims and legal actions would not have a material effect on the Company's business, results of operations or financial position.

**Item 1A. Risk Factors**

The operating results of life insurance companies have historically been subject to significant fluctuations. The factors which could affect the Company's future results include, but are not limited to, general economic conditions and the known trends and uncertainties are discussed more fully in the Company's Risk Factors included in Part I, Item 1A of the Company's 2010 Form 10-K.

**Table of Contents****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****Issuer Purchases of Equity Securities**

| Period           | Total Number of Shares Purchased Open Market/ Benefit Plans | Average Purchase Price Paid per Share | Total Number of Shares Purchased as a Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs |
|------------------|---|---------------------------------------|--|--|
| 1/1/11 - 1/31/11 | - <sup>1</sup>  | \$ -                                  | -  | 1,000,000  |
|                  | 15 <sup>2</sup>   | 32.44                                 |  |  |
| 2/1/11 - 2/28/11 | - <sup>1</sup>  | -                                     | -  | 1,000,000  |
|                  | - <sup>2</sup>  | -                                     |  |  |
| 3/1/11 - 3/31/11 | - <sup>1</sup>  | -                                     | -  | 1,000,000  |
|                  | - <sup>2</sup>  | -                                     |  |  |
| 4/1/11 - 4/30/11 | - <sup>1</sup>  | -                                     | -  | 1,000,000  |
|                  | 657 <sup>2</sup>  | 31.98                                 |  |  |
| 5/1/11 - 5/31/11 | - <sup>1</sup>  | -                                     | -  | 1,000,000  |
|                  | - <sup>2</sup>  | -                                     |  |  |
| 6/1/11 - 6/30/11 | - <sup>1</sup>  | -                                     | -  | 1,000,000  |
|                  | - <sup>2</sup>  | -                                     |  |  |
| 7/1/11 - 7/31/11 | - <sup>1</sup>  | -                                     | -  | 1,000,000  |
|                  | 388 <sup>2</sup>  | 31.15                                 |  |  |
| 8/1/11 - 8/31/11 | 16,880 <sup>1</sup>   | 30.02                                 | 16,880   | 983,120  |
|                  | - <sup>2</sup>  | -                                     |  |  |
| 9/1/11 - 9/30/11 | 104,361 <sup>1</sup>  | 30.67                                 | 104,361  | 878,759  |
|                  | - <sup>2</sup>  | -                                     |  |  |
| Total            | 122,301   |                                       | 121,241  |  |

<sup>1</sup> On January 24, 2011, the Company's Board of Directors authorized the repurchase of up to 1,000,000 shares of its common stock through January 22, 2012.

<sup>2</sup> Included in this column are the total shares purchased from the employee stock ownership plan sponsored by the Company during the consecutive months of January through September 2011.

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**Item 5. Other Information**

**3520 Broadway, Kansas City, MO 64111**

**Contact:** Tracy W. Knapp, Chief Financial Officer,  
(816) 753-7299, Ext. 8216

**For Immediate Release:** October 28, 2011, press release reporting financial results for the third quarter of 2011.

**Kansas City Life Announces Third Quarter 2011 Results**

Kansas City Life Insurance Company recorded net income of \$4.5 million or \$0.39 per share in the third quarter of 2011 and 2010. The results in 2011 were most significantly impacted by a \$7.8 million decrease in policyholder benefits, a \$4.5 million decrease in insurance revenues and a \$2.9 million increase in the amortization of deferred acquisition costs (DAC).

Net income for the nine months of 2011 was \$20.4 million or \$1.78 per share, an increase of \$5.0 million or \$0.43 per share compared with the same period in the prior year. This increase was primarily the result of a \$12.3 million decline in benefits and expenses, along with a \$6.0 million increase in total investment revenues. These improvements were partially offset by a \$12.6 million decrease in insurance revenues and a \$1.1 million increase in income tax expense. Realized investment gains, along with an increase in net investment income provided the positive contribution in total investment revenues.

Total premiums declined \$2.1 million or 4% in the third quarter and \$5.9 million or 4% in the nine-month period relative to the prior year. These changes were primarily the result of elevated sales of immediate annuities during 2010, as premiums from new immediate annuities declined \$4.8 million and \$10.7 million during these respective quarter and nine-month periods. These changes were partially offset by increases in renewal premiums of \$2.3 million or 7% in the quarter and \$3.7 million or 3% for the nine months. Life insurance and individual and group accident and health premiums were the largest contributors to the improvements in renewal premiums for both periods.

New deposits decreased \$11.6 million or 34% in the third quarter and \$2.6 million or 3% in the nine-month period versus the prior year. The changes were primarily due to declines in sales of new deferred annuities in both periods.

Total investment revenues, composed of net investment income and net realized investment gains and losses, decreased \$0.3 million or 1% for the third quarter versus one year earlier. This was largely the result of a \$1.2 million decline in the market value of an alternative investment fund. Total investment revenues increased \$6.0 million or 5% for the nine months versus one year earlier. This improvement included an increase in net investment income of \$2.7 million or 2%, as the Company experienced an increase in average invested assets and a slight increase in overall yield. In addition, the Company recorded net realized investment gains of \$2.6 million for the nine months, compared with a \$0.7 million loss in the same period last year.

Policyholder benefits decreased \$7.8 million or 17% and \$14.1 million or 10% in the third quarter and nine months, compared to the same respective periods in 2010. Most of these changes were the result of reduced additions to reserves from lower sales of immediate annuities. The increase in benefit and contract reserves, which is a component of policyholder benefits, was also unfavorably impacted by a \$3.4 million and a \$3.5 million increase in reserves for the third quarter and nine months, respectively. These unfavorable increases were the result of an increase in the liability for guaranteed minimum withdrawal benefits (GMWB) in both the third quarter and nine months. The increase in the GMWB liability value reflected unfavorable returns in the capital markets, declines in risk-free swap rates and increased market volatility. Also in the third quarter, the Company had an increase in the benefit and contract reserves due to a refinement in estimate of \$2.2 million on traditional life insurance products, the result of enhancements to the Company's valuation system.

The amortization of DAC increased \$2.9 million or 34% for the third quarter largely due to the refinement in estimate of \$2.4 million, as identified above. The amortization of DAC increased \$2.1 million or 11% for the nine months.

On October 24, 2011, the Kansas City Life Board of Directors declared a quarterly dividend of \$0.27 per share that will be paid on November 9, 2011 to stockholders of record on November 3, 2011.

Kansas City Life Insurance Company (NASDAQ: KCLI) was established in 1895 and is based in Kansas City, Missouri. The Company's primary business is providing financial protection through the sale of life insurance and annuities. The Company's revenues were \$431.4 million in 2010, and assets and life insurance in force were \$4.3 billion and \$29.7 billion, respectively, as of December 31, 2010. The Company operates in 49 states and the District of Columbia. For more information, please visit [www.kclife.com](http://www.kclife.com).



**Table of Contents****Kansas City Life Insurance Company****Condensed Consolidated Income Statement (Unaudited)**

(amounts in thousands, except share data)

|   | Quarter Ended<br>September 30 |            | Nine Months Ended<br>September 30 |            |
|---|-------------------------------|------------|-----------------------------------|------------|
|   | 2011                          | 2010       | 2011                              | 2010       |
| Revenues                                | \$ 103,271                    | \$ 108,125 | \$ 315,553                        | \$ 321,787 |
| Net income                              | \$ 4,466                      | \$ 4,456   | \$ 20,430                         | \$ 15,479  |
| Net income per share, basic and diluted | \$ 0.39                       | \$ 0.39    | \$ 1.78                           | \$ 1.35    |
| Dividends paid                          | \$ 0.27                       | \$ 0.27    | \$ 0.81                           | \$ 0.81    |
| Average number of shares outstanding    | 11,432,209                    | 11,467,605 | 11,453,124                        | 11,492,090 |

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**Item 6. Exhibits**

(a) Exhibits:

|         |  |
|---------|--|
| 31(a)   | Section 302 Certification.                             |
| 31(b)   | Section 302 Certification.                             |
| 32      | Section 1350 Certification.                            |
| 101.INS | XBRL Instance Document                                 |
| 101.SCH | XBRL Taxonomy Extension Schema Document                |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF | XBRL Taxonomy Extension Definition Document            |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document        |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

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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.

**KANSAS CITY LIFE INSURANCE COMPANY**

(Registrant)

/s/ R. Philip Bixby

R. Philip Bixby

President, Chief Executive Officer

and Chairman of the Board

/s/ Tracy W. Knapp

Tracy W. Knapp

Senior Vice President, Finance

Date: October 28, 2011