

KANSAS CITY LIFE INSURANCE CO

Form 10-K

February 28, 2013

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2012 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 1-33348

KANSAS CITY LIFE INSURANCE COMPANY

(Exact name of registrant as specified in its charter)

Missouri

44-0308260

(State or other jurisdiction of

(I.R.S. Employer

incorporation or organization)

Identification No.)

3520 Broadway, Kansas City, Missouri

64111-2565

(Address of principal executive offices)

(Zip Code)

816-753-7000

Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

Title of each class

Name of each exchange on

which registered

\$1.25 par value common stock

NASDAQ Capital Market LLC

Securities registered pursuant to section 12(g) of the Act:

None

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes

No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes

No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes

No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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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 Act).

Yes  No

At December 31, 2012, 11,032,857 shares of Kansas City Life Insurance Company's common stock par value \$1.25 were outstanding, and the aggregate market value of the common stock (based upon the average of bid and ask price according to Company records) on June 30, 2012 of Kansas City Life Insurance Company held by non-affiliates was approximately \$107,694,760.

Documents incorporated by reference: Portions of the registrant's definitive proxy statement relating to its 2013 annual meeting of shareholders (the “2013 Proxy Statement”) are incorporated by reference into Part III of this Annual Report on Form 10-K where indicated. The 2013 Proxy Statement will be filed with the U.S. Securities and Exchange Commission within 120 days after the end of the fiscal year to which this report relates.

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PART I

Item 1. Business

Amounts are stated in thousands, except share data, or as otherwise noted.

General

Kansas City Life Insurance Company (Kansas City Life) was incorporated under the assessment laws of Missouri in 1895 as the Bankers Life Association. In 1900, its present corporate title was adopted and it was reorganized as a stock life insurance company in 1903. Kansas City Life operates in 48 states and the District of Columbia.

Kansas City Life, the parent company, and wholly owned insurance subsidiaries Sunset Life Insurance Company of America (Sunset Life) and Old American Insurance Company (Old American), comprise the consolidated entity (the Company). The Company offers investment and broker-dealer services through its subsidiary Sunset Financial Services (SFS) for both proprietary and non-proprietary variable insurance products, mutual funds and other securities. The Company also has several non-insurance subsidiaries that individually and collectively are not material.

In 1974, the Company acquired Sunset Life in a stock acquisition transaction. Sunset Life is a life insurance company that was organized in 1937 that marketed and sold business in the western region of the United States. In 2006, the Sunset Life sales force was integrated into the Kansas City Life sales force by appointing Sunset Life agents as agents of Kansas City Life. All of Sunset Life's operations, administration, and accounting are consolidated as part of the Company's home office operations. Sunset Life maintains its closed 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 life, immediate annuity, and interest sensitive products, including universal life and fixed deferred annuity products. Sunset Life operates in 43 states and the District of Columbia.

In 1991, the Company acquired Old American in a stock acquisition transaction. Old American is a life insurance company that was organized in 1939. Old American sells final expense traditional life insurance products primarily to the senior market, as well as a term product targeted at younger individuals. These products are marketed 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 and independent field force and is identified as a separate segment. Old American operates in 47 states and the District of Columbia.

In 1997, the Company entered into a coinsurance assumption and servicing agreement with another insurer to acquire a block of traditional life and universal life products. Under this agreement, the Company assumed the policy liabilities as defined in the contract. Investments equal to the policy reserves are held in a trust to secure payment of the estimated liabilities relating to the policies. This closed block of policies continues to make a significant contribution to the Company's results, which are included in the Individual Insurance segment.

In 2003, the Company acquired GuideOne Life Insurance Company (GuideOne). GuideOne principally marketed traditional life and annuity products, as well as universal life and fixed deferred annuity products. In addition, the Company entered into a marketing arrangement with GuideOne Mutual Insurance Company, which allows GuideOne Mutual's agents to sell the Company's various traditional, interest sensitive, and variable life and annuity products. Subsequent to the purchase, the Company merged GuideOne into Kansas City Life as a closed block of policies.

In 2006, the Company entered into a Master General Agent and Marketing Agreement which enables American Republic Insurance Company (American Republic) agents to market Kansas City Life's insurance products. This agreement offers the Company additional distribution opportunities, while offering American Republic's agents competitive life and annuity products to strengthen their portfolio of available products in which to serve their clients.

Business Segments

The Company has three reportable business segments, which are generally 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 generated approximately 49% of consolidated insurance revenues for the year ended December 31, 2012, compared to 48% and 54% for the years ended December 31, 2011 and 2010, respectively.

The Group Insurance segment is operated as part of Kansas City Life and its administrative and accounting operations are part of the Company's home office. This segment generated 21% of consolidated insurance revenues for the year ended December 31, 2012 compared to 22% and 20% for the years ended December 31, 2011 and 2010, respectively.

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The Old American segment accounted for 30% of consolidated insurance revenues for the years ended December 31, 2012 and 2011, compared to 26% for the year ended December 31, 2010.

For more information concerning the Company's business segments, please see Note 18 - Segment Information in the Notes to Consolidated Financial Statements and the Operating Results by Segment Section in Management's Discussion and Analysis of Financial Condition and Results of Operations.

Products, Marketing and Distribution

The Company markets individual life insurance and annuity products, including traditional, interest sensitive, and variable products through its sales force and third-party marketing arrangements, as identified below. The interest sensitive products are universal life, variable universal life, fixed deferred annuities, and variable annuities. The group products marketed by the Company include life, dental, vision, and long-term and short-term disability. The Company offers investment products and broker-dealer services through SFS for both proprietary and non-proprietary variable life insurance and annuity products, mutual funds, and other securities.

The following table details the Company's gross premiums and deposits by product for the years ended December 31.

	2012	% of Total	2011	% of Total	
Individual life insurance	\$117,834	28	% \$115,316	27	%
Immediate annuities	12,497	3	% 7,151	2	%
Group life insurance	10,971	3	% 10,701	3	%
Group accident & health insurance	51,030	12	% 50,507	12	%
Other	1,060	—	% 1,335	—	%
Total premiums	193,392	46	% 185,010	44	%
Universal life insurance	96,776	23	% 95,946	23	%
Variable universal life insurance	10,984	3	% 11,682	3	%
Fixed deferred annuities	93,432	22	% 100,646	24	%
Variable annuities	26,640	6	% 25,681	6	%
Total deposits	227,832	54	% 233,955	56	%
Total	\$421,224	100	% \$418,965	100	%

The following table provides the geographic distribution of gross premiums and deposits by state greater than 5% of the total for the years ended December 31.

	2012		2011	
Missouri	8	%	Missouri	9
Texas	7	%	Texas	7
California	6	%	Kansas	6
Kansas	6	%	California	6
Colorado	6	%	Colorado	5
Florida	5	%	All others	67
All others	62	%	Total	100
Total	100	%		

Individual Insurance

The Individual Insurance segment is comprised of sales of non-group products from Kansas City Life and the closed blocks of Sunset Life, GuideOne Life, and the reinsurance transaction originated in 1997. This segment also includes sales from third-party marketing arrangements, including American Republic and GuideOne Mutual. This segment offers an array of traditional whole life, term life, and universal life products, along with fixed deferred and immediate annuity products, and variable universal life and annuity products.

Products are marketed through a nationwide sales force of independent general agents, agents, and third-party marketing arrangements. These general agents and agents are contracted individually and are not exclusive with Kansas City Life. The





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Company does not restrict general agents or agents to designated sales territories. Kansas City Life provides commissions and allowances based on sales results. In addition, the Company has had selected occasions to use additional third-party arrangements for product specific or market niche sales opportunities.

Kansas City Life offers a portfolio of life insurance products for individuals. Universal life products have the ability to deliver flexibility in coverage and competitive long-term cash values or premiums that guarantee coverage for a desired period or through the insured's lifetime. Kansas City Life also offers variable universal life products that allow the policyholder to participate in the equity markets. Variable universal life combines the advantages of a range of investment options with life insurance. In addition, Kansas City Life offers traditional whole life products, products geared towards juveniles that offer additional coverage as the child ages, and term life insurance products for a wide range of ages and coverage.

Kansas City Life offers multiple fixed deferred annuity products. In addition, Kansas City Life offers immediate annuity products with a broad variety of payout options, including guaranteed specified amounts and life contingencies. Kansas City Life also offers variable annuity products which allow the policyholder to participate in equity market growth potential. These options include either single or flexible-premium contracts combined with the advantages of a range of investment options and the advantages of an annuity.

Finally, in both the individual life insurance products and annuity products, selected riders are also available for added coverage and protection.

The following table details gross premiums and deposits by product for the Individual Insurance segment for the years ended December 31.

	2012	% of Total	2011	% of Total	
Individual life insurance	\$46,262	16	% \$46,597	16	%
Immediate annuities	12,497	4	% 7,151	3	%
Other	285	—	% 405	—	%
Total premiums	59,044	20	% 54,153	19	%
Universal life insurance	96,776	34	% 95,946	33	%
Variable universal life insurance	10,984	4	% 11,682	4	%
Fixed deferred annuities	93,432	33	% 100,646	35	%
Variable annuities	26,640	9	% 25,681	9	%
Total deposits	227,832	80	% 233,955	81	%
Total	\$286,876	100	% \$288,108	100	%

The following table provides the geographic distribution of gross premiums and deposits by state greater than 5% of the total for the Individual Insurance segment for the years ended December 31.

	2012		2011		
California	7	%	Missouri	9	%
Missouri	7	%	Kansas	7	%
Colorado	7	%	Colorado	7	%
Florida	7	%	California	7	%
Kansas	6	%	Texas	6	%
Texas	6	%	Washington	5	%
Washington	5	%	Iowa	5	%
All others	55	%	All others	54	%
Total	100	%	Total	100	%

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## Closed Blocks

The Company has closed blocks of business that are primarily from three sources. First, the Company has sizeable blocks of business obtained through the acquisition of certain companies such as Sunset Life and GuideOne. Second, the Company completed a sizeable reinsurance assumption transaction as described previously. Third, the Company may determine that it no longer intends to actively market selected products or to continue to remain active in certain niche markets. These closed blocks of business decline in premiums and deposits and insurance in force over time. However, the Company seeks to actively conserve this business. The types of products included in the Company's closed blocks are traditional life, immediate annuities, universal life, fixed deferred annuities, and individual accident and health. At December 31, 2012, 6% of total premiums and 17% of total deposits were from closed blocks.

## Group Insurance

Kansas City Life offers a range of group products. The group portfolio has two primary markets, groups with two to nine employees and groups with ten or more employees. This segment's marketing focus is to create a range of products in the group life, dental, long-term and short-term disability areas, as well as vision products. This segment primarily uses two marketing approaches. The first is to market business using Kansas City Life's internal sales representatives and an independent general agent and agent field force. The second is through independent third-party arrangements, whereby business sold through these arrangements is primarily administered by the third parties.

The Group Insurance segment tailors products and services to employees' needs depending upon such factors as the following:

Employer contributions towards the cost of coverage;

Employee participation levels;

Benefits desired versus product cost;

Number of employees; and

Plan design features, such as coinsurance percentages, deductibles, waiting periods, plan maximums, and more.

This segment also assists employers using its flexible plan design for its group life product, which can include many features such as:

Spouse and dependent benefits;

Annual enrollments;

Accidental death and dismemberment and waiver of premium benefit coverage; and

Policy conversion and portability privileges.

The following table details gross premiums by product for the Group Insurance segment for the years ended December 31.

	2012	% of Total	2011	% of Total	
Group life insurance	\$10,971	18	% \$10,701	18	%
Group dental insurance	27,194	44	% 28,497	47	%
Group disability insurance	21,819	35	% 19,882	32	%
Other group insurance	2,017	3	% 2,128	3	%
Total	\$62,001	100	% \$61,208	100	%

The following table provides the geographic distribution of gross premiums by state greater than 5% of the total for the Group Insurance segment for the years ended December 31.

	2012		2011		
Missouri	10	%	Missouri	10	%
Texas	8	%	Texas	9	%
North Carolina	7	%	North Carolina	7	%
Indiana	6	%	Georgia	6	%
All others	69	%	Indiana	5	%
Total	100	%	Pennsylvania	5	%
			All others	58	%
			Total	100	%



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## Old American

Old American sells final expense traditional life insurance products. This segment is marketed through a nationwide general agency sales force with exclusive territories, using direct response marketing to supply agents with leads. The Company manages the territories based upon production and directly supports and subsidizes general agent managers and agents with marketing leads and allowances based upon sales results. The Old American segment consists of individual insurance products designed primarily as final expense products for the senior market. Agents primarily market to individuals in the age range of 50 to 85, principally through final arrangements planning.

Old American offers several products geared primarily towards supporting policyholders' final expense needs. This segment offers final expense products, including preferred products with guaranteed level death benefits for individuals in good health, and sub-standard products with graded or increasing benefits for those individuals who cannot qualify for standard or preferred risk due to health issues. Old American also offers a juvenile product designed for parents or grandparents to insure children of ages up to 15 and a term life insurance product to individuals ages from 20 to 65. Old American also offers several riders, including accidental death and dismemberment and waiver of premium. All of Old American's products are traditional individual life insurance products.

Old American has focused on expanding its sales territories, recruiting, and agent productivity for its general agencies in order to effectively meet the sales goals of the Company. Furthermore, this segment seeks to expand its target market to include younger individuals by offering additional insurance products, as described above. Finally, a main driving force behind Old American's sales efforts is the approach to support its field force through its lead generation efforts.

The following table provides the geographic distribution of gross premiums by state greater than 5% of the total for the Old American segment for the years ended December 31.

	2012			2011	
Texas	7	%	Missouri	7	%
Missouri	7	%	Texas	7	%
California	6	%	Illinois	6	%
Illinois	6	%	California	5	%
All others	74	%	Kansas	5	%
Total	100	%	All others	70	%
			Total	100	%

## Reinsurance

Consistent with the general practice of the life insurance industry, the Company enters into traditional agreements of indemnity reinsurance with other insurance companies to support sales of new products and the in force business. The reinsurance arrangements have taken various forms over the years. The Company has reinsurance in force on all of the following bases: automatic and facultative; yearly renewable term (YRT) and coinsurance; and excess and quota share basis. For additional information pertaining to the Company's significant reinsurers, along with additional information pertaining to reinsurance, please see Note 15 - Reinsurance in the Notes to Consolidated Financial Statements.

Currently, new sales of traditional life and universal life products are reinsured on a YRT basis in excess of the Company's retention limits, while sales of certain term life insurance products are reinsured on a quota share (a portion of each policy is reinsured) coinsurance basis. Sales of group disability income products are reinsured on a quota share coinsurance basis. New group life sales are reinsured on an excess of retention basis, with the accidental death and dismemberment benefits being 100% reinsured. During 2012, the Company's maximum retention limit was five hundred thousand dollars on individual life products and one hundred thousand dollars on group life business. During 2011, the Company's maximum retention limit on individual life insurance products was three hundred fifty thousand dollars and one hundred thousand dollars on group life business.

In addition to reinsurance coverage for new business, the Company has also engaged in various reinsurance arrangements for in force blocks of business:

-

In 1991, the Company purchased Old American Insurance Company. Old American had an existing coinsurance agreement in place that ceded on a 100% coinsurance basis certain whole life policies issued by Old American prior to December 1, 1986. These policies had life insurance in force of \$29.6 million at December 31, 2012 (2011 - \$32.9 million) with a ceded reserve for future policy benefits under this agreement of \$16.7 million (2011 - \$18.3 million).

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In 1997, the Company acquired a block of traditional life and universal life products by way of a coinsurance and servicing agreement with another insurer. Investments equal to the statutory policy reserves are held in a trust to secure payment of the estimated liabilities relating to the policies. At December 31, 2012, the block had \$1.2 billion of life insurance in force (2011 - \$1.3 billion) and a reserve of \$198.2 million (2011 - \$208.0 million).

In 1998, Old American executed a coinsurance agreement ceding 100% of its retained risk on a closed block of individual accident and health business. At December 31, 2012, the reserve credit on these policies was \$9.1 million (2011 - \$11.2 million).

In 2002, Sunset Life entered into a yearly renewal term bulk reinsurance agreement whereby it ceded 80% of its retained mortality risk on traditional and universal life policies. This was accomplished through a reinsurance pool involving four primary reinsurers. In June, 2012, Sunset Life recaptured approximately 9% of the outstanding bulk reinsurance agreement. The net impact of this recapture event to the Consolidated Statements of Comprehensive Income was less than \$0.5 million. At December 31, 2012, the ceded insurance in force was approximately \$1.1 billion (2011 - \$1.3 billion) with reserves of \$4.0 million (2011 - \$4.7 million).

### Governmental Regulations

The Company is subject to state regulations in its states of domicile and in the states in which it does business. Although the federal government generally does not regulate the business of insurance, federal initiatives often have an impact on the business in a variety of ways, including the taxation of insurance companies and the tax treatment of insurance products. In addition, the Company is a stock life insurance company and is subject to the rules and regulations of the United States Securities and Exchange Commission (SEC). SFS is a registered broker-dealer, which is regulated by the Financial Industry Regulatory Authority (FINRA) and the SEC.

### State Regulation

State insurance laws establish extensive regulation and supervisory agencies with broad regulatory authority, including the power to:

- Grant and revoke licenses to companies to transact business and to license agents;
- Regulate and supervise trade practices and market conduct;
- Establish guaranty associations which levy mandatory fees used for insurers with solvency issues;
- Approve policy forms, advertising, and marketing materials;
- Establish reserve requirements;
- Prescribe the form and content of required financial statements and reports;
- Determine the reasonableness and adequacy of statutory capital and surplus;
- Perform financial, market conduct, and other examinations;
- Define acceptable accounting principles for statutory reporting purposes;
- Regulate the type and amount of permitted investment activity; and
- Limit the amount of dividends that can be paid without prior regulatory approval.

The Company's life insurance entities are subject to periodic examinations by state regulatory authorities. Financial statements are prepared and examined on a basis other than U.S. generally accepted accounting principles (GAAP), namely statutory accounting principles. The most recently completed examination performed by the State of Missouri occurred as of December 31, 2009 for Kansas City Life, Sunset Life, and Old American. There were no adjustments recommended to any of the insurance companies as a result of that examination.

The National Association of Insurance Commissioners (NAIC) has received regulatory authority by the respective state departments of insurance. Accordingly, the NAIC has been able to establish more consistency for insurers with regard to financial reporting requirements. In one such measure, the NAIC has adopted risk-based capital (RBC) guidelines to assist in the evaluation of the adequacy of statutory capital and surplus in relation to an insurance company's risks. RBC requirements are intended to be used by insurance regulators as an early warning tool to identify deteriorating or weakly capitalized insurance companies for the purpose of initiating regulatory action. RBC guidelines consist of target statutory surplus levels based on the relationship of statutory capital and surplus to the sum

of weighted risk exposures. At December 31, 2012 and 2011, the statutory capital and surplus of each of the Company's insurance entities was substantially above the required levels. The NAIC continues to assess solvency issues and makes recommendations to enhance the existing guidelines, such as solvency modernization and own risk and solvency assessment (ORSA). While the Company is not subject to these regulations, it continues to monitor them for ongoing developments.

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The Company and its insurance subsidiaries have received inquiries from a number of state regulatory authorities regarding its use of the U.S. Social Security Administration's Death Master File ("Death Master File") and its compliance with state unclaimed property and escheatment laws. Certain states have proposed, and many other states are considering, new legislation and regulations related to unclaimed life insurance benefits and the use of the Death Master File in the claims process. It is possible that audits and/or the enactment of new state laws could result in identifying payments to beneficiaries more quickly than under the current legislative and regulatory standards established for life insurance claims or may provide for additional escheatment of funds deemed abandoned under state laws. The audits could also result in administrative penalties. Given the legal and regulatory uncertainty in this area, it is also possible that life insurers, including the Company, may be subject to claims concerning their business practices. West Virginia, for example, has initiated litigation against a large number of life insurance companies. Under insurance solvency or guaranty laws in most states in which the Company operates, insurers doing business can be assessed for policyholder losses related to insolvencies of other insurance companies. The amount and timing of any future assessments on the Company under these laws cannot be reasonably estimated and are beyond the control of the Company. For the three years ended December 31, 2012, the Company's assessments, net of related premium tax credits, were not material.

### Federal Regulation

The federal government does not directly regulate the business of insurance. However, the federal government does regulate through legislation and administrative policies several aspects of the business including but not limited to:

- The Sarbanes-Oxley Act (SOX) regarding financial reporting internal controls;
- Pension regulations and other qualified retirement plans such as 401(k) plans;
- Certain employer hiring considerations, specifically including but not limited to race, age, and sexual discrimination;
- The sale of securities and investment-related products;
- Corporate and individual taxation;
- Prescribe the form and content of required financial statements and reports;
- Define acceptable accounting principles for reporting purposes;
- Health care reform; and
- Other federal initiatives.

In addition, legislation which has been passed and is also being contemplated could result in the federal government assuming some role in the regulation or oversight of insurance companies. Specifically, the Dodd-Frank Wall Street Reform and Consumer Protection Act may enhance and expand the federal government's role in insurance company regulation.

As a publicly traded stock life insurance entity, the Company is also subject to the SEC's regulations for such items as financial reporting requirements, accounting rules, public disclosure of accounting practices and policies, internal control regulations as defined under SOX, a wide variety of governance considerations promulgated under proxy statements and proxy disclosure related matters, and other items as may be enacted by legislation. These regulations place an expanded burden on insurance companies both in financial aspects as well as the timely filing and reporting of items covered under each of these requirements. In addition, future enactments may have a material impact on the Company, depending upon the regulation and its requirements.

Life insurance companies are taxed under the life insurance company provisions of the Internal Revenue Code of 1986, as amended (the Code). Provisions of the Code have various impacts on the Company and changes to the Code that may be enacted in the future could also negatively impact the Company's net income and stockholders' equity. Certain securities policies, contracts, and annuities offered through SFS are subject to regulation under the federal securities laws administered by the SEC and FINRA. Federal securities laws contain regulatory restrictions and criminal, administrative, and private remedial provisions related to the offering of these products. From time to time, the SEC and FINRA examine or investigate the activities of broker-dealers and investment advisors. These examinations often focus on the activities of registered principals, registered representatives and registered investment advisors doing business through that entity. It is possible that the results of any examination may lead to changes in systems or procedures, payments of fines and penalties, payments to customers, or a combination thereof.



### Competition and Ratings

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 products, 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. General economic conditions may affect future results. Many of the Company's competitors are considerably larger and have substantially greater financial resources, have higher ratings from rating agencies, have broader and more diversified product lines, and have more agency relationships.

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The Company's insurance products compete with a wide variety of other products, including products from other insurance companies, financial intermediaries, and other institutions. In addition, competition arises from a number of features, including crediting rates, policy terms and conditions, service provided to distribution channels and policyholders, ratings reputation, and agent compensation. Insurance products also compete with products offered from mutual funds; traditional bank investments; and other investment and retirement funding alternatives offered by asset managers, banks, and broker-dealers.

The sales agents for the Company's products use the financial strength ratings assigned to an insurer by independent rating agencies as one factor in their sales materials. The market has generally been influenced by those insurers with the highest ratings. However, the degree to which ratings and changes in ratings affect sales and persistency cannot be definitively measured.

Following is a summary of the Company's insurance ratings and outlook for the three insurance companies, as assigned by the A. M. Best Company, which is an independent rating agency.

	2012	2011	2010
Kansas City Life	A (Excellent) Stable	A (Excellent) Stable	A (Excellent) Stable
Sunset Life	A- (Excellent) Stable	A- (Excellent) Stable	A (Excellent) Stable
Old American	B++(Good) Stable	B++(Good) Positive	B++(Good) Positive

Financial strength ratings generally involve quantitative and qualitative evaluations by rating agencies of a company's financial condition and operating performance. Generally, rating agencies base their ratings upon information furnished to them by the insurer and upon their own investigations, studies, and assumptions. Ratings are based upon factors of concern to policyholders, agents, and intermediaries and are not directed toward the protection of investors and are not recommendations to buy, sell, or hold securities.

In addition to the financial strength ratings, rating agencies use an "outlook statement" to indicate a medium or long-term trend which, if continued, may lead to a rating change. A positive outlook indicates a rating may be raised and a negative outlook indicates a rating may be lowered. A stable outlook is assigned when ratings are not likely to be changed. Outlook statements should not be confused with expected stability of the issuer's financial or economic performance. A rating may have a stable outlook to indicate that the rating is not expected to change, but a stable outlook does not preclude a rating agency from changing a rating at any time without notice.

A. M. Best Company ratings currently range from "A++" (Superior) to "F" (In Liquidation), and include 16 separate ratings categories. Within these categories, "A++" (Superior) and "A+" (Superior) are the highest, followed by "A" (Excellent) and "A-" (Excellent), then followed by "B++" (Good) and "B+" (Good). A. M. Best Company reviews its ratings of insurance companies from time to time. There can be no assurance that any particular rating will continue or that it will not be changed or withdrawn entirely if, in its judgment, circumstances so warrant.

Employees

The Company had 443 full-time employees at December 31, 2012. The Company experienced no work stoppages or strikes and considers relations with its employees to be good. None of the Company's employees are represented by a union.

Access to Public Filings

Additional information about the Company beyond what is included in this Form 10-K is available at the Company's website: [www.kclife.com](http://www.kclife.com). You may also read and copy these materials at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549, or obtain them by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet website that contains reports, proxy and other information statements and other information regarding issuers that file electronically with the SEC at [www.sec.gov](http://www.sec.gov). You may also access the SEC website through a link on the Company's website. The Company will provide a copy of any of those reports free of charge upon request. None of the information on the Company's website that is not otherwise expressly set forth or incorporated by reference in the Form 10-K is a part of this Form 10-K.

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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 which are discussed more fully below.

Strategic, Product, and Operational Risks:

The Company operates in a mature, highly competitive industry, which could limit its ability to grow sales or maintain its position in the industry and negatively affect profitability.

Life insurance is a mature and highly competitive industry. The Company encounters significant competition in all lines of business from other insurance companies, many of which have greater financial resources, a greater market share, a broader range of products, lower product prices, better name recognition, greater actual or perceived financial strength, higher claims-paying ratings, the ability to assume a greater level of risk, lower operating or financing costs, or lower profitability expectations.

Changes in competition and the business environment could negatively affect the Company's ability to maintain or increase its profitability.

In recent years, there has been substantial consolidation and convergence among companies in the financial services industry, resulting in increased competition from large, well-capitalized financial services firms. Furthermore, many of these larger competitors may have lower operating costs and an ability to absorb greater risk while maintaining their financial strength ratings, thereby allowing them to price their products more competitively. The Company expects consolidation to continue, thereby increasing competitive pressures.

Changes in demographics, particularly the aging of the population and the decline in the number of agents in the industry, affect the demand for life insurance products. Also, as technology evolves, customers and agents may be able to compare products of any particular company with any other, which could lead to increased competition as well as changes in agent or customer behavior, including persistency that differs from past behavior.

The Company may be unable to attract agencies and sales representatives.

The Company sells insurance and annuity products through independent agents and agencies. These agencies and sales representatives are not captive and may sell products of the Company's competitors. The Company's ability to compete is dependent upon, among other things, its ability to attract agents and agencies to market its insurance products, its ability to develop competitive and profitable products, its ability to control unit cost growth, and its maintenance of strong financial strength ratings. Sales and the results of operations and financial condition could be adversely affected if the Company is unsuccessful in attracting agencies and sales representatives.

The Company's ability to retain agents and sales representatives is dependent upon a number of factors including: the ability of the Company to maintain a competitive compensation system while also offering products with competitive features and benefits for policyholders; the ability to maintain a level of service and support activities that effectively support the agent and sales representative needs; and the ability to approve and monitor agent and sales representative sales and business practices that are consistent with regulatory requirements and expectations of the Company.

The Company's ability to maintain competitive unit costs is dependent upon the level of new sales.

The Company's ability to maintain competitive unit costs is dependent upon a number of factors, such as the level of new sales, persistency (continuation or renewal) of existing business, and expense management. A decrease in sales or the amount of total existing business or deterioration in the profitability of the existing business without a corresponding reduction in expenses may result in higher unit costs, which would affect the Company's operating results.

The Company's policy claims fluctuate from period to period, resulting in earnings volatility.

The Company's financial results may fluctuate from period to period due to fluctuations in policy claims incurred by the Company. However, the Company reinsures a significant amount of the mortality risk on fully underwritten and newly issued individual life insurance contracts. The Company regularly reviews retention limits for continued appropriateness and these limits may be changed in the future. If the Company was to experience significant adverse mortality or morbidity experience, it is expected that a significant portion of that expense would be reimbursed by reinsurers.



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The Company's results may be negatively affected should actual experience differ from management's assumptions and estimates.

The Company makes certain assumptions regarding mortality, persistency, expenses, interest rates, tax liability, business mix, policyholder behavior, or other factors appropriate for the type of business results it expects to experience in future periods. These assumptions are also used to estimate the amounts of deferred acquisition costs (DAC), value of business acquired (VOBA), policy reserves and accruals, future earnings, and various components of the Company's Consolidated Balance Sheets. These assumptions are used in the operations of the Company's business in making decisions crucial to the success of the Company, including the pricing of products and expense structures relating to products. The Company's actual experience and changes in estimates are reflected in the Company's financial statements. The Company's actual experience may vary from period to period and from established assumptions, potentially resulting in variability in the financial statements.

Assumptions and estimates involve judgment and are subject to changes and revision over time.

The calculations the Company uses to estimate various components of its financial statements are complex and involve analyzing and interpreting large quantities of data. The Company employs various techniques for such calculations and, from time to time, will develop and implement more sophisticated systems and procedures to facilitate calculations and improve estimates. Accordingly, the Company's results may be affected, positively or negatively, by actual results differing from assumptions, by changes in estimates, and by changes resulting from implementing new administrative systems and procedures.

The Company's reserves for future policy benefits may prove to be inadequate.

The Company establishes and carries a reserve liability based on estimates of how much will be needed to pay for future benefits and claims. The assumptions and estimates used in connection with establishing and carrying reserves are inherently uncertain and in some cases are mandated by regulators. If actual experience is significantly different from assumptions or estimates or if regulators decide to increase or change regulations, reserves may prove to be inadequate in relation to estimated future benefits and claims. As a result, a charge to earnings would be incurred in the quarter in which the Company increases reserves.

The amortization of DAC and VOBA may change, impacting both the level of the asset and the timing of the Company's net income.

Amortization of DAC and VOBA depends on the actual and expected profits generated by the lines of business that incurred the costs. Expected profits are dependent on assumptions regarding a number of factors, including investment returns, benefit payments, expenses, mortality, and policy lapse. Due to the nature of the business, the Company cannot anticipate the exact pattern of profit emergence. As a result, amortization of DAC and VOBA will vary from period-to-period as actual profits replace expected profits and future expected profits are re-projected based on management's best estimates as of the reporting dates. To the extent that actual experience emerges less favorably than expected or expectations for future profits decrease, the DAC and VOBA assets may be reduced. This would likely result in increased amortization and reduced profitability in the current period.

The Company is dependent on the performance of others.

The Company's results may be affected by the performance of others because the Company has entered into various arrangements involving other parties. For example, most of the Company's products are sold through independent distribution channels, and variable universal life and annuity deposits are invested in funds managed by third parties. Additionally, the Company's operations are dependent on various technologies, some of which are provided by other parties.

As with all financial services companies, the Company's ability to conduct business is dependent upon consumer confidence in the industry and its products. Actions of competitors and financial difficulties of other companies in the industry could undermine consumer confidence and adversely affect retention of existing business and future sales of the Company's insurance and investment products.

Risk management policies and procedures may leave the Company exposed to unidentified or unanticipated risk, which could negatively affect business or result in losses.

The Company has devoted significant resources to develop risk management policies and procedures and will continue to do so in the future. However, the Company's policies and procedures used to identify, monitor, and

manage risks may not be fully effective. Many of the methods of managing risk and exposures are based upon the use of observed historical policyholder and market behavior or statistics based on historical models. As a result, these methods may not effectively identify or evaluate the magnitude of existing or future exposures, which could be significantly greater than the historical measures indicate. An example of such risks includes the risk of pandemics, which could cause a large number of deaths. Other risk management methods depend upon the evaluation of information regarding markets, agents, clients, catastrophe occurrence, or other matters that are publicly available or otherwise accessible to us. This information may not always be accurate, complete, up-to-date, or properly evaluated.

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Management of operational, legal, and regulatory risks requires, among other things, policies and procedures to record properly and verify a large number of transactions and events, and these policies and procedures may not be fully effective. Additional risks and uncertainties not currently known or that the Company currently deems to be immaterial may adversely affect the business, financial condition, and/or operating results.

A rating downgrade could adversely affect the Company's ability to compete and increase the number or value of policies surrendered.

The Company's financial strength rating, which is intended to measure its ability to meet policyholder obligations, is an important factor affecting public confidence in most of the Company's products and, as a result, the Company's competitiveness. Rating organizations periodically review the financial performance and condition of insurers, including the Company, and downgrades of insurance companies occur frequently.

A downgrade in the Company's rating could adversely affect the Company's ability to sell its products, retain existing business, and compete for attractive acquisition opportunities. Rating organizations assign ratings based upon several factors. While most of the factors relate to the rated company, some of the factors relate to the views of the rating organization, general economic conditions, and circumstances outside the rated company's control. In addition, rating organizations use various models and formulas to assess the strength of a rated company, and from time to time rating organizations have, in their discretion, altered the models. Changes to the models could impact the rating organizations' judgment of the rating to be assigned to the rated company. The Company cannot predict what actions rating organizations may take or what actions the Company may be required to take in response to the actions of the rating organizations, which could adversely affect the Company.

The Company may be unable to complete additional acquisitions.

One of the Company's growth strategies is to acquire other life insurance companies and/or blocks of business. The Company's previous acquisitions have increased earnings by allowing the Company to realize certain operating efficiencies or increase sales. There can be no assurance, however, that suitable acquisitions presenting opportunities for continued growth and operating efficiencies will continue to be available to the Company. Further, sufficient capital to fund acquisitions may not be available at the time opportunities become available.

The Company may not realize its anticipated financial results from its acquisitions.

The completion of an acquisition may be more costly or take longer than expected. There may be unforeseen liabilities that arise in connection with businesses that the Company acquires. Additionally, in connection with its acquisitions, the Company assumes or otherwise becomes responsible for the obligations of policies and liabilities of other insurers. Any regulatory, legal, financial, or other adverse development affecting the other insurer could also have an adverse effect on the Company.

### Investment and Asset/Liability Management Risks:

The Company's investments are subject to market and credit risks.

The Company's invested assets, primarily including fixed income securities, are subject to customary risks of credit defaults and changes in fair value. The value of the Company's commercial mortgage loan and real estate portfolios also depend on the financial condition of the tenants occupying the properties which the Company has financed.

Factors that may affect the overall default rate on and fair value of the Company's invested assets include interest rate levels and changes, availability and cost of liquidity, financial market performance, and general economic conditions, as well as particular circumstances affecting the businesses of individual borrowers and tenants.

Interest rate fluctuations could negatively affect the Company's spread income or otherwise impact its business.

Interest rate fluctuations or sustained low interest rate environments could negatively affect earnings because the profitability of certain products depends in part on interest rate spreads. These products include fixed annuity, interest-sensitive whole life, universal life, and the fixed portion of variable universal life insurance business. Changes in interest rates or sustained low interest rate environments may reduce both the profitability and the return on invested capital.

Some of the Company's products, principally fixed annuities, interest-sensitive whole life, universal life, and the fixed portion of variable universal life insurance have interest rate guarantees that expose the Company to the risk that changes in interest rates will reduce the spread, or the difference between the amounts the Company is required to credit to policyholder contracts and the amounts earned by the Company on general account investments. Declines in

spread or instances where the returns on the general account investments are not sufficient to support the interest rate guarantees on these products could have a material adverse effect on the results of operations. In periods of increasing interest rates, the Company may not be able to replace the assets in the general account with higher yielding assets needed to fund the higher crediting rates that may be necessary to keep interest sensitive

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products competitive. The Company, therefore, may have to accept a lower spread and profitability or face a decline in sales, loss of existing contracts from non-renewed maturities, early withdrawals, or surrenders. In periods of declining interest rates, the Company has to reinvest the cash received from interest or return of principal on investments in lower yielding instruments than available. Moreover, issuers of fixed-income investment securities and borrowers related to the Company's commercial mortgage investments may prepay these obligations in order to borrow at lower market rates, which may exacerbate the risk for the Company of having to reinvest at lower rates. The Company is entitled to reset the interest rates it credits on fixed-rate annuities. Because many of the Company's policies have guaranteed minimum interest or crediting rates, spreads could decrease and potentially become negative. Increases in interest rates may cause increased surrenders and withdrawals of insurance products. In periods of increasing interest rates, policy loans and surrenders and withdrawals of life insurance policies and annuity contracts may increase as policyholders seek to buy products with higher returns. These outflows may require investment assets to be sold at a time when the prices of those assets are lower because of the increase in market interest rates, which may result in realized investment losses.

Changes in interest rates may also impact the business in other ways. Lower interest rates may result in lower sales of certain of the Company's insurance products. Higher interest rates may create a less favorable environment for the origination of mortgage loans. Higher interest rates may also result in lower sales of variable products. Further, higher interest rates may result in significant unrealized losses on investments, which could cause changes in agent and policy retention and new product sales.

While the Company develops and maintains asset/liability management programs and procedures designed to mitigate the effect on spread income in rising or falling interest rate environments, no assurance can be given that changes in interest rates will not affect such spreads. Additionally, the Company's asset/liability management programs incorporate assumptions about the relationship between short-term and long-term interest rates (i.e., the slope of the yield curve) and relationships between risk-adjusted and risk-free interest rates, market liquidity, and policyholder behavior in periods of changing interest rates and other factors. The effectiveness of the Company's asset/liability management programs and procedures may be negatively affected whenever actual results differ from these assumptions.

Prolonged periods of low interest rates can affect policyholder behavior and negatively impact earnings.

As interest rates decline, policyholders may become more likely to extend the retention or duration of fixed-rate products previously purchased and may seek alternatives to fixed-rate products for new purchases. Many of the products sold in earlier periods may have minimum guaranteed interest crediting rates or other features that are greater than those being offered in the current low interest rate environment. Additionally, cash flows from existing investments, including interest and principal payments, may be reinvested at lower interest rates relative to prior periods. As a result, a prolonged low interest rate environment can result in significant changes to cash flows, lower investment income, compressed product spreads, reduced earnings, and increased surplus strain. In addition, the Company may change its risk profiles in regards to selecting investment opportunities to reduce the impact on earnings.

The change from a low interest rate environment to an environment of increasing interest rates can affect policyholder behavior and negatively impact earnings.

The change from a period of low interest rates to a period of significantly higher and increasing interest rates may cause policyholders to surrender policies or to make early withdrawals in order to maximize their returns.

Accordingly, the Company may become more susceptible to increased surrenders and withdrawals on policies as surrender charges and other features that help protect the Company from increased or unexpected policyholder withdrawals or lapses. Increases in policyholder surrenders, withdrawals, or lapses could negatively affect the Company's operating results.

The Company's valuation of fixed maturity and equity securities may include methodologies, estimations, and assumptions and could result in changes to investment valuations that may have a material adverse effect on the results of operations or financial condition.

Fixed maturity securities, equity securities, and short-term investments are reported at fair value in the Consolidated Balance Sheets and represent the majority of total cash and invested assets. Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820 establishes a three-level hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The level in the fair value hierarchy is based on the priority of the inputs to the respective valuation technique. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and lowest priority to unobservable inputs (Level 3). An asset or liability's classification within the fair value hierarchy is based on the lowest level of input that is significant to its valuation.

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During periods of market disruption, including periods of significantly rising or high interest rates, rapidly widening credit spreads or illiquidity, it may be difficult to value certain securities if trading becomes less frequent and/or market data becomes less observable. There may be certain asset classes that were previously acquired and valued in active markets with significant observable data that are now valued in illiquid markets with little observable data. In such cases, more securities may be classified in Level 3 and, therefore, require more subjectivity and management judgment. As such, valuations may include inputs and assumptions that are less observable or require greater estimation as well as valuation methods which are more complex or require increased estimation, thereby resulting in values which may have greater variance from the value at which the investments may or could be ultimately sold. Further, rapidly changing credit and equity market conditions could materially impact the valuation of securities as reported in the consolidated financial statements, and the period-to-period changes in value could vary significantly. Decreases in value could have a material adverse effect on the Company's results of operations or financial condition. Equity market volatility could negatively impact the Company's profitability.

The Company is exposed to equity market volatility in the following ways:

The Company has exposure to equity price risk through investments, but this exposure is limited due to the relatively small equity portfolio held during the periods presented.

The Company earns investment management fees and mortality and expense fee income based upon the value of assets held in the Company's separate accounts. Revenues from these sources fluctuate with changes in the fair value of the separate accounts.

Volatility in equity markets may discourage purchasers of variable universal life and annuity products that have returns linked to the performance of the equity markets and may also result in existing customers withdrawing cash values or reducing investments in those products.

The Company has equity price risk to the extent that it may affect the liability recognized under guaranteed minimum death benefits and guaranteed minimum withdrawal benefit provisions of the variable contracts. Periods of significant and sustained downturns in equity markets, increased equity volatility or reduced interest rates could result in an increase in the valuation of the future policy benefit or policyholder account balance liabilities associated with such products, which ultimately results in a reduction to net income.

The amortization of DAC relating to variable products can fluctuate with changes in the performance of the underlying separate accounts.

The determination of the amount of realized and unrealized impairments and allowances established on the Company's investments is highly subjective and could materially impact results of operations or financial position.

The determination of the amount of impairments and allowances varies by investment type and is based upon the Company's evaluation and assessment of known and inherent risks associated with the respective asset class. Such evaluations and assessments are revised as conditions change and new information becomes available. There can be no assurance that the assumptions, methodologies, and judgments employed in these evaluations and assessments will be accurate or sufficient in later periods. As a result, additional impairments may need to be realized or allowances provided in future periods. Further, historical trends may not be indicative of future impairments or allowances.

Additionally, the Company considers a wide range of factors about security issuers and uses its best judgment in evaluating the cause of the decline in the fair value of the security and in assessing the prospects for recovery. Inherent in management's evaluation of the security are assumptions and estimates about the operations of the issuer, its future earnings potential, and the ability and timeliness of the security's recovery in fair value.

The Company could be forced to sell investments at a loss to meet policyholder withdrawals.

Many of the products offered by the Company allow policyholders and contract holders to withdraw their funds under defined circumstances. The Company manages liabilities and attempts to align the investment portfolio so as to provide and maintain sufficient liquidity to support anticipated withdrawal demands, contract benefits, and maturities. While the Company owns a significant amount of liquid assets, a certain portion of investment assets are relatively illiquid. If the Company experiences unanticipated withdrawal or surrender activity, the Company could exhaust all other sources of liquidity and be forced to liquidate assets, perhaps on unfavorable terms. If the Company is forced to dispose of assets on unfavorable terms, it could have an adverse effect on the Company's results of operations and financial condition.



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The Company invests in certain low income housing real estate properties specifically to generate state and federal tax credits. These tax credits have become targets of regulatory bodies to reduce the available tax credits. Additionally, economic forces may negatively impact the ongoing performance of these investments.

In recent periods, both the state and federal governments have offered selected tax credits for low income housing real estate properties. These tax credits have become the targets of certain regulators to either reduce or to eliminate the available credits that companies can receive. The willingness of regulators to reduce or eliminate these available credits could have a negative impact on the Company's tax strategy. In addition, the economic environment may negatively impact the operating performance of these properties and result in either losses for these properties or tax credit recapture to the holders of these credits. Accordingly, these items may negatively impact or impair the value of the properties or the current or future ability to realize or maintain tax credits previously recognized or tax credits to be realized in the future.

The Company's mortgage loan investments are subject to default and volatility in performance.

As an asset class, mortgage loans have experienced heightened delinquency and default risk in certain historical periods due to difficult economic conditions. These conditions may result in a negative impact on the performance of the underlying collateral, resulting in declining values and volatility in the ability of the holders to repay these instruments. An increase in defaults on the Company's mortgage loan investments could have an adverse effect on the Company's results of operations and financial condition.

The Company may be exposed to environmental liability from its commercial loan and real estate investments.

The Company customarily conducts environmental assessments prior to making commercial mortgage loans secured by real estate and before taking title to real estate. Based on the Company's environmental assessments made through the date of the financial statements, 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 results of operations or financial condition. However, no assurance can be provided that material compliance costs will not be incurred by the Company in future periods.

The Company's mortgage loan investments in the Pacific region of the United States may subject it to losses resulting from certain natural catastrophes in this area.

The Company has a sizeable concentration of commercial mortgage loans in the Pacific region of the United States. This concentration exposes the Company to potential losses resulting from certain natural catastrophes, such as earthquakes and fires, which may occur in the region. While the Company diversifies its commercial mortgage loan portfolio in this region by both location and type of property in an effort to reduce catastrophic exposure, such diversification does not eliminate the risk of such losses, which could have a material adverse effect on the Company's business, financial position, results of operations or cash flows.

The Company's mortgage loan investments in regions with significant concentration may subject it to losses resulting from the impact of the economic downturn in that region.

The Company has a sizeable concentration of commercial mortgage loans in certain regions of the United States.

Severe adverse economic conditions in these regions could have a material adverse effect on the Company's business, financial position, results of operations, or cash flows.

### Liquidity and Capital Resources Risks:

Adverse capital and credit market conditions may significantly affect the Company's ability to meet liquidity needs, as well as access to capital and cost of capital.

The capital and credit markets can experience extreme volatility and disruption. The volatility and disruption can exert downward pressure on availability of liquidity and credit for certain sectors and issuers. Although the Company has not issued new equity or debt securities in recent years, including 2012 and 2011, the Company's results of operations, financial condition, cash flows, and statutory capital position could be materially adversely affected by future disruptions in the capital and credit markets.

The Company's level of cash and investments, along with expected cash inflows from investments and operations, is believed to be adequate to meet anticipated short-term and long-term policyholder and operational obligations.

However, withdrawal and surrender levels may differ from anticipated levels for a variety of reasons, such as changes in economic conditions, changes in policyholder behavior, changes in agent practices, or changes in the Company's

claims-paying ability or financial strength ratings. Any of these occurrences could adversely affect the Company's profitability and financial condition. In the event that the Company's current internal sources of liquidity do not satisfy these needs, additional financing may be required and, in such case, the Company may not be able to successfully obtain additional financing on favorable terms, or at all. The availability of additional financing will depend on a variety of factors, such as market conditions, the general availability of credit, the volume of trading activities,

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the overall availability of credit to the financial services industry, the Company's credit ratings and credit capacity, as well as the possibility that customers or lenders could develop a negative perception of long- or short-term financial prospects if the Company incurs large realized or unrealized investment losses or if the level of business activity is decreased due to a market downturn. Similarly, access to funds may be impaired if regulatory authorities or rating agencies take negative actions against the Company.

Disruptions, uncertainty, or volatility in the capital and credit markets may also limit the Company's access to external sources of liquidity, which could be required to operate its business. Such market conditions could limit the Company's ability to replace maturing liabilities in a timely manner; satisfy capital requirements; fund redemption requests on insurance or other financial products; generate fee income and market-related revenue; meet liquidity needs; and access the capital necessary to grow the business. As such, the Company could be forced to delay raising capital, utilize available internal resources, or bear an unattractive cost of capital, which could decrease the Company's profitability and significantly reduce financial flexibility and liquidity.

The Company's ability to grow depends in large part upon the continued availability of capital.

The Company deploys significant amounts of capital to support its sales and acquisition efforts. Although the Company believes it has sufficient capital to fund its immediate growth and capital needs, the amount of capital available could vary in the future due to a variety of circumstances, some of which are neither predictable nor foreseeable, nor within the Company's control. A lack of sufficient capital could impair the Company's ability to grow.

**Regulatory Risks:**

Insurance companies are highly regulated and are subject to numerous legal restrictions and regulations.

The Company is subject to government regulation in each of the states in which business is conducted. Such regulation is vested in state agencies having broad administrative and, in some instances, discretionary power dealing with many aspects of the Company's business. This may include, among other things, premium rates and increases thereto, reserve requirements, marketing practices, advertising, privacy, policy forms, reinsurance reserve requirements, acquisitions, mergers, and capital adequacy. Government regulation of insurers is concerned primarily with the protection of policyholders and other customers rather than shareholders. Interpretations of regulations by regulators may change and statutes, regulations, and interpretations may be applied with retroactive impact, particularly in areas such as accounting or reserve requirements.

The Company cannot predict whether or in what manner regulatory reforms will be enacted and, if so, whether the enacted reforms will positively or negatively affect the Company or whether any effects will be material. The NAIC generally formulates and promulgates statutory-based insurance regulations. However, each state is independent and must separately enact these financial regulations and guidelines. As such, insurers follow the interpretations and legal approvals of their respective states of domicile.

Other types of regulation that could affect the Company include insurance company investment laws and regulations, state statutory accounting practices, state escheatment practices, anti-trust laws, minimum solvency requirements, state securities laws, federal privacy laws, insurable interest laws, federal money laundering, and anti-terrorism laws. Further, because the Company owns and operates real property, state, federal, and local environmental laws could affect the Company. The Company cannot predict what form any future changes in these or other areas of regulation affecting the insurance industry might take or what effect, if any, such proposals might have on the Company if enacted into law.

The Company is also subject to various government regulations at the federal level. As a result of economic and market conditions in recent years, the federal government has become increasingly more active in issuing and enforcing regulations. The implementation of these legislative or regulatory requirements may make it more expensive for the Company to conduct its business, may have a material adverse effect on the overall business climate, and could materially affect the profitability of the results of operations and financial condition of financial institutions. The Company is uncertain as to all of the impacts that new legislation will have and cannot provide assurance that it will not adversely affect its results of operations and financial condition.

Publicly held companies in general and the financial services industry, in particular, are sometimes the target of law enforcement investigations and the focus of increased regulatory scrutiny.

The financial services industry has become the focus of increased scrutiny by regulatory and law enforcement authorities relating to allegations of improper special payments, price-fixing, bid-rigging, and other alleged misconduct, including payments made by insurers and other financial services providers to brokers and the practices surrounding the placement of insurance business and sales of other financial products.



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New accounting rules or changes to existing accounting rules could negatively impact the Company. Like all publicly traded companies, the Company is required to comply with GAAP. A number of organizations are instrumental in the development and interpretation of GAAP, such as the SEC, the FASB, and the American Institute of Certified Public Accountants (AICPA).

GAAP is subject to constant review by these organizations and others in an effort to address emerging accounting issues and develop interpretative accounting guidance on a continual basis. The implementation of new accounting guidance could result in substantial costs and or changes in assumptions or estimates, which could negatively impact the results of operations for the Company. Accordingly, the Company can give no assurance that future changes to GAAP or the required adherence to International Financial Reporting Standards (IFRS) will not have a negative impact on the Company.

In addition, the Company is required to comply with statutory accounting principles (SAP). SAP and various components of SAP, such as statutory actuarial reserving methodology, are subject to constant review by the NAIC, NAIC taskforces and committees, as well as state insurance departments to address emerging issues and otherwise improve or modify financial reporting. Various proposals are typically pending before committees and taskforces of the NAIC. If enacted, some of these may negatively affect the Company and some could positively impact the Company. The NAIC also typically works to reform state regulation in various areas, including reforms relating to life insurance reserves and the accounting for such reserves. The Company cannot predict whether or in what manner reforms will be enacted and, if so, whether the enacted reforms will positively or negatively affect the Company. Although states generally defer to the interpretation of the insurance department of the state of domicile with regards to regulations and guidelines, neither the action of the domiciliary state nor action of the NAIC is binding on a state. Accordingly, a state could choose to follow a different interpretation. The Company can give no assurance that future changes to SAP or components of SAP will not have a negative impact on the Company.

Changes to tax law or interpretations of existing tax law could adversely affect the Company and its ability to compete with non-insurance products or could reduce the demand for certain insurance products.

Under the Internal Revenue Code of 1986, as amended (the Code), income tax payable by policyholders on investment earnings is deferred during the accumulation period of certain life insurance and annuity products. This favorable tax treatment may give certain of the Company's products a competitive advantage over other non-insurance products. To the extent that the Code is revised to reduce the tax-deferred status of life insurance and annuity products or to increase the tax-deferred status of competing products, all life insurance companies, including the Company, would be adversely affected with respect to their ability to sell such products. Further, depending upon grandfathering provisions, life insurance companies would be affected by the surrenders of existing annuity contracts and life insurance policies. Changes in tax law, which have reduced the federal income tax rates on corporate dividends in certain circumstances, could make the tax advantages of investing in certain life insurance or annuity products less attractive. Additionally, changes in tax law based on proposals to establish new tax-advantaged retirement and life savings plans, if enacted, could reduce the tax advantage of investing in certain life insurance or annuity products. The Company cannot predict what changes to tax law or interpretations of existing tax law may ultimately be enacted or whether such changes could adversely affect the Company.

### Litigation Risk:

Financial services companies are frequently the targets of litigation, including class action litigation, which could result in substantial judgments.

A number of civil jury verdicts have been returned against insurers, broker-dealers, and other providers of financial services involving sales or claims practices; alleged agent misconduct; failure to properly supervise representatives; relationships with agents or other persons with whom the insurer does business; and other matters. Often these lawsuits have resulted in the award of substantial judgments that are disproportionate to the actual damages, including material amounts of punitive non-economic compensatory damages. In some states, juries, judges, and arbitrators have substantial discretion in awarding punitive and non-economic compensatory damages, which creates the potential for unpredictable material adverse judgments or awards in any given lawsuit or arbitration. Arbitration awards are subject to very limited appellate review. In addition, in some class actions and other lawsuits, companies have made material settlement payments.

The Company, like other financial services companies, is involved in litigation and arbitration in the ordinary course of business. Although the Company makes every effort to appropriately accrue liability for litigation and other legal proceedings, the outcome of such matters (including any amount of settlement, judgment or fine) is inherently difficult to predict. As a result, an adverse development or an increase in associated legal fees could have a negative impact on the financial condition of the Company.

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### Catastrophic Event Risk:

The Company is exposed to the risks of climate change, natural disasters, pandemics, or other acts that could adversely affect the Company's operations.

While the Company has implemented risk management and contingency plans and taken preventive measures and other precautions, no predictions of specific scenarios can be made nor can assurance be given that there are not scenarios that could have an adverse effect on the Company. Climate change, a natural disaster, a pandemic, or an outbreak of an easily communicable disease could adversely affect the mortality or morbidity experience of the Company or its reinsurers. A pandemic could also have an adverse effect on lapses and surrenders of existing policies, as well as sales of new policies. In addition, a pandemic could result in large areas being subject to quarantine, with the result that economic activity slows or ceases, adversely affecting the marketing or administration of the Company's business. These effects, in turn, could have an adverse financial effect on the Company. The possible macroeconomic effects of climate change, natural disasters, or pandemics could also adversely affect the Company's asset portfolio, as well as many other variables.

### Information Technology Risk:

Unauthorized disclosure of sensitive or confidential corporate or customer information through social media outlets or through a breach of the Company's computer systems may not be prevented by the Company's cybersecurity controls. As part of the Company's normal course of business, it collects, processes, and retains sensitive and confidential corporate and customer information. In addition, the Company uses third-party vendors and cloud technology on a limited basis for storage, processing, and data support of certain activities. Despite the cybersecurity measures the Company has in place, its facilities and systems may be vulnerable to security breaches, acts of vandalism, computer viruses, misplaced or lost data, programming and/or human error, or other similar events. Any security breach involving the misappropriation, loss, or other unauthorized disclosure of confidential information by the Company could severely damage its reputation, expose it to an increase in the risk of litigation, disrupt its operations, incur significant technical, legal, and operating expenses, or otherwise harm its business.

While the Company has limited social media content, it recognizes that social media outlets are independent of the Company and its security measures. Inaccurate presentations based upon incorrect information or assumptions could be distributed via social media outlets and could harm the Company and its reputation.

### Reinsurance Risks:

Significant adverse mortality experience may result in the loss of, or higher prices for, reinsurance.

Prolonged or severe adverse mortality or morbidity experience could result in increased reinsurance costs, and ultimately, reinsurers not being willing to offer coverage. If the Company was unable to maintain its current level of reinsurance or purchase new reinsurance protection in amounts considered sufficient, the Company would either have to be willing to accept an increase in net exposures or revise pricing to reflect higher reinsurance premiums. If this were to occur, the Company may be exposed to reduced profitability and cash flow strain or may not be able to price new business at competitive rates.

The Company's reinsurers could fail to meet assumed obligations or be subject to adverse developments that could affect the Company.

The Company follows the insurance practice of reinsuring a portion of the risks under the policies written by the Company (known as ceding). The Company cedes significant amounts of insurance to other insurance companies through reinsurance. This reinsurance makes the assuming reinsurer liable to the Company for the reinsured portion of the risk. However, reinsurance does not discharge the Company from its primary obligation to pay policyholders for losses insured under the policies that are issued. Therefore, the Company is subject to the credit risk of reinsurers and the failure of one or more of the Company's reinsurers could negatively impact the Company's earnings and financial position.

The Company's ability to compete is dependent on the availability of reinsurance, cost of reinsurance, or other substitute capital market solutions.

Premium rates charged by the Company are based, in part, on the assumption that reinsurance will be available at a certain cost. Under certain reinsurance agreements, the reinsurer may increase the rate it charges the Company for the reinsurance. Therefore, if the cost of reinsurance were to increase for existing business, or if reinsurance were to

become unavailable for new business, or if alternatives to reinsurance were not available, the Company could be adversely affected.

Recently, access to reinsurance has become more costly for the Company, as well as the insurance industry in general. In recent years, the number of life reinsurers has decreased as the reinsurance industry has consolidated. The decreased number of participants

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in the life reinsurance market results in increased concentration risk for insurers, including the Company. If the reinsurance market further contracts, the Company's ability to continue to offer its products on terms favorable to the Company could be adversely impacted.

The use of reinsurance introduces variability in the Company's financial statements.

The timing of premium payments to and receipt of expense allowances from reinsurers may differ from the Company's receipt of customer premium or deposit payments and incurrence of expenses. Reinsurance may introduce variability in certain components of the Company's financial statements.

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Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The Company's home office is located at 3520 Broadway in Kansas City, Missouri. The Company owns and wholly occupies two five-story buildings on an eight-acre site.

The Company owns various other properties held for investment.

Item 3. 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 and oil and gas investments) have continued to be significant. Given the significant decline in the major market indices beginning in 2008, the generally poor performance of investments that have historically been considered safe and conservative, and the continued volatility in the market, 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 4. Mine Safety Disclosures

Not applicable.

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PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Stockholder Information

Corporate Headquarters

Kansas City Life Insurance Company

3520 Broadway

Post Office Box 219139

Kansas City, Missouri 64121-9139

Telephone: (816) 753-7000

Fax: (816) 753-4902

Internet: [www.kclife.com](http://www.kclife.com)

E-mail: [kclife@kclife.com](mailto:kclife@kclife.com)

Notice of Annual Meeting

The annual meeting of stockholders will be held at 9 a.m. on Thursday, April 18, 2013 at Kansas City Life's corporate headquarters.

Transfer Agent

Janice Poe, Stock Agent and Assistant Secretary

Kansas City Life Insurance Company

Post Office Box 219139

Kansas City, Missouri 64121-9139

10-K Request

Stockholders may request a free copy of Kansas City Life's Form 10-K, as filed with the Securities and Exchange Commission, by writing to Secretary, Kansas City Life Insurance Company.

Security Holders

At January 31, 2013, Kansas City Life had approximately 3,355 security holders, including individual participants in security position listings.

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## Stock and Dividend Information

The following table presents the high and low prices for the Company's common stock for the periods indicated and the dividends declared per share and paid during such periods. The Company's common stock is traded on the NASDAQ Capital Market under the symbol "KCLI."

	High	Low	Dividends Paid
2012:			
First quarter	\$34.54	\$31.29	\$0.27
Second quarter	34.94	30.82	0.27
Third quarter	38.84	34.31	0.27
Fourth quarter*	39.36	34.61	0.54
			\$1.35
2011:			
First quarter	\$34.45	\$29.70	\$0.27
Second quarter	32.35	28.48	0.27
Third quarter	31.57	28.37	0.27
Fourth quarter	36.07	30.16	0.27
			\$1.08

\*In the fourth quarter, the Company declared and paid two dividends. The first was for \$0.27 per share, which was declared in October 2012 and paid in November 2012. The second dividend was a special dividend of \$0.27 per share, which was declared and paid in December 2012.

A quarterly dividend of \$0.27 per share was paid February 13, 2013.

NASDAQ market quotations are compiled according to Company records and may reflect inter-dealer prices, without markup, markdown, or commission and may not necessarily represent actual transactions.

The Company has determined at this time that all compensation shall be paid in cash. As a result, the Company currently offers no equity compensation or equity compensation plan to its employees.



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## Performance Comparison

The following graph provides a comparison of the cumulative total return on Kansas City Life's common stock over the last five fiscal years to the S&P 500 Index ("S&P 500") and to a peer comparison group ("Peer Group"). The graph assumes that \$100 was invested on December 31, 2007, and that all dividends were reinvested on the last day of each quarter. Points on the graph represent performance as of the last business day of each of the years indicated.

## Comparison of 5 Year Cumulative Total Return

Among Kansas City Life, the S&P 500, and a Peer Group

	2007	2008	2009	2010	2011	2012
Kansas City Life	\$100.00	\$101.88	\$72.42	\$83.21	\$85.54	\$103.21
S&P 500	\$100.00	\$63.06	\$79.70	\$91.68	\$93.63	\$108.55
Peer Group	\$100.00	\$66.73	\$65.60	\$97.81	\$97.09	\$114.55

The Peer Group index weights individual company returns for stock market capitalization. The companies included in the Peer Group index are shown in the following table.

American Equity Investment Life Holding Co.  
 FBL Financial Group, Inc.  
 Horace Mann Educators Corp.  
 Kemper Corporation  
 National Western Life Insurance Co.  
 The Phoenix Companies, Inc.  
 Presidential Life Corporation

Primerica, Inc.  
 Protective Life Corporation  
 StanCorp Financial Group, Inc.  
 Symetra Financial Corporation  
 Torchmark Corporation  
 United Fire and Casualty  
 Universal American Corp.

The Peer Group index has changed during the five-year period. Nationwide Financial Services, Inc. was removed in 2009 due to being fully acquired. Unitrin, Inc. changed its name to Kemper Corporation in 2011. Delphi Financial Group, Inc. and Harleysville Group Inc. were removed in 2012 due to being acquired, and they were replaced with Symetra Financial Corporation and Primerica, Inc. Due to data availability, the starting date for the total return calculation for both Symetra Financial Corporation and Primerica, Inc. is March 31, 2010. Presidential Life Corporation was acquired in 2012, and the total return period ended December 28, 2012. The chart above only includes the data from the current peer group member companies listed above.

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The companies in the Peer Group index include many of the same companies used by the Compensation Committee in evaluating compensation. The group of companies used by the Compensation Committee can be found in the Compensation Disclosure and Analysis section of the Company's Proxy Statement.

The disclosure set forth above under the caption "Performance Comparison" shall not be deemed to be soliciting material and is not incorporated by reference into any of the Company's prior filings under the Securities Act of 1933 or the Securities Exchange Act of 1934, as amended, that incorporated future filings or portions thereof.

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## 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
1/1/12 - 1/31/12	— 2,464	<sup>1</sup> \$— <sup>2</sup> 33.53	—	1,000,000
2/1/12 - 2/29/12	— 1,675	<sup>1</sup> — <sup>2</sup> 34.33	—	1,000,000
3/1/12 - 3/31/12	— 407	<sup>1</sup> — <sup>2</sup> 32.37	—	1,000,000
4/1/12 - 4/30/12	13,047 2,870	<sup>1</sup> 31.76 <sup>2</sup> 32.13	13,047	986,953
5/1/12 - 5/31/12	42,382 3,060	<sup>1</sup> 32.21 <sup>2</sup> 32.24	42,382	944,571
6/1/12 - 6/30/12	16,697 223	<sup>1</sup> 32.19 <sup>2</sup> 33.39	16,697	927,874
7/1/12 - 7/31/12	— 21	<sup>1</sup> — <sup>2</sup> 35.19	—	927,874
8/1/12 - 8/31/12	— —	<sup>1</sup> — <sup>2</sup> —	—	927,874
9/1/12 - 9/30/12	— 94	<sup>1</sup> — <sup>2</sup> 35.40	—	927,874
10/1/12 - 10/31/12	— —	<sup>1</sup> — <sup>2</sup> —	—	927,874
11/1/12 - 11/30/12	16,944 —	<sup>1</sup> 36.54 <sup>2</sup> —	16,944	910,930
12/1/12 - 12/31/12	7,627 —	<sup>1</sup> 37.56 <sup>2</sup> —	7,627	903,303
Total	107,511		96,697	

On January 23, 2012, the Company's Board of Directors authorized the repurchase of up to 1,000,000 shares of its <sup>1</sup> common stock. Under this program in 2012, the Company acquired 96,697 shares at an average price of \$33.32. The Company purchased 157,182 shares in 2011



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at an average price of \$30.66. The 2012 repurchase authorization expired January 27, 2013. On January 28, 2013, the Company's Board of Directors authorized the repurchase of up to 1,000,000 shares of its common stock through January 27, 2014.

Included in this column are: 1) the total shares purchased from the employee stock ownership (ESOP) plan sponsored by the Company during the consecutive months of January through December 2012; 2) the total shares<sup>2</sup> purchased from a former participant of the ESOP plan during September 2012; and 3) the total shares purchased attributable to the Company's deferred compensation plans during the consecutive months of January through June 2012.

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## Item 6. Selected Financial Data

Amounts in thousands, except per share data.

	Year Ended December 31				
	2012	2011	2010	2009	2008
<b>Income Statement Data:</b>					
<b>Revenues:</b>					
Insurance revenues	\$235,983	\$228,399	\$245,830	\$242,802	\$236,173
Net investment income	176,154	177,228	175,859	177,428	177,419
Realized investment gains (losses)	18,436	3,142	535	(10,076	) (52,271
Other revenues	9,354	10,274	9,139	10,491	13,005
Total revenues	\$439,927	\$419,043	\$431,363	\$420,645	\$374,326
Net income (loss)	\$39,867	\$26,133	\$22,302	\$10,732	\$(17,050
<b>Per Common Share Data:</b>					
Net income (loss), basic and diluted	\$3.59	\$2.29	\$1.95	\$0.93	\$(1.47
Cash dividends to stockholders	\$1.35	\$1.08	\$1.08	\$1.08	\$1.08
Stockholders' equity	\$68.02	\$62.84	\$59.25	\$54.33	\$46.11
	December 31				
	2012	2011	2010	2009	2008
<b>Balance Sheet Data:</b>					
Assets	\$4,525,745	\$4,398,242	\$4,333,102	\$4,175,981	\$3,967,091
Notes payable	—	—	—	—	2,900
Stockholders' equity	750,401	710,705	679,472	628,363	527,107
Life insurance in force	28,701,373	29,202,126	29,708,102	30,683,571	30,300,286

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Amounts are stated in thousands, except share data, or as otherwise noted.

Management's Discussion and Analysis of Financial Condition and Results of Operations for the three years ended December 31, 2012 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. This discussion should be read in conjunction with the consolidated financial statements and accompanying notes included in this document.

Overview

Kansas City Life Insurance Company is a financial services company that is predominantly focused on the underwriting, sales, and administration of life insurance and annuity 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 annuities, and accident and health policies; from earnings on its investment portfolio; and from the sale of investment assets.

Insurance 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 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 Financing Activities section of the Consolidated Statements of Cash Flows. Accordingly, insurance 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 policyholder balances.

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

- The sale of life, interest sensitive, 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;

- Interest rates credited to policyholders;
- The effectiveness of reinsurance programs;
- The amount of investment assets under management;
- 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.



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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 other 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. Market fluctuations, often extreme in nature, have significantly impacted the financial markets and the Company's investments, revenues, and policyholder benefits in recent periods. The sustained low interest rate environment and volatile equity markets have presented significant challenges to the financial markets as a whole and specifically to companies invested in fixed maturity and equity securities. These conditions may continue and the stressed economic and market environment may persist into the future, affecting the Company's revenue, net income, and financial position.

### Business Changes

The Company did not have any significant business changes in the three years ended December 31, 2012.

### 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, expressions with similar meaning.

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

- Changes in general economic conditions, including the performance of financial markets and interest rates;
- Increasing competition and changes in consumer behavior, which may affect the Company's ability to sell its products and retain business;
- Increasing competition in the recruiting of new agents and agent practices;
- Customer and agent response to new products, distribution channels, and marketing initiatives;
- Fluctuations in experience regarding current mortality, morbidity, persistency, and interest rates relative to expected amounts used in pricing the Company's products;
- Changes in assumptions related to DAC and VOBA;
- Regulatory, accounting, or tax changes that may affect the cost of, or the demand for, the Company's products or services; and
- Unanticipated changes in industry trends and ratings assigned by nationally recognized rating organizations.

The Company cannot give assurances that such statements will prove to be correct. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results.

### Critical Accounting Policies

The preparation of the financial statements requires management to use a variety of assumptions and estimates. Actual results may differ from these estimates under different assumptions or conditions. The profitability of life insurance and annuity products is dependent on actual experience, and differences between actual experience and pricing assumptions may result in variability of net income in amounts which may be material. On an ongoing basis, the

Company evaluates the estimates, assumptions, and judgments based on historical experience and other information that the Company believes to be relevant under the circumstances. A detailed discussion of significant accounting policies is provided in Note 1 – Nature of Operations and Significant Accounting Policies in the Notes to Consolidated Financial Statements.

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### Valuation of Investments and Impairments

#### Securities

Fixed maturity and equity securities, which are classified as available for sale, are carried at fair value in the Company's Consolidated Balance Sheets, with unrealized gains or losses recorded in accumulated other comprehensive income. The Company's fair value of fixed maturity and equity securities is derived from external pricing services, brokers, and internal matrices and calculations. At December 31, 2012, approximately 96% of the carrying value of these investments was from external pricing services and 4% was derived from brokers and internal matrices or calculations.

The Company monitors the various markets in which its investments are traded. The Company utilizes a primary independent third-party pricing service to determine the majority of its fair values. The Company uses a second independent third-party pricing service to validate the fair market values provided by the primary pricing service. The Company also uses the second pricing service to determine the fair value of certain securities for which the primary pricing service is unable to provide. The Company evaluates individual price fluctuations provided by the pricing services and reviews overall data provided by the pricing services for consistency and reasonableness. The Company reviews values received from independent pricing sources for validity. In addition, the Company tests a limited number of securities from each pricing service each reporting period to further validate reliance on the fair values provided. These tests occur in two forms. First, the Company validates a representative sample of securities from each pricing service, reviewing and evaluating methodologies and assumptions used by the pricing services for reasonableness. Second, the Company independently calculates fair values for a sample set of securities and then compares results to those provided by the pricing services.

When fair values are not available from external service providers, where possible, the Company utilizes quotes from brokers who are believed to have expertise in the markets in which the subject securities are traded. The Company reviews the prices received from brokers for reasonableness. When the Company cannot obtain reliable broker pricing, a fair value is determined based upon an assessment of several factors appropriate for the specific issue, including but not limited to: the issuer's industry; liquidity; cash flows; marketability, ratings, and the ability of the issuer to satisfy the obligation; government intervention or regulations; fair value of comparable securities in actively traded or quoted markets; or other factors. The Company creates a matrix of factors from which to calculate an estimable value. However, all factors may not be known or publicly available from which to determine a value and, as such, the fair value used by the Company may not be truly indicative of the actual value available in an active market or an actual exit price if the Company were to sell the security in the current market.

See further discussion of the valuation techniques and processes identified in Notes 4 and 5 to the Consolidated Financial Statements.

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. The evaluation includes, but is not limited to, such factors as the issuer's stated 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, and litigation and government actions. This process also involves monitoring late payments, downgrades by rating agencies, key financial ratios, financial statements, revenue forecasts, asset quality, and cash flow projections as indicators of credit issues.

All securities are reviewed to determine whether 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. Please refer to Note 1 for information concerning these factors.

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. Please refer to Note 1 for a description of these risks and uncertainties.

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, an analysis of the fair value of the investment is performed and 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 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

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investment is expected to be fully realized. If the present value of the 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 were high quality investments at the time of acquisition, and they 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.

**Mortgage Loans**

Mortgage loans are stated at cost, net of an allowance for potential future losses. 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 in Note 6 - Financing Receivables. If delinquent payments are made and the loan is brought current, then the Company returns the loan to active status and accrues income accordingly.

The allowance for potential future 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. The Company evaluates the amount it maintains in the mortgage loan allowance through an assessment of what the Company believes are relevant factors at both the macro-environmental level and specific loan basis, which are detailed in Note 6. Generally, the Company establishes the allowance for potential future losses using a collective impairment methodology at an overall portfolio level that relies on monitoring certain metrics such as debt service coverage and loan-to-value, as well as other qualitative factors. If the Company determines through its evaluation that a loan has an elevated specific risk profile or it does not expect to collect all contractual cash flows, it then individually assesses the loan's risk profile and assigns a specific allowance value.

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

**Deferred Acquisition Costs (DAC) and Value of Business Acquired (VOBA)**

DAC, principally agent commissions and other selling, selection and issue costs, which are related directly to the successful acquisition of new or renewal insurance contracts, are capitalized as incurred. These 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 in relation to the estimated gross profits to be realized over the lives of the contracts.

Historically, when a new block of business was acquired or when an insurance company was purchased, a portion of the purchase price was allocated to a separately identifiable intangible asset, called VOBA. VOBA is established as the actuarially determined present value of future gross profits of the business acquired and is amortized with interest in proportion to future premium revenues or the expected future profits, depending on the type of business acquired. For additional information pertaining to DAC and VOBA, please see Note 1.

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The following table reflects the estimated pre-tax impact to DAC on universal life, variable universal life, and fixed and variable deferred annuity products that could occur in a twelve-month period for an unlocking adjustment due to potential changes in significant assumptions. Changes in assumptions of the same magnitude in the opposite direction would have an impact of a similar magnitude but opposite direction of the examples provided.

Critical Accounting Estimate	Determination Methodology	Potential One-Time Effect on DAC and Related Items
Mortality Experience	Based on Company mortality experience. Industry experience and trends are also considered.	A 2.5% increase in expected mortality experience for all future years would result in a reduction in DAC and an increase in current period amortization expense of \$2.3 million.
Surrender Rates	Based on Company surrender experience. Industry experience and trends are also considered.	A 10% increase in expected surrender rates for all future years would result in a reduction in DAC and an increase in current period amortization expense of \$1.3 million.
Interest Spreads	Based on expected future investment returns and expected future crediting rates applied to policyholder account balances; future crediting rates include constraints imposed by policy guarantees.	A 10 basis point reduction in future interest rate spreads would result in a reduction in DAC and an increase in current period amortization expense of \$2.6 million.
Maintenance Expenses	Based on Company experience using an internal expense allocation methodology.	A 10% increase in future maintenance expenses would result in a reduction in DAC and an increase in current period amortization expense of \$1.8 million.

The following table reflects the estimated pre-tax impact to VOBA on universal life and fixed deferred annuity products that could occur in a twelve-month period for an unlocking adjustment due to reasonably likely changes in significant assumptions. Changes in assumptions of the same magnitude in the opposite direction would have an impact of a similar magnitude but opposite direction of the examples provided.

Critical Accounting Estimate	Determination Methodology	Potential One-Time Effect on VOBA and Related Items
Mortality Experience	Based on Company mortality experience. Industry experience and trends are also considered.	A 2.5% increase in expected mortality experience for all future years would result in a reduction in VOBA and an increase in current period amortization expense of \$1.2 million.
Surrender Rates	Based on Company surrender experience. Industry experience and trends are also considered.	A 10% increase in expected surrender rates for all future years would result in a reduction in VOBA and an increase in current period amortization

expense of \$0.7 million.

Interest Spreads

Based on expected future investment returns and expected future crediting rates applied to policyholder account balances; future crediting rates include constraints imposed by policy guarantees.

A 10 basis point reduction in future interest rate spreads would result in a reduction in VOBA and an increase in current period amortization expense of \$0.7 million.

Maintenance Expenses

Based on Company experience using an internal expense allocation methodology.

A 10% increase in future maintenance expenses would result in a reduction in VOBA and an increase in current period amortization expense of \$0.3 million.

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### Reinsurance

A variety of reinsurance arrangements are currently in use, including individual and bulk arrangements on both coinsurance and mortality/morbidity-only basis. Reinsurance is an actively managed tool for the Company that supports several objectives, including managing statutory capital and reducing volatility and surplus strain. At the customer level, reinsurance increases the Company's capacity, provides access to additional underwriting expertise, and generally makes it possible for the Company to offer products at competitive levels that could not otherwise be made available.

The Company remains contingently liable if the reinsurer should be unable to meet obligations assumed under the reinsurance contract. The Company monitors the relative financial strength and viability of its reinsurance partners. Reinsurance recoverables include amounts related to paid benefits and estimated amounts related to unpaid policy and contract claims, future policy benefits, and policyholder account balances.

Liabilities for reinsurance are calculated on an actuarial present value method consistent with the risks being transferred.

### Future Policy Benefits

The Company establishes liabilities for amounts payable under insurance policies, including traditional life insurance, immediate annuities with life contingencies, supplementary contracts with life contingencies, and accident and health insurance. Generally, amounts are payable over an extended period of time. Liabilities for future policy benefits of traditional life insurance have been computed using a net level premium method based upon estimates at the time of issue for investment yields, mortality, and withdrawals. These estimates include provisions for experience less favorable than initially expected. Mortality assumptions are based on Company experience expressed as a percentage of standard mortality tables. The 2001 Valuation Basic Table and the 1975-1980 Select and Ultimate Basic Table serve as the basis for most mortality assumptions.

Liabilities for future policy benefits of immediate annuities and supplementary contracts with life contingencies are computed by calculating an actuarial present value of future policy benefits, based upon estimates for investment yields and mortality at the time of issue. Liabilities for future policy benefits of immediate annuities and supplementary contracts with life contingencies are also computed by a net level premium method, based upon estimates at the time of issue for investment yields and mortality.

Liabilities for future policy benefits of accident and health insurance represent estimates of payments to be made on reported insurance claims, as well as claims incurred but not yet reported. These liabilities are estimated using actuarial analyses and case basis evaluations that are based upon past claims experience, claim trends, and industry experience.

### Policyholder Account Balances

Policyholder account balances include universal life insurance, fixed deferred annuity contracts, and investment-type contracts. Liabilities for these policyholder account balances are included without reduction for potential surrender charges and deferred front-end contract charges. The account balances for these types of contracts are equal to cumulative deposits, less contract charges and withdrawals, plus interest credited. Front-end contract charges are deferred and amortized over the term of the policies. Policyholder benefits incurred in excess of related policyholder account balances are charged to policyholder benefits expense. Interest on policyholder account balances is credited as earned.

On an ongoing basis, the Company performs testing and analysis on its blocks of business to ensure the assumptions made when the Company purchases a block of business or sells new policies remain viable. The Company also periodically performs sensitivity testing on these blocks of business to ensure it maintains the capacity to meet an increase in demand in policyholder benefits, namely increased surrenders, policy loans, or other policyholder elective withdrawals, especially when financial markets become volatile.

### Pensions and Other Postretirement Benefits

The measurement of pension and other postretirement benefit obligations and costs depends on a variety of assumptions. Changes in the valuation of pension obligations and assets supporting this obligation can significantly impact the funded status. Assumptions are made regarding the discount rate, expected long-term rate of return on plan assets, health care claim costs, health care cost trends, retirement rates, and mortality. The discount rate and the



expected return on plan assets have the most significant impact on the level of cost. See Note 13 – Pensions and Other Postretirement Benefits in the Notes to Consolidated Financial Statements for further details.

The Kansas City Life Cash Balance Pension Plan was amended effective December 31, 2010 to provide that participants' accrued benefits were frozen at, and that no further benefits or accruals will be earned after, December 31, 2010. However, the cash balance account will continue to earn annual interest.

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## Recognition of Revenues

Premiums for traditional life insurance products are reported as revenue when due. Premiums on accident and health, disability, vision, and dental insurance are reported as earned ratably over the contract period in proportion to the amount of insurance protection provided. A reserve is provided for the portion of premiums written which relates to unexpired terms of coverage.

Deposits related to universal life, fixed deferred annuity contracts, and investment-type products are credited to policyholder account balances. Revenues from such contracts consist of amounts assessed against policyholder account balances for mortality, policy administration, and surrender charges, and are recognized in the period in which the benefits and services are provided as contract charges in the Consolidated Statements of Comprehensive Income. The cash flows from deposits are credited to policyholder account balances. Deposits are not recorded as revenue. Instead, deposits are included as a financing activity in the Consolidated Statements of Cash Flows.

The Company measures its sales or new business production with two components: new premiums recorded and new deposits received. Premiums and deposits are also identified by general product type. New premiums and new deposits are considered to be first year and single receipts. Premiums and deposits are subdivided into two categories: new and renewal. New premiums and deposits are measures of sales or new business production. Renewal premiums and deposits occur as continuing business from existing customers.

## Income Taxes

Deferred income taxes are recorded based on the differences between the tax bases of assets and liabilities and the amounts at which they are reported in the consolidated financial statements. Recorded amounts are adjusted to reflect changes in income tax rates and other tax law provisions as they become enacted. Deferred income tax assets are subject to ongoing evaluation of whether such assets will be realized. The ultimate realization of deferred income tax assets generally depends on the reversal of deferred tax liabilities and the generation of future taxable income and realized gains during the periods in which temporary differences become deductible. Deferred income taxes include future deductible differences relating to unrealized losses on investment securities. The Company evaluates the character and timing of unrealized gains and losses to determine whether available future taxable amounts are sufficient to offset future deductible amounts. A valuation allowance against deferred income tax assets may be required if future taxable income is believed to be insufficient to fully realize the assets.

## Consolidated Results of Operations

## Summary of Results

The Company earned net income of \$39.9 million in 2012 compared to \$26.1 million in 2011 and \$22.3 million in 2010. Net income per share was \$3.59 in 2012 versus \$2.29 in 2011 and \$1.95 in 2010. The following table presents year-over-year variances in results for the two years ended December 31, 2012 and 2011.

	2012 Versus 2011	2011 Versus 2010
Insurance and other revenues	\$6,664	\$(16,296)
Net investment income	(1,074)	) 1,369
Net realized investment gains	15,294	2,607
Policyholder benefits and interest credited to policyholder account balances	(2,962)	) 29,687
Amortization of deferred acquisition costs	5,924	(6,933)
Operating expenses	(4,049)	) (5,495)
Income tax expense	(6,063)	) (1,108)
Total variance	\$13,734	\$3,831

Net income increased \$13.7 million in 2012 compared to 2011. Contributing to this improvement were increases in net realized investment gains and insurance revenues, along with lower amortization of deferred acquisition costs. Partially offsetting these were increases in policyholder benefits and operating expenses, along with lower net investment income. Additional information on these items is presented below.

## 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.

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The Company's marketing plan for individual products 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 of the Company's products 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. The Company also places an emphasis on training and direct support to the field force to assist new agents in their start-up phase. In addition, the Company provides support to existing agents to stay abreast of the ever-changing regulatory environment and to introduce agents to new products and enhanced features of existing products. The Company also selectively utilizes third-party marketing arrangements to enhance its sales objectives. This allows the Company the flexibility to identify niches or pursue unique opportunities in the existing markets 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 to selectively utilize third-party marketing arrangements. Further, growth is to be supported by the addition of new products to the portfolio.

The following table presents gross premiums on new and renewal business, less reinsurance ceded, as included in insurance revenues, for the three years ended December 31. New premiums are also detailed by product.

	2012	% Change	2011	% Change	2010	
New premiums:						
Individual life insurance	\$17,560	2	% \$17,222	4	% \$16,494	
Immediate annuities	12,470	82	% 6,860	(69	)% 22,313	
Group life insurance	2,459	26	% 1,951	(14	)% 2,280	
Group accident and health insurance	11,681	(10	)% 12,978	3	% 12,606	
Total new premiums	44,170	13	% 39,011	(27	)% 53,693	
Renewal premiums	149,222	2	% 145,999	3	% 141,094	
Total premiums	193,392	5	% 185,010	(5	)% 194,787	
Reinsurance ceded	(57,303	) (1	)% (57,672	) 5	% (54,976	)
Net premiums	\$136,089	7	% \$127,338	(9	)% \$139,811	

Consolidated total premiums increased \$8.4 million or 5% in 2012 compared to 2011, as total new premiums increased \$5.2 million and total renewal premiums increased \$3.2 million or 2%. The largest contributor to the increase in new premiums was a \$5.6 million or 82% increase in new immediate annuity premiums. Immediate annuity receipts can have sizeable fluctuations, as receipts from policyholders largely result from one-time premiums rather than recurring premiums. The increase in immediate annuity receipts was partially offset by a \$1.3 million or 10% decrease in new group accident and health premiums. This reflected a \$2.2 million decline in the short-term disability line. This change was partially offset by a \$0.5 million increase in new dental premiums. The increase in renewal premiums reflected a \$2.2 million or 2% increase in individual life insurance premiums, largely from the Old American segment. In addition, group accident and health renewal premiums increased \$1.8 million or 5%. This increase was largely from the short-term disability line.

Consolidated total premiums decreased \$9.8 million or 5% in 2011 compared to 2010, as total new premiums decreased \$14.7 million or 27% and total renewal premiums increased \$4.9 million or 3%. The decrease in new premiums was due to a \$15.5 million or 69% decline in immediate annuity sales. This decrease was largely the result of elevated sales of this product in 2010 due to the heightened preference of guaranteed benefits by consumers at that time. In addition to the sizeable fluctuations mentioned above, the decrease in new immediate annuity sales can also be attributed to lower interest rates during 2011 and increased competition from alternative products. Partially offsetting the decrease in immediate annuities, new individual life insurance premiums increased, largely from the Old American segment. The increase in renewal premiums reflected a \$2.1 million or 2% increase in individual life

insurance renewal premiums and a \$2.5 million or 7% increase in group accident and health renewal premiums. The increase in individual life insurance renewal premiums largely resulted from the Old American segment. The increase in group accident and health renewal premiums reflected growth in short-term disability and dental premiums. The following table reconciles deposits with the Consolidated Statements of Cash Flows and provides detail by new and renewal deposits for the three years ended December 31. New deposits are also detailed by product.

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	2012	% Change	2011	% Change	2010
New deposits:					
Universal life insurance	\$12,388	11	% \$11,159	(16	)% \$13,330
Variable universal life insurance	563	(32	)% 834	(32	)% 1,226
Fixed deferred annuities	56,788	(8	)% 62,060	(8	)% 67,709
Variable annuities	18,039	11	% 16,291	(10	)% 18,121
Total new deposits	87,778	(3	)% 90,344	(10	)% 100,386
Renewal deposits	140,054	(2	)% 143,611	4	% 137,827
Total deposits	\$227,832	(3	)% \$233,955	(2	)% \$238,213

Total new deposits decreased from the prior year by \$2.6 million or 3% in 2012, following a \$10.0 million or 10% decrease in 2011. The decrease in 2012 was largely due to a \$5.3 million decrease in new fixed deferred annuity deposits. This was partially offset by a \$1.7 million or 11% increase in new variable annuity deposits and a \$1.2 million or 11% increase in new universal life deposits. The decline in 2011 was largely due to a decrease in new fixed deferred annuities, as well as declines in new universal life and variable annuity deposits.

Total renewal deposits decreased from the prior year by \$3.6 million or 2% in 2012 following a \$5.8 million or 4% increase in 2011. The decline in 2012 was largely attributable to a decrease in fixed deferred annuity renewal deposits. The improvement in 2011 was due to an increase in renewal fixed deferred annuity deposits.

**Insurance Revenues**

Insurance revenues consist of premiums, net of reinsurance, and contract charges. Insurance revenues are affected by the level of new sales, the type of products sold, the persistency of policies, general economic conditions, and competitive forces. The Company strives to provide a portfolio of products with safety and competitive return objectives. The Company offers a broad range of products, including variable insurance products, which allow policyholders to participate in both the equity and fixed income markets. Interest sensitive and traditional insurance products combine safety of principal with competitive interest returns.

Contract charges consist of cost of insurance, expense loads, amortization of unearned revenues, and surrender charges on policyholder account balances. The cost of insurance and expense loads are earned over time by the continued persistency of these products. Surrender charges result from charges levied for withdrawals of policies during time frames defined in the policy contract. Finally, a component of contract charges is the recognition over time of the deferred revenue liability (DRL) from certain fixed and variable universal life policies. This liability arises from front-end loads on such policies and is recognized in concert with the future expected gross profits, similar to the amortization of DAC. Unlocking or other events may also have an impact on future expected gross profits on products and policies. If it is determined that it is appropriate to change the assumptions of future experience, then an unlocking adjustment is recognized for the block of business being evaluated. Certain assumptions, such as interest spreads and surrender rates, may be interrelated. As such, unlocking adjustments often reflect revisions to multiple assumptions. In addition, the Company may also consider refinements in estimates for other unusual or one-time occurrences for events such as administrative or actuarial system upgrades. These items are applied to the appropriate financial statement line items similar to unlocking adjustments.

Total contract charges declined \$1.2 million or 1% in 2012 and \$5.0 million or 5% in 2011, relative to the same periods one year earlier. The decline in 2012 was due to several factors including a decrease in cost of insurance charges, largely due to the runoff of closed blocks; a decrease in expense loads that resulted from increased sales of products with lower expense loads in 2012 relative to the prior year; and a decline in surrender charges, reflecting lower surrenders on universal life products. Partially offsetting these, the amortization of deferred revenue increased due to improved reinsurance modeling capabilities resulting from a system upgrade during 2011. The decline in 2011 primarily resulted from factors including lower amortization of deferred revenue due to unlocking, as discussed below; a decline in cost of insurance charges, largely due to the runoff of closed blocks; and a decline in surrender charges, reflecting reduced surrenders of universal life and variable universal life products in the ongoing blocks of business.

Included in total contract charges are groups of policies and companies that the Company considers to be closed blocks. Total contract charges on these closed blocks equaled 35% of total consolidated contract charges during 2012,

compared to 36% in 2011. Total contract charges on closed blocks declined 3% from \$35.9 million in 2011 to \$34.8 million in 2012, reflecting the runoff of this business. Total contract charges on open blocks of business were essentially flat in 2012 compared to 2011.

At least annually, a review is performed regarding the assumptions related to future expected gross profits on products and policies consistent with those performed for DAC and VOBA. If it is determined that the assumptions should be revised, an adjustment may be recorded to the deferred revenue component of contract charges in the current period as an unlocking adjustment. The

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Company had unlocking in the DRL in both 2012 and 2011. In 2012, unlocking due to changes in the interest and mortality margins resulted in a decrease to the deferred revenue liability and a \$1.8 million increase to contract charges. In 2011, the unlocking was the result of several factors, the largest of which was associated with future mortality experience. This included the use of a new industry mortality table and the corresponding impact of reinsurance. The impact of the unlocking in 2011 was an increase in the DRL liability and a reduction in contract charges in the amount of \$1.9 million.

The Company uses reinsurance as a means to mitigate its risks and to reduce the earnings volatility from claims. Reinsurance ceded premiums decreased \$0.4 million to \$57.3 million in 2012 from \$57.7 million in 2011. In 2010, reinsurance ceded was \$55.0 million. The decrease in 2012 was largely the result of two factors, including an increase in retention limit on new business effective January 1, 2012. This reduced the amount of reinsurance on new business written in 2012. The Company also recaptured a block of reinsurance in its individual life insurance business on a closed block of business, which reduced the overall ceded premiums in 2012 by \$0.4 million.

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 \$1.1 million or 1% in 2012 compared to 2011, as an increase in average invested assets was more than offset by lower yields earned. Gross investment income increased \$1.7 million or 1% in 2011 compared to 2010, as an increase in average invested assets was partially offset by lower yields.

Fixed maturity securities provided a majority of the Company's investment income during 2012. Approximately 75% of the Company's investments were in fixed maturity securities at December 31, 2012. Gross investment income from these investments declined \$4.0 million compared to 2011. This decrease was primarily the result of lower yields available in the marketplace and a lower average balance of fixed maturity assets.

The Company has significantly increased its holdings in commercial mortgage loans in recent periods. The Company owned \$674.0 million in mortgage loans at December 31, 2012, up from \$601.9 million at December 31, 2011 and \$559.2 million at December 31, 2010. Over this time, mortgage loan investment income increased from 17% of gross investment income to 20% in 2012. It is anticipated that the increased allocation to mortgage loans will provide a favorable impact on investment portfolio yields.

Investment income from real estate properties provided \$9.5 million or 5% of gross investment income in 2012 compared to \$7.7 million or 4% in 2011. This increase was largely the result of a change in the mix of real estate investments and improved occupancy in certain properties.

In addition, the increase in the fair value of an alternative investment fund, resulted in an increase in investment income of \$1.5 million in 2012 compared to 2011.

The Company realizes investment gains and losses from several sources, including write-downs of investments and sales of investment securities and real estate. Many securities purchased by the Company contain call provisions, which allow the issuer to redeem the securities at a particular price. Depending upon the terms of the call provision and price at which the security was purchased, a gain or loss may be realized.



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The following table provides detail concerning realized investment gains and losses for the three years ended December 31.

	2012	2011	2010
Gross gains resulting from:			
Sales of investment securities	\$2,670	\$3,945	\$2,545
Investment securities called and other	3,806	3,519	2,139
Sales of real estate	18,884	—	—
Total gross gains	25,360	7,464	4,684
Gross losses resulting from:			
Sales of investment securities	(2,651	) (1,666	) (67
Investment securities called and other	(865	) (376	) (253
Mortgage loans	(220	) (3	) —
Impairment losses on real estate	(838	) —	—
Total gross losses	(4,574	) (2,045	) (320
Change in allowance for potential future losses on mortgage loans	(497	) 102	—
Amortization of DAC and VOBA	(135	) (370	) (9
Net realized investment gains, excluding other-than-temporary impairment losses	20,154	5,151	4,355
Net impairment losses recognized in earnings:			
Other-than-temporary impairment losses on fixed maturity and equity securities	(2,526	) (2,952	) (4,129
Portion of loss recognized in other comprehensive income	808	943	309
Net other-than-temporary impairment losses recognized in earnings	(1,718	) (2,009	) (3,820
Net realized investment gains	\$18,436	\$3,142	\$535

The Company recorded net realized investment gains of \$18.4 million in 2012, \$3.1 million in 2011, and \$0.5 million in 2010. During 2012, investment losses of \$1.7 million were due to write-downs of investment securities that were considered other-than-temporarily impaired. In addition the Company recorded impairment losses of \$0.8 million on the Company's real estate investments. Partially offsetting these were \$2.7 million in gains resulting from sales of investment securities and \$3.8 million in gains from securities called and other. In the above table, investment securities called and other includes, but is not limited to, principal pay downs and sinking funds.

During 2011, investment losses of \$2.0 million were due to write-downs of investment securities that were considered other-than-temporarily impaired. These were partially offset by \$3.9 million in gains on the sale of investment securities and \$3.6 million of investment gains realized on securities called and other.

The Company reviews and analyzes its securities on an ongoing basis to determine whether impairments exist that are other-than-temporary. Based upon these analyses, specific securities' credit impairments may be written down through earnings as a realized investment loss if the security's fair value is considered to be other-than-temporarily impaired. Non-credit impairments are charged to other comprehensive income.

During 2012, two securities were written down through earnings that were equal to or exceeded \$0.5 million on a consolidated basis. The first was a collateralized debt obligation that was written down by \$0.5 million due to an increase in projected future losses on the underlying collateral. The second was a corporate security that was written down by \$0.6 million due to the expected settlement value after the issuer filed for bankruptcy. The Company did not have any individual investment securities that were written down through earnings during 2011 that exceeded \$0.5 million on a consolidated basis. During 2010, two securities were written down through earnings that exceeded \$0.5 million on a consolidated basis. The first was a securitization of U.S. government guaranteed student loans that was written down by \$1.0 million due to the liquidation of the security by the trustees at the direction of a majority of bondholders. The second was a mortgage-backed security that was written down \$0.6 million due to a 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.

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## 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 primary sources of investment risk to which the Company is exposed include credit risk, interest rate risk, and liquidity risk. 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. 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.

For additional information regarding the Company's asset/liability management program, please see the Asset/Liability Management section within Item 7A: Quantitative and Qualitative Disclosures About Market Risk.

The following table provides asset class detail of the investment portfolio at December 31. Fixed maturity and equity securities represented 76% of the entire investment portfolio at December 31, 2012 and 2011.

	2012	% of Total	2011	% of Total	
Fixed maturity securities	\$2,788,141	75	% \$2,682,142	75	%
Equity securities	20,061	1	% 36,689	1	%
Mortgage loans	674,034	18	% 601,923	17	%
Real estate	124,742	3	% 127,962	4	%
Policy loans	77,133	2	% 80,375	2	%
Short-term investments	24,902	1	% 49,316	1	%
Other investments	2,572	—	3,364	—	
Total	\$3,711,585	100	% \$3,581,771	100	%

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The following table provides information regarding fixed maturity and equity securities by asset class at December 31, 2012.

	Total Fair Value	% of Total	Fair Value of Securities with Gross Unrealized Gains	Gross Unrealized Gains	Fair Value of Securities with Gross Unrealized Losses	Gross Unrealized Losses
U.S. Treasury securities and obligations of U.S. Government	\$ 136,051	5	% \$ 134,062	\$ 14,302	\$ 1,989	\$ 25
Federal agencies <sup>1</sup>	26,069	1	% 26,069	3,999	—	—
Federal agency issued residential mortgage-backed securities <sup>1</sup>	91,985	3	% 91,569	8,381	416	4
Subtotal	254,105	9	% 251,700	26,682	2,405	29
Corporate obligations:						
Industrial	545,883	19	% 517,017	51,645	28,866	377
Energy	211,249	8	% 209,267	22,473	1,982	14
Communications and technology	221,600	8	% 218,891	23,283	2,709	15
Financial	313,874	11	% 305,633	27,487	8,241	1,467
Consumer	526,238	19	% 509,095	49,395	17,143	70
Public utilities	286,127	10	% 274,543	39,840	11,584	102
Subtotal	2,104,971	75	% 2,034,446	214,123	70,525	2,045
Corporate private-labeled residential mortgage-backed securities	148,131	5	% 134,081	4,033	14,050	754
Municipal securities	167,984	6	% 167,984	27,141	—	—
Other	104,744	4	% 62,849	6,494	41,895	8,192
Redeemable preferred stocks	8,206	—	% 6,695	266	1,511	44
Fixed maturities	2,788,141	99	% 2,657,755	278,739	130,386	11,064
Equity securities	20,061	1	% 19,788	1,956	273	90
Total	\$ 2,808,202	100	% \$ 2,677,543	\$ 280,695	\$ 130,659	\$ 11,154

<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 at December 31, 2011.

	Total Fair Value	% of Total	Fair Value of Securities with Gross Unrealized Gains	Gross Unrealized Gains	Fair Value of Securities with Gross Unrealized Losses	Gross Unrealized Losses
U.S. Treasury securities and obligations of U.S. Government	\$ 134,437	5	% \$ 133,478	\$ 13,856	\$ 959	\$ 12
Federal agencies <sup>1</sup>	25,881	1	% 25,881	3,480	—	—
Federal agency issued residential mortgage-backed securities <sup>1</sup>	119,637	4	% 118,694	9,901	943	2
Subtotal	279,955	10	% 278,053	27,237	1,902	14
Corporate obligations:						
Industrial	486,880	18	% 461,425	43,710	25,455	860
Energy	171,711	6	% 171,711	19,131	—	—
Communications and technology	201,393	7	% 194,154	16,566	7,239	156
Financial	318,078	12	% 250,403	15,155	67,675	5,890
Consumer	496,487	18	% 481,033	43,788	15,454	263
Public utilities	296,337	11	% 280,475	38,094	15,862	1,366
Subtotal	1,970,886	72	% 1,839,201	176,444	131,685	8,535
Corporate private-labeled residential mortgage-backed securities	156,902	6	% 53,304	1,856	103,598	12,620
Municipal securities	168,522	6	% 164,613	18,316	3,909	61
Other	94,656	4	% 38,253	3,576	56,403	9,235
Redeemable preferred stocks	11,221	1	% 5,226	226	5,995	740
Fixed maturities	2,682,142	99	% 2,378,650	227,655	303,492	31,205
Equity securities	36,689	1	% 35,566	1,873	1,123	135
Total	\$ 2,718,831	100	% \$ 2,414,216	\$ 229,528	\$ 304,615	\$ 31,340

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

At December 31, 2012, the Company's unrealized losses on fixed maturity and equity securities had decreased to \$11.2 million and were offset by \$280.7 million in gross unrealized gains. At December 31, 2011, the Company had \$31.3 million in gross unrealized losses on fixed maturity and equity securities which were offset by \$229.5 million in gross unrealized gains. At December 2012, 95% of the fixed maturity and equity securities portfolio had unrealized gains, an improvement from 89% at December 31, 2011. At December 31, 2012, 7% of the total gross unrealized losses were in the category of corporate private-labeled residential mortgage-backed securities obligations. This category also was the area with the greatest decrease in unrealized losses for the comparative year-end dates, as this figure decreased from \$12.6 million to \$0.8 million, reflecting a general improvement in the market.

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The following table identifies fixed maturity securities available for sale by actual or equivalent Standard & Poor's rating at December 31.

	2012	% of Total	2011	% of Total	
AAA	\$ 114,276	4	% \$ 161,802	6	%
AA	576,113	21	% 570,157	21	%
A	857,265	31	% 799,565	30	%
BBB	1,067,373	38	% 939,373	35	%
Total investment grade	2,615,027	94	% 2,470,897	92	%
BB	39,084	1	% 79,760	3	%
B and below	134,030	5	% 131,485	5	%
Total below investment grade	173,114	6	% 211,245	8	%
	\$2,788,141	100	% \$2,682,142	100	%

The following table provides information regarding fixed maturity and equity security investments available for sale with unrealized losses by length of time at December 31, 2012.

	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	\$ 1,328	\$ 18	\$ 661	\$ 7	\$ 1,989	\$ 25
Federal agency issued residential mortgage-backed securities <sup>1</sup>	124	3	292	1	416	4
Subtotal	1,452	21	953	8	2,405	29
Corporate obligations:						
Industrial	28,866	377	—	—	28,866	377
Energy	1,982	14	—	—	1,982	14
Communications and technology	2,709	15	—	—	2,709	15
Financial	—	—	8,241	1,467	8,241	1,467
Consumer	17,143	70	—	—	17,143	70
Public utilities	11,584	102	—	—	11,584	102
Subtotal	62,284	578	8,241	1,467	70,525	2,045
Corporate private-labeled residential mortgage-backed securities	—	—	14,050	754	14,050	754
Municipal securities	—	—	—	—	—	—
Other	—	—	41,895	8,192	41,895	8,192
Redeemable preferred stocks	—	—	1,511	44	1,511	44
Fixed maturity securities	63,736	599	66,650	10,465	130,386	11,064
Equity securities	—	—	273	90	273	90
Total	\$ 63,736	\$ 599	\$ 66,923	\$ 10,555	\$ 130,659	\$ 11,154

<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 at December 31, 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	\$—	\$—	\$959	\$12	\$959	\$12
Federal agency issued residential mortgage-backed securities <sup>1</sup>	649	—	294	2	943	2
Subtotal	649	—	1,253	14	1,902	14
Corporate obligations:						
Industrial	25,455	860	—	—	25,455	860
Communications and technology	7,239	156	—	—	7,239	156
Financial	51,273	2,107	16,402	3,783	67,675	5,890
Consumer	11,765	119	3,689	144	15,454	263
Public utilities	4,710	344	11,152	1,022	15,862	1,366
Subtotal	100,442	3,586	31,243	4,949	131,685	8,535
Corporate private-labeled residential mortgage-backed securities	41,734	2,668	61,864	9,952	103,598	12,620
Municipal securities	—	—	3,909	61	3,909	61
Other	9,257	921	47,146	8,314	56,403	9,235
Redeemable preferred stocks	2,939	115	3,056	625	5,995	740
Fixed maturity securities	155,021	7,290	148,471	23,915	303,492	31,205
Equity securities	69	104	1,054	31	1,123	135
Total	\$155,090	\$7,394	\$149,525	\$23,946	\$304,615	\$31,340

<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 of 12 months or longer decreased from \$23.9 million at December 31, 2011 to \$10.6 million at December 31, 2012. The largest component of this decrease was from the corporate private-labeled residential mortgage-backed securities category, which decreased \$9.2 million during 2012. Gross unrealized losses on fixed maturity and equity securities for less than 12 months accounted for \$0.6 million or 49% of the securities in a gross loss position at December 31, 2012. In addition, 71% of the unrealized losses were less than 20% of the amortized cost at December 31, 2012 compared to 51% at December 31, 2011. The three classes of investments with the largest amount of unrealized losses at December 31, 2012 were from the corporate private-labeled residential mortgage backed securities category, the financial sector, and the other sector. The other sector is largely composed of asset-backed securities. The fair value in these three sectors remain some of the more price-challenged investments. The Company performs present value calculations of future cash flow projections for a majority of these investments to evaluate the potential for other-than-temporary impairment. The Company continues to monitor these investments as defined in Note 4 - Investments. Please refer to that note for further information.

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The following table summarizes the Company's investments in securities available for sale with unrealized losses at December 31, 2012.

	Amortized Cost	Fair Value	Gross Unrealized Losses
Securities owned without realized impairment:			
Unrealized losses of 10% or less	\$72,980	\$72,154	\$826
Unrealized losses of 20% or less and greater than 10%	40,283	34,300	5,983
Subtotal	113,263	106,454	6,809
Unrealized losses greater than 20%:			
Investment grade:			
Less than twelve months	—	—	—
Twelve months or greater	908	500	408
Total investment grade	908	500	408
Below investment grade:			
Less than twelve months	—	—	—
Twelve months or greater	173	98	75
Total below investment grade	173	98	75
Unrealized losses greater than 20%	1,081	598	483
Subtotal	114,344	107,052	7,292
Securities owned with realized impairment:			
Unrealized losses of 10% or less	14,803	14,050	753
Unrealized losses of 20% or less and greater than 10%	2,289	1,928	361
Subtotal	17,092	15,978	1,114
Unrealized losses greater than 20%:			
Investment grade:			
Less than twelve months	—	—	—
Twelve months or greater	—	—	—
Total investment grade	—	—	—
Below investment grade:			
Less than twelve months	—	—	—
Twelve months or greater	10,377	7,629	2,748
Total below investment grade	10,377	7,629	2,748
Unrealized losses greater than 20%	10,377	7,629	2,748
Subtotal	27,469	23,607	3,862
Total	\$141,813	\$130,659	\$11,154



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The following table summarizes the Company's investments in securities available for sale with unrealized losses at December 31, 2011.

	Amortized Cost	Fair Value	Gross Unrealized Losses
Securities owned without realized impairment:			
Unrealized losses of 10% or less	\$154,445	\$151,008	\$3,437
Unrealized losses of 20% or less and greater than 10%	53,042	45,689	7,353
Subtotal	207,487	196,697	10,790
Unrealized losses greater than 20%:			
Investment grade:			
Less than twelve months	4,946	3,752	1,194
Twelve months or greater	908	450	458
Total investment grade	5,854	4,202	1,652
Below investment grade:			
Less than twelve months	8,210	5,977	2,233
Twelve months or greater	—	—	—
Total below investment grade	8,210	5,977	2,233
Unrealized losses greater than 20%	14,064	10,179	3,885
Subtotal	221,551	206,876	14,675
Securities owned with realized impairment:			
Unrealized losses of 10% or less	37,639	36,420	1,219
Unrealized losses of 20% or less and greater than 10%	24,789	20,843	3,946
Subtotal	62,428	57,263	5,165
Unrealized losses greater than 20%:			
Investment grade:			
Less than twelve months	—	—	—
Twelve months or greater	—	—	—
Total investment grade	—	—	—
Below investment grade:			
Less than twelve months	29,391	23,178	6,213
Twelve months or greater	22,585	17,298	5,287
Total below investment grade	51,976	40,476	11,500
Unrealized losses greater than 20%	51,976	40,476	11,500
Subtotal	114,404	97,739	16,665
Total	\$335,955	\$304,615	\$31,340

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The following table provides information on fixed maturity securities with gross unrealized losses by actual or equivalent Standard & Poor's rating at December 31, 2012.

	Fair Value	% of Total	Gross Unrealized Losses	% of Total	
AAA	\$518	—	% \$5	—	%
AA	31,910	25	% 4,586	41	%
A	12,325	9	% 542	5	%
BBB	54,461	42	% 1,387	13	%
Total investment grade	99,214	76	% 6,520	59	%
BB	5,249	4	% 161	1	%
B and below	25,923	20	% 4,383	40	%
Total below investment grade	31,172	24	% 4,544	41	%
	\$130,386	100	% \$11,064	100	%

The following table provides information on fixed maturity securities with gross unrealized losses by actual or equivalent Standard & Poor's rating at December 31, 2011.

	Fair Value	% of Total	Gross Unrealized Losses	% of Total	
AAA	\$32,245	11	% \$4,475	14	%
AA	8,986	3	% 125	1	%
A	32,550	11	% 1,207	4	%
BBB	65,557	21	% 2,925	9	%
Total investment grade	139,338	46	% 8,732	28	%
BB	45,845	15	% 4,063	13	%
B and below	118,309	39	% 18,410	59	%
Total below investment grade	164,154	54	% 22,473	72	%
	\$303,492	100	% \$31,205	100	%

The following is a discussion of all non-asset backed securities whose fair value had been less than 80% of amortized cost for at least six consecutive months at December 31, 2012. 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.

The Company has written down certain investments in previous periods. Securities written down and still owned at December 31, 2012 had a fair value of \$132.3 million with a net unrealized gain of \$1.1 million, which compares to the December 31, 2011 fair value of \$105.2 million and a net unrealized loss of \$15.6 million.

The Company evaluated the current status of all investments previously written-down to determine whether the Company continues to believe that these investments were still credit-impaired to the extent previously recorded. The Company's evaluation process is similar to its impairment evaluation process. If evidence exists that 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 2012 or 2011.

The Company's residential mortgage-backed securities, commercial mortgage-backed securities, and asset-backed securities that were rated below investment grade at year-end 2012 were 32% of the total, compared to 28% at year-end 2011. More of these securities moved into the below investment grade category during 2012 due to ratings downgrades resulting from the troubled housing market.



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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 21 and 17 non-U.S. Agency mortgage-backed securities that were determined to have such indications at December 31, 2012 and December 31, 2011, 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 of the Company's residential mortgage-backed securities, commercial mortgage-backed securities, and asset-backed securities at December 31. The Company believes that the assumptions below are reasonable and they are based largely upon the actual historical results of the underlying security collateral.

2012

Vintage	Initial Default Rate		Initial Severity Rate		Prepayment Speed		
	Low	High	Low	High	Low	High	
2003	1.0	% 4.6	% 35	% 56	% 16.0	% 28.0	%
2004	1.0	% 6.8	% 35	% 53	% 8.0	% 18.0	%
2005	4.7	% 15.1	% 40	% 74	% 6.0	% 15.0	%
2006	5.9	% 6.2	% 49	% 90	% 8.0	% 16.0	%
2007	10.5	% 10.5	% 58	% 58	% 8.0	% 8.0	%

2011

Vintage	Initial Default Rate		Initial Severity Rate		Prepayment Speed		
	Low	High	Low	High	Low	High	
2003	3.9	% 3.9	% 40	% 40	% 18.0	% 18.0	%
2004	4.9	% 7.7	% 40	% 56	% 8.0	% 13.0	%
2005	3.5	% 13.7	% 40	% 68	% 6.0	% 15.0	%
2006	4.9	% 10.0	% 52	% 90	% 8.0	% 18.0	%
2007	8.8	% 8.8	% 66	% 66	% 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 Comprehensive 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.

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 years. 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. At December 31, 2012, the fair value of investments with subprime residential mortgage exposure was \$14.7 million with a related \$2.2 million unrealized loss. At December 31, 2011, the fair value of investments with subprime residential mortgage exposure was \$17.4

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million with a related \$3.5 million unrealized loss. This exposure amounted to less than 1% of the Company's invested assets at both December 31, 2012 and 2011. 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 factors.

The following tables divide these investment types among vintage and credit ratings at December 31, 2012.

	Fair Value	Amortized Cost	Unrealized Gains (Losses)
Residential & Non-agency MBS: 1			
Investment Grade:			
Vintage 2003 and earlier	\$19,426	\$18,667	\$759
2004	26,163	25,186	977
2005	—	—	—
2006	—	—	—
2007	—	—	—
Total investment grade	45,589	43,853	1,736
Below Investment Grade:			
Vintage 2003 and earlier	—	—	—
2004	31,415	30,760	655
2005	75,636	78,334	(2,698)
2006	7,369	6,536	833
2007	4,359	4,209	150
Total below investment grade	118,779	119,839	(1,060)
Other Structured Securities:			
Investment grade	65,481	67,250	(1,769)
Below investment grade	2,559	2,378	181
Total other	68,040	69,628	(1,588)
Total structured securities	\$232,408	\$233,320	\$(912)

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

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The following tables divide these investment types among vintage and credit ratings at December 31, 2011.

	Fair Value	Amortized Cost	Unrealized Gains (Losses)
Residential & Non-agency MBS: 1			
Investment Grade:			
Vintage 2003 and earlier	\$27,700	\$26,974	\$726
2004	29,682	28,693	989
2005	—	—	—
2006	—	—	—
2007	—	—	—
Total investment grade	57,382	55,667	1,715
Below Investment Grade:			
Vintage 2003 and earlier	—	—	—
2004	34,497	34,821	(324 )
2005	72,619	87,447	(14,828 )
2006	6,960	7,309	(349 )
2007	3,868	4,864	(996 )
Total below investment grade	117,944	134,441	(16,497 )
Other Structured Securities:			
Investment grade	58,793	57,998	795
Below investment grade	16,179	18,444	(2,265 )
Total other	74,972	76,442	(1,470 )
Total structured securities	\$250,298	\$266,550	\$(16,252 )

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

Total unrealized losses on non-U.S. Agency structured securities decreased from \$16.3 million at December 31, 2011 to \$0.9 million at December 31, 2012. Total unrealized losses on these securities as a percent of total amortized cost decreased from 6% in 2011 to less than 1% in 2012.

The Company maintains a diversified investment portfolio, including 5% of its investment portfolio in municipal bond securities and 6% in bond securities from foreign issuers. at December 31, 2012. Approximately 73% of the Company's foreign securities were from issuers in Canada, Australia, and Great Britain at December 31, 2012. The Company has no holdings in European sovereign debt and all investments are denominated in U.S. dollars. The fair value of the Company's securities from foreign issuers at December 31, 2012 was \$238.9 million with a net unrealized gain of \$17.9 million. This compares to a fair value of \$199.5 million with a net unrealized gain of \$8.7 million at December 31, 2011.

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 at December 31, 2012 or December 31, 2011. The Company's indirect exposure to financial guarantors totaled \$34.7 million, which was 1% of the Company's investments at December 31, 2012. The unrealized gains on these investments totaled \$3.3 million at December 31, 2012. The Company's indirect exposure to financial guarantors at December 31, 2011 totaled \$36.8 million, which was 1% of the Company's investment assets. Total unrealized gains on these investments totaled \$1.7 million at December 31, 2011.

#### Policyholder Benefits

Policyholder benefits consist of death benefits, immediate annuity benefits, accident and health benefits, surrenders, 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, mortality experience has generally remained within pricing expectations for the periods presented. Following is a discussion of significant fluctuations in policyholder benefits during the periods presented.

Policyholder benefits increased \$4.4 million or 3% in 2012 compared to 2011, primarily due to an increase in benefit and contract reserves. This increase was the result of several factors, including: increased traditional life insurance sales, primarily from the Old American Segment; higher immediate annuity premiums from the Individual Insurance segment; the recapture of a block of



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policies in the second quarter of 2012; impacts resulting from changes and refinements that the Company made to its reserving systems in 2011, as discussed below; and the change in the value of the guaranteed minimum withdrawal benefit (GMWB) rider liability, as discussed below. Partially offsetting the increase in reserves, the Company experienced favorable mortality, and group accident and health dental benefits decreased.

Policyholder benefits decreased \$27.2 million or 15% in 2011 compared to 2010. This decrease was primarily the result of a decline in benefit and contract reserves. The decline was attributed to several factors, including a decline in sales of immediate annuities. A second factor was refinements in estimates, which resulted from the implementation of a new actuarial valuation system on traditional life insurance products. Refinements made during 2011 impacted the methods used in the calculation of reserves for certain traditional life insurance contracts. The Company also released accrued non-guaranteed interest bonus on certain universal life products in 2011. Partially offsetting these factors was the change in the fair value of the GMWB rider, described below. Another factor in the decrease in policyholder benefits was a decline in benefits paid from the group accident and health dental product line. Partially offsetting these, death benefits, net of reinsurance, increased.

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. At December 31, 2012, the fair value of the liability decreased \$0.9 million compared to the fair value at December 31, 2011. This fluctuation can be attributed to favorable capital market returns, a decline in market volatility, and increased interest rates, partially offset by declines in issuer discount spreads. At December 31, 2011, the fair value of the liability increased \$2.6 million compared to the fair value at December 31, 2010. This fluctuation was attributed to declines in discount rates and increased market volatility, partially offset by increases in issuer discount spreads.

**Interest Credited to Policyholder Account Balances**

Interest is credited to policyholder account balances according to terms of the policies or contracts 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 \$1.4 million or 2% in 2012 and \$2.5 million or 3% in 2011. While total policyholder account balances increased during 2012 compared to 2011, this increase was offset by a decline in crediting rates. In both 2012 and 2011, the Company lowered crediting rates on in force funds at the beginning of each year and adjusted new money rates in response to changing market rates.

Total policyholder account balances increased \$38.6 million or 2%, following a \$23.6 million or 1% increase in 2011. The average interest rate credited to policyholder account balances was 3.77% in 2012, 3.92% in 2011, and 4.14% in 2010. On a portfolio basis, investment yields exceeded the crediting rates on the matched liabilities for all three periods.

**Amortization of DAC**

The amortization of DAC decreased \$5.9 million or 17% in 2012, following a \$6.9 million or 26% increase in 2011. The primary factor in the decrease in DAC amortization in 2012 versus 2011 was the unlocking that occurred in 2011. As identified in the 2011 Form 10-K, this segment had an unlocking that included both an upgrade and refinements in the processing system, primarily related to reinsurance. In addition, increases in account values decreased the amortization of DAC for certain variable products. Partially offsetting these was the impact of an unlocking that occurred during 2012. This unlocking resulted in an increase to the DAC asset of \$1.3 million and was primarily attributable to refinements in mortality, interest, and persistency assumptions.

Several factors contributed to the increase that occurred during 2011. During 2011, the Company unlocked assumptions impacting the calculation of future gross profit expectations which resulted in a decrease to amortization of DAC of \$9.7 million. In addition to unlocking, the Company had adjustments in the amortization of DAC associated with refinements in estimates from software enhancements to its DAC modeling system and refinements to

specific plans. These changes resulted in increases to the amortization of DAC associated with interest sensitive products and traditional life insurance products in the amount of \$6.5 million and \$1.5 million, respectively, during 2011. These refinements in estimates increased the amortization associated with the Individual Insurance segment in the amount of \$8.9 million and decreased the amortization of DAC in the Old American segment in the amount of \$0.9 million.

#### Reinsurance

The Company reinsures certain risks with unaffiliated insurance companies under traditional indemnity reinsurance arrangements. These arrangements include yearly renewable term agreements and coinsurance agreements. The Company enters into these agreements to assist in diversifying risks and to limit the maximum loss from risks on certain policies. The ceded reinsurance

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agreements do not relieve the Company of its obligations to its policyholders. As such, the Company monitors the ongoing ability of the reinsurers to perform under the terms of the reinsurance agreements.

Premiums are reported in the Consolidated Statements of Comprehensive Income net of premiums ceded under reinsurance agreements. Policyholder benefits and expenses are also reported in the Consolidated Statements of Comprehensive Income net of reinsurance ceded and equaled \$54.3 million, \$63.7 million, and \$59.7 million for the years ended December 31, 2012, 2011 and 2010, respectively. The largest single component of the reinsurance ceded premiums is associated with reinsurance on purchased blocks and closed blocks of business. In 2012, the Company recaptured a previously closed block of reinsurance business on policies from Sunset Life. This recaptured business reduced ceded premiums \$0.4 million in 2012. In addition, the Company's reinsurance on certain group accident and health business, specifically disability products, increased in both 2012 and 2011, reflecting improved sales from these products.

Future policy benefits and other related assets and liabilities are not reduced for reinsurance in the Consolidated Balance Sheet. A reinsurance recoverable is established for these items. Reinsurance related to policy and claim reserves ceded of \$177.1 million and \$176.7 million were included in the reinsurance recoverables at December 31, 2012 and 2011, respectively. Ceded benefits recoverable from reinsurers were \$13.5 million and \$13.2 million at December 31, 2012 and 2011, respectively.

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 successful acquisition of new business; expenses from the Company's operations; the amortization of VOBA; and other expenses. In total, operating expenses increased \$4.0 million or 4% in 2012 and \$5.5 million or 5% in 2011, compared to the same periods one year earlier.

The increase in 2012 reflected increased salaries and employee benefit costs, legal fees, and depreciation of a long-lived asset. The increased depreciation expense resulted from a change in accounting estimate for a long-lived asset, as described in Note 3. These were partially offset by a decline in the amount charged to allowance for doubtful accounts for agent receivables. The increase in 2011 was due to several factors, including an increase in uncollectible agent receivables; an increase in commission expense, net of the deferral in capitalized commission costs; an increase in legal fees; and an increase in expenses related to the third-party administration costs associated with certain group products. Partially offsetting these, employee salaries and benefits decreased due to a decrease in pension expense.

Income Taxes

The Company recorded income tax expense of \$19.6 million or 33% of income before tax in 2012, compared to income tax expense of \$13.6 million or 34% of income before tax in 2011 and \$12.5 million or 36% of income before tax in 2010. The increase in tax expense in 2012 versus 2011 was primarily due to higher income before tax. The decrease in the effective tax rate was primarily attributable to favorable changes in low income housing tax credit investments. The increase in tax expense in 2011 versus 2010 was primarily due to higher income before tax.

Favorable changes in low income housing tax credit investments exceeded the increase in tax related to differences in the tax contingency, resulting in a lower effective tax rate in 2011 as compared to 2010.

The Company's investments in affordable housing decreased tax expense in 2012, as low income tax credits earned exceeded the equity adjustment related to the affordable housing investments and the recapture of tax credits previously recognized. The Company's investments in affordable housing increased tax expense in 2011 due to the equity adjustment related to the affordable housing investments exceeding the tax credits earned and the recapture of tax credits previously recognized. In 2012, the effect of the investments in affordable housing on the effective tax rate was a tax benefit of \$0.4 million or 1% of income before tax. This was the result of \$0.5 million in tax credits earned in excess of equity adjustments, partially offset by \$0.1 million of recaptured tax credits previously recognized. In 2011, current-year equity adjustments exceeded tax credits earned, resulting in tax expense of \$0.1 million or less than 1% of income before tax.

The Company establishes contingent tax assets or liabilities, when appropriate, to provide for potential challenges by taxing jurisdictions. The Company did not have any change in the tax contingency in 2012 and 2011.



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## 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 18 - Segment Information in the Notes to Consolidated Financial Statements.

## Individual Insurance

The following table presents financial data of the Individual Insurance business segment for the years ended December 31.

	2012	2011	2010
Insurance revenues:			
Net premiums	\$ 16,885	\$ 10,320	\$ 25,755
Contract charges	99,894	101,061	106,019
Total insurance revenues	116,779	111,381	131,774
Investment revenues:			
Net investment income	163,706	164,595	162,997
Net realized investment gains, excluding other-than-temporary impairment losses	20,714	5,184	3,687
Net impairment losses recognized in earnings:			
Total other-than-temporary impairment losses	(2,491	) (2,832	) (3,828
Portion of impairment losses recognized in other comprehensive income	809	930	343
Net other-than-temporary impairment losses recognized in earnings	(1,682	) (1,902	) (3,485
Total investment revenues	182,738	167,877	163,199
Other revenues	9,196	10,110	8,978
Total revenues	308,713	289,368	303,951
Policyholder benefits	86,627	81,859	106,523
Interest credited to policyholder account balances	82,043	83,446	85,949
Amortization of deferred acquisition costs	14,712	21,645	14,976
Operating expenses	70,711	63,700	60,141
Total benefits and expenses	254,093	250,650	267,589
Income before income tax expense	54,620	38,718	36,362
Income tax expense	17,762	13,107	12,855
Net income	\$ 36,858	\$ 25,611	\$ 23,507

The net income for this segment in 2012 was \$36.9 million, compared to \$25.6 million in 2011, and \$23.5 million in 2010. Contributing to the improvement in 2012 were increases in net realized investment gains and insurance revenues, along with lower amortization of deferred acquisition costs and interest credited to policyholder account

balances. Partially offsetting these changes were increases in policyholder benefits and operating expenses.

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Total insurance revenues increased 5% in 2012 and declined 15% in 2011 compared to the same periods one year earlier. In 2012, gross premiums increased 9%, contract charges decreased 1%, and reinsurance ceded decreased 4%. In 2011, gross premiums decreased 22%, contract charges decreased 5% and reinsurance ceded increased 1%.

The Individual Insurance segment is central to the Company's overall performance and produced 49% of consolidated insurance revenues for the years ended December 31, 2012 and 2011 and 54% for the year ended December 31, 2010. In addition, this segment also provided 93% of consolidated net income for the year ended December 31, 2012 compared to 98% for the year ended December 31, 2011.

The following table presents gross premiums by new and renewal business, less reinsurance ceded, as included in insurance revenues for the three years ended December 31. New premiums are also detailed by product.

	2012	% Change	2011	% Change	2010
New premiums:					
Individual life insurance	\$4,640	(6	)% \$4,934	(5	)% \$5,171
Immediate annuities	12,470	82	% 6,860	(69	)% 22,313
Total new premiums	17,110	45	% 11,794	(57	)% 27,484
Renewal premiums	41,934	(1	)% 42,359	2	% 41,667
Total premiums	59,044	9	% 54,153	(22	)% 69,151
Reinsurance ceded	(42,159	) (4	)% (43,833	) 1	% (43,396
Net premiums	\$16,885	64	% \$10,320	(60	)% \$25,755

Total premiums for this segment increased \$4.9 million or 9% in 2012 compared to the prior year, and declined \$15.0 million or 22% in 2011 compared to 2010. Total new premiums increased \$5.3 million or 45% in 2012, resulting from higher sales of immediate annuities. Total renewal premiums decreased \$0.4 million or 1% in 2012 relative to the prior year, due to lower renewals of immediate annuities and individual accident and health products.

The following table provides detail by new and renewal deposits for the three years ended December 31. New deposits are also detailed by product.

	2012	% Change	2011	% Change	2010
New deposits:					
Universal life insurance	\$12,388	11	% \$11,159	(16	)% \$13,330
Variable universal life insurance	563	(32	)% 834	(32	)% 1,226
Fixed deferred annuities	56,788	(8	)% 62,060	(8	)% 67,709
Variable annuities	18,039	11	% 16,291	(10	)% 18,121
Total new deposits	87,778	(3	)% 90,344	(10	)% 100,386
Renewal deposits	140,054	(2	)% 143,611	4	% 137,827
Total deposits	\$227,832	(3	)% \$233,955	(2	)% \$238,213

Total new deposits declined \$2.6 million or 3% in 2012, following a \$10.0 million or 10% decline in 2011. The decline in 2012 was due to a decrease in new fixed deferred annuities. Partially offsetting this decline were increases in new universal life and variable annuity deposits. The decline in 2011 was largely due to a decrease in new fixed deferred annuities.

Total renewal deposits decreased \$3.6 million or 2% in 2012, following a \$5.8 million or 4% increase in 2011. The decrease in 2012 was largely due to declines in fixed deferred annuity and variable annuity renewal deposits. The improvement in 2011 was due to an increase in fixed deferred annuity renewals.

Contract charges decreased \$1.2 million or 1% in 2012 and \$5.0 million or 5% in 2011, compared to the same periods one year earlier. The decline in 2012 was due to several factors. First, cost of insurance charges decreased, largely due to the runoff of closed blocks. Second, a decrease in expense loads resulted from increased sale of products with lower expense loads in 2012 than the prior year. Third, surrender charges declined reflecting lower surrenders on universal life products. Finally, the amortization of deferred revenue increased due to a system upgrade during 2011 that led to

enhanced reinsurance modeling capabilities. The decline in 2011 was primarily due to three factors: lower amortization of deferred revenue due to unlocking, as discussed below;



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the cost of insurance charges declined, largely due to the runoff of closed blocks; and surrender charges declined, reflecting reduced surrenders of universal life and variable universal life products in the ongoing blocks of business. As previously mentioned, the Company has both closed blocks and ongoing blocks of business. Total contract charges on closed blocks comprised 35% of total consolidated contract charges during 2012, compared to 36% in 2011. Total contract charges on closed blocks declined 3% from \$35.9 million in 2011 to \$34.8 million in 2012, reflecting the runoff of this business. Total contract charges on open blocks of business were essentially flat in 2012 compared to 2011.

The Company unlocked assumptions impacting the deferred revenue liability in both 2012 and 2011. In 2012, unlocking due to changes in the interest and mortality margins resulted in a decrease to the deferred revenue liability and a \$1.8 million increase to contract charges. In 2011, the unlocking was the result of several factors, the largest of which was associated with future mortality experience. This included the use of a new industry mortality table and the corresponding impact of reinsurance. The impact of the unlocking in 2011 was an increase in the deferred revenue liability liability and a reduction in contract charges in the amount of \$1.9 million.

Net investment income decreased \$0.9 million in 2012 and increased \$1.6 million or 1% in 2011. The 2012 results reflected an increase in average invested assets that was more than offset by lower yields earned. The 2011 results reflected an increase in average invested assets that was partially offset by lower yields earned.

Gross investment income from fixed maturity securities declined \$3.6 million in 2012 compared to 2011. This decrease was primarily the result of continued declines in yields available in the marketplace.

Policyholder benefits increased \$4.8 million or 6% in 2012 compared to a decrease of \$24.7 million or 23% in 2011. The largest factor in the 2012 results was an increase in benefit and contract reserves. This increase was the result of several factors, including: higher immediate annuity premiums; the recapture of a block of policies in the second quarter of 2012; impacts resulting from changes and refinements that the Company made to its reserving systems in 2011, as discussed below; and the change in the value of the GMWB rider liability, as discussed below. Partially offsetting these changes, were decreases in death benefits, net of reinsurance; supplementary contract payments; and policy dividends and coupons.

The largest factor in the 2011 results was a decrease in benefit and contract reserves. This decrease was the result of several factors. The first factor was a decline in sales of immediate annuities. A second factor was refinements in estimates that resulted from the implementation of a new actuarial valuation system on traditional life insurance products. Refinements made during 2011 impacted the methods used to calculate the amortization of deferred acquisition costs and the calculation of reserves for certain traditional life insurance contracts. The Company also released reserves for non-guaranteed interest bonus on certain universal life products. Partially offsetting these factors, the change in the fair value of the GMWB rider resulted in an increase in benefit and contract reserves. Partially offsetting these items, death benefits paid, net of reinsurance, increased, reflecting less favorable mortality results. In addition, other benefits paid, net of reinsurance, increased due to an increase in annuity payments.

Interest credited to policyholder account balances decreased \$1.4 million or 2% in 2012 and \$2.5 million or 3% in 2011. In both years, the impact of increases in total policyholder account balances was more than offset by declines in crediting rates.

The amortization of DAC decreased \$6.9 million or 32% in 2012 compared to a \$6.7 million or 45% increase in 2011. The primary factor in the decrease in DAC amortization in 2012 versus 2011 was the unlocking that occurred in 2011. As identified in the 2011 Form 10-K, this segment had an unlocking that included both an upgrade and refinements in the processing system, primarily related to reinsurance. In addition, increases in account values decreased the amortization of DAC for certain products. Partially offsetting these was the impact of an unlocking that occurred during 2012.

Operating expenses increased \$7.0 million or 11% in 2012 and \$3.6 million or 6% in 2011. The 2012 results reflected increased salaries and employee benefit costs; legal fees; the depreciation of a long-lived asset; and amortization of VOBA. The increase in VOBA amortization was largely due to unlocking that occurred during the second quarter of 2012. These were partially offset by a decline in the amount charged to allowance for doubtful accounts for agent receivables. The 2011 results reflected increased salaries and employee benefit costs, legal costs, third-party administration charges, and expenses related to the sales of LIHTC investments.



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## Group Insurance

The following table presents financial data of the Group Insurance business segment for the years ended December 31.

	2012	2011	2010
Insurance revenues:			
Net premiums	\$48,823	\$49,684	\$49,355
Total insurance revenues	48,823	49,684	49,355
Investment revenues:			
Net investment income	524	547	553
Other revenues	145	149	156
Total revenues	49,492	50,380	50,064
Policyholder benefits	26,803	27,777	32,131
Operating expenses	23,699	23,675	21,917
Total benefits and expenses	50,502	51,452	54,048
Loss before income tax benefit	(1,010 )	(1,072 )	(3,984 )
Income tax benefit	(354 )	(375 )	(1,394 )
Net loss	\$(656 )	\$(697 )	\$(2,590 )

The following table presents gross premiums by new and renewal business, less reinsurance ceded, as included in insurance revenues, for the three years ended December 31. New premiums are also detailed by product.

	2012	% Change	2011	% Change	2010
New premiums:					
Group life insurance	\$2,459	26	% \$1,951	(14 )%	\$2,280
Group dental insurance	4,553	13	% 4,018	(49 )%	7,813
Group disability insurance	6,996	(21 )%	8,819	89	% 4,665
Other group insurance	132	(6 )%	141	10	% 128
Total new premiums	14,140	(5 )%	14,929	—	% 14,886
Renewal premiums	47,861	3	% 46,279	7	% 43,398
Total premiums	62,001	1	% 61,208	5	% 58,284
Reinsurance ceded	(13,178 )	14	% (11,524 )	29	% (8,929 )
Net premiums	\$48,823	(2 )%	\$49,684	1	% \$49,355

This segment uses direct sales representatives managed by the home office group marketing division, independent third-party distributors, and the Company's agent and general agent field force. Sales from internal producers accounted for 72% of this segment's total sales during 2012, while sales from third-party providers made up the remaining portion of sales. No one third-party provider accounts for a majority of this segment's sales.

New group premiums decreased \$0.8 million or 5% in 2012 compared with 2011. This was primarily due to a \$1.8 million or 21% decrease in new group disability premiums. Partially offsetting this decline were increases of \$0.5 million or 26% in new group life premiums and \$0.5 million or 13% increase in new group dental premiums.

New group premiums were flat in 2011 compared with 2010. While new sales were flat, this segment had growth in the short-term disability insurance product. Short-term disability sales were \$7.6 million, an increase of \$4.4 million compared with 2010. This improvement was largely the result of a third-party arrangement that provides a significant portion of the new disability premiums and accounted for about 54% of the new disability sales. The premiums provided from the third-party arrangement are highly reinsured.



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Renewal premiums increased \$1.6 million or 3% in 2012 compared with 2011, as disability renewal premiums increased \$3.8 million or 34%. Partially offsetting this was a \$1.8 million decrease in dental renewal premiums. Renewal premiums increased \$2.9 million or 7% in 2011 compared with 2010. All significant group products experienced growth in renewal premiums. Group disability premiums increased \$2.1 million and group life and group dental premiums each increased \$0.4 million.

This segment uses reinsurance in several of its group product lines to help mitigate risk and to allow for a higher level and volume of sales. Reinsurance is used for group life, along with group short-term and long-term disability. Reinsurance premiums increased \$1.7 million or 14% in 2012, largely reflecting increases in this segment's life and disability products.

Reinsurance premiums increased \$2.6 million or 29% in 2011. This increase was largely due to an increase in short-term disability sales as described above.

Policyholder benefits for this segment consist of death benefits, accident and health benefits, and the associated increase or decrease in reserves for future policy benefits. Policyholder benefits decreased \$1.0 million and \$4.4 million in 2012 and 2011, respectively. The 2012 results reflected decreased benefits in both the group dental and group life product lines, which more than offset increases in the short-term and long-term disability product lines. The improvement in the group dental product line continues the progress identified in 2011, when this segment made several changes to reduce benefits and improve profitability. In 2011, these improvements were important to the significant decline in policyholder benefits.

This segment identifies a policyholder benefit ratio which is derived by dividing policyholder benefits, net of reinsurance, by total revenues. This ratio allows for a measure of the comparability of improvement in this segment's ability to monitor the relative overall success of product changes related to contract benefits. The ratio for the Group Insurance segment was 55% at December 31, 2012 compared to 56% at December 31, 2011 and 65% at December 31, 2010. During 2012, the policyholder benefit ratios for the group life and dental lines declined, while the ratios increased for disability lines.

Operating expenses consist of commissions, fees to third-party marketing and administrative organizations, and expenses from the Company's operations. Operating expenses for this segment remained flat in 2012, after increasing \$1.8 million or 8% in 2011. The increase in 2011 reflected a \$1.3 million increase in commissions and an increase in payments to third-party administrators. Partially offsetting these expenses was a decrease in direct operating expenses. This segment continues to focus on improving the profitability of business written through enhanced technology for its customers and sales force.

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## Old American

The following table presents financial data of the Old American business segment for the years ended December 31.

	2012	2011	2010
Insurance revenues:			
Net premiums	\$70,773	\$67,869	\$65,229
Total insurance revenues	70,773	67,869	65,229
Investment revenues:			
Net investment income	11,924	12,086	12,309
Net realized investment gains (losses), excluding other-than-temporary impairment losses	(560	) (33	) 668
Net impairment losses recognized in earnings:			
Total other-than-temporary impairment losses	(35	) (120	) (301
Portion of impairment losses recognized in other comprehensive income	(1	) 13	(34
Net other-than-temporary impairment losses recognized in earnings	(36	) (107	) (335
Total investment revenues	11,328	11,946	12,642
Other revenues	13	15	5
Total revenues	82,114	79,830	77,876
Policyholder benefits	46,748	46,177	44,343
Amortization of deferred acquisition costs	13,330	12,321	12,057
Operating expenses	16,151	19,280	19,095
Total benefits and expenses	76,229	77,778	75,495
Income before income tax expense	5,885	2,052	2,381
Income tax expense	2,220	833	996
Net income	\$3,665	\$1,219	\$1,385

Net income for this segment increased \$2.4 million or 201% to \$3.7 million in 2012 and decreased \$0.2 million or 12% to \$1.2 million in 2011. The increase in net income for 2012 was due to an increase in premiums and a decrease in operating expenses. Partially offsetting these items were realized investment losses, along with increases in policyholder benefits and the amortization of deferred acquisition costs.

The decline in net income for 2011 was largely due to increases in policyholder benefits and operating expenses, but these factors were mostly offset by an increase in premiums.

The following table presents gross premiums by new and renewal business, less reinsurance ceded, as included in insurance revenues for the three years ended December 31.

	2012	% Change	2011	% Change	2010
New individual life premiums	\$12,920	5	% \$12,288	9	% \$11,323
Renewal premiums	59,819	3	% 57,896	2	% 56,557
Total premiums	72,739	4	% 70,184	3	% 67,880
Reinsurance ceded	(1,966	) (15	)% (2,315	) (13	)% (2,651
Net premiums	\$70,773	4	% \$67,869	4	% \$65,229

Total new premiums increased 5% in 2012 and 9% in 2011. Total renewal premiums increased 3% in 2012 and 2% in 2011. The increase in new premiums reflects a combination of expanded distribution efforts and improved productivity from the Company's sales agents. Old American continues to focus on the recruitment and development of new agencies and agents, along with generating improved production from existing agencies and agents. In addition, this segment has aggressively managed territories assigned to agencies and emphasized recruiting to improve production of new sales.



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Net investment income decreased \$0.2 million or 1% in 2012. This segment's total investments increased during 2012, largely due to an increased allocation of commercial mortgage loans. However, the yields available in the marketplace continued to reflect the difficult environment. Thus, while the Company's average assets increased versus the prior year, the overall portfolio yield declined.

Net investment income decreased \$0.2 million or 2% in 2011. This decrease primarily reflected a reduction in yields available in the market, offsetting an increase in average assets during 2011.

Policyholder benefits increased \$0.6 million or 1% in 2012. This increase was largely due to an increase in benefit and contract reserves, which was partially offset by a decrease in death benefits, net of reinsurance. The Company's mortality experience was favorable compared to the prior year. The increase in reserves can largely be attributed to the increase in both sales and retention of business. In 2011, policyholder benefits increased 4%, primarily due to increased death benefits. The increase in death benefits reflected the growth of sales in recent years, as well as less favorable mortality experience relative to prior years.

The Company identifies the policyholder benefit ratio to measure comparability of improvement in revenue results to changes in contract benefits. This ratio is derived by dividing policyholder benefits, net of reinsurance, by total revenues excluding realized investment gains and losses and has remained relatively consistent over the years ended December 31, 2012, 2011, and 2010.

	2012	2011	2010	
Total revenue	\$82,114	\$79,830	\$77,876	
Less: Realized investment gains (losses)	(596)	(140)	333	
Revenue excluding realized investment gains (losses)	82,710	79,970	77,543	
Policyholder benefits	46,748	46,177	44,343	
Policyholder benefit ratio	57	% 58	% 57	%

The amortization of DAC increased \$1.0 million or 8% in 2012 and \$0.3 million or 2% in 2011. The increase in 2012 was primarily the result of a refinement in actuarial assumptions that occurred in 2011 that decreased amortization for this segment in the amount of \$0.9 million. In addition, a \$0.3 million increase in amortization resulted from the implementation of ASU No. 2010-26 in 2012, as described in Note 3 to the Consolidated Financial Statements.

Operating expenses decreased 16% in 2012, following a 1% increase in 2011. The reduction in expenses in 2012 was due to several factors. First, VOBA from the traditional life insurance block that was established at the time of purchase 20 years ago became fully amortized at December 31, 2011. This resulted in a \$1.9 million decrease of VOBA amortization in 2012 compared to 2011. In addition, there was a reduction in agent meeting costs in 2012 relative to the prior year. Partially offsetting these decreases, capitalized commissions increased in 2012, primarily related to the implementation of ASU No. 2010-26. Capitalized commissions increased \$1.1 million as a result of the aforementioned ASU implementation.

#### Liquidity and Capital Resources

##### Liquidity

The Company meets liquidity requirements primarily through positive cash flows from operations. 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. 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 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, withdrawals from policyholder accounts, and costs related to acquiring new business. In addition, the Company uses cash for other purposes, including the payment of stockholder dividends and income taxes. 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.

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Net cash provided by operating activities was \$15.2 million in the year ended December 31, 2012. The primary sources of cash from operating activities in 2012 were premium receipts and net investment income. The primary uses of cash from operating activities in 2012 were for the payment of policyholder benefits and operating expenses. Net cash used for investing activities was \$51.6 million. The primary sources of cash were sales, maturities, calls, and principal paydowns of investments totaling \$500.2 million. Offsetting these, the Company's new investments totaled \$575.3 million. Net cash provided by financing activities was \$32.9 million, primarily including \$50.2 million of deposits net of withdrawals from interest sensitive policyholder account balances, and reflecting the payment of \$15.1 million in stockholder dividends.

Separate Accounts

At December 31, 2012, the Company had \$340.1 million in separate account assets. This was an increase of \$23.5 million from \$316.6 million at December 31, 2011. Improved investment performance of the funds increased separate accounts by \$43.4 million versus a decrease of \$2.2 million in 2011. Deposits in separate accounts increased from \$33.1 million in 2011 to \$33.7 million in 2012. Policyholder withdrawals increased \$0.5 million from \$35.3 million in 2011 to \$35.8 million in 2012. Transfers to the general account totaled \$5.1 million in 2012 and \$5.2 million in 2011. In addition, contract charges were flat at \$12.8 million for 2012 and 2011.

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). At December 31, 2012 and 2011 there were no outstanding balances with the FHLB. The Company has access to unsecured revolving lines of credit of \$60.0 million with two major commercial banks with no balances outstanding at December 31, 2012 or 2011. These lines of credit will expire in June of 2013. The Company anticipates renewing these lines of credit as they come due.

Capital Resources

The Company considers existing capital resources to be adequate to support the current level of business activities. The following table shows the capital adequacy of the Company at December 31.

	2012	2011	
Total assets, excluding separate accounts	\$4,185,652	\$4,081,633	
Total stockholders' equity	750,401	710,705	
Ratio of stockholders' equity to assets, excluding separate accounts	18	% 17	%

The ratio of equity to assets less separate accounts was 18% at December 31, 2012, an increase from 17% at December 31, 2011. Stockholders' equity increased \$39.7 million from year-end 2011. The increase was largely due to growth in retained earnings from increased net income. In addition, the Company experienced growth in accumulated other comprehensive income, reflecting an increase in net unrealized gains. Stockholders' equity per share, or book value, equaled \$68.02 at year-end 2012, an 8% increase for the year.

Unrealized gains on available for sale securities, which are included as a component of stockholders' equity (net of securities gains and losses, related taxes, policyholder account balances, future policy benefits, and DAC), totaled \$107.2 million at December 31, 2012. This represents an improvement of \$26.1 million from the \$81.1 million unrealized investment gain position at December 31, 2011.

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. See further discussion in Note 20 to the Consolidated Financial Statements.

During the year ended December 31, 2012, the Company purchased 2,669 shares and sold 1,036 shares of treasury stock from the Company's employee stock ownership plan for a net increase in treasury stock of \$0.1 million. During the second quarter of 2012, the Company purchased 8,098 shares and sold 18,588 shares of treasury stock from the Company's deferred compensation plans for a net decrease in treasury stock of \$0.5 million.

During the second quarter of 2012, the Company reclassified 188,621 shares from other assets to treasury stock. Please see the discussion of the immaterial correction in Note 1 - Nature of Operations and Significant Accounting Policies for additional information.

The stock repurchase program was extended by the Board of Directors through January 2014 to permit the purchase of up to one million of the Company's shares on the open market, which would represent approximately 9% of the shares currently outstanding.

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During 2012, the Company purchased 96,697 of its shares under the stock repurchase program for \$3.2 million (2011 – 157,182 shares for \$4.8 million).

On December 4, 2012, the Company declared a special stockholder dividend of \$0.27 per share. This dividend was paid on December 21, 2012. The dividend reflected the strong earnings results in 2012 and was in addition to the dividends paid quarterly through 2012.

On January 28, 2013, the Board of Directors declared a quarterly dividend of \$0.27 per share that was paid February 13, 2013 to stockholders of record at February 7, 2013.

The Company cannot predict whether current legislative activities will have a significant impact on the ongoing operations of the Company.

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## Contractual Obligations

The following table summarizes (in millions) the Company's contractual obligations by due date, expiration date, or projected dates as of December 31, 2012. Contractual obligations of the Company are those obligations fixed by agreement as to dollar amount and date of payment, but which may include policyholder options that require assumptions to be made to project future cash flows.

	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Borrowings <sup>1</sup>	\$—	\$—	\$—	\$—	\$—
Operating lease obligations <sup>2</sup>	15.2	2.6	4.1	2.8	5.7
Purchase obligations <sup>3</sup>	0.9	0.9	—	—	—
Mortgage loan commitments and other investments <sup>4</sup>	15.1	15.1	—	—	—
Annuity certain contracts <sup>5</sup>	53.9	12.7	17.7	10.8	12.7
Insurance liabilities <sup>6</sup>	2,963.2	279.2	551.1	523.8	1,609.1
Total contractual obligations	\$3,048.3	\$310.5	\$572.9	\$537.4	\$1,627.5

<sup>1</sup> The Company had no outstanding borrowings at December 31, 2012. Borrowings include short-term debt as described in the previous section - Debt and Short-Term Borrowing.

<sup>2</sup> The Company leases its mainframe computer and certain related support equipment.

<sup>3</sup> Purchase obligations include contracts where the Company has a non-cancelable commitment to purchase goods and services.

<sup>4</sup> The Company's mortgage loan commitments provide funding to originate commercial mortgage loans. Mortgage loan commitments generally do not extend beyond 90 days. Other investments are primarily commitments to fund the development of a real estate construction project, affordable housing project obligations, and one construction loan.

<sup>5</sup> Annuity certain contracts are those insurance liabilities (included in future policy benefits and policyholder account balances on the balance sheet) which do not have life contingencies and have scheduled payments. Annuity certain contracts without life contingencies consist of single premium immediate annuities, supplementary contracts and structured settlements.

<sup>6</sup> Insurance liabilities consist primarily of future policy benefits and policyholder account balances for which the timing of cash flows is uncertain and which have life contingencies. The schedule of payments for these liabilities can vary significantly because of the uncertainty of the timing of cash flows, which depend upon insurable events or policyholder surrenders. Projected amounts shown in the table are derived from dynamic projection models used for asset adequacy analysis. These provide projections of liability benefit cash flows by calendar year and incorporate mortality, persistency and other policyholder behavior assumptions. Projection amounts reflect current balance sheet values and do not include an expectation of future sales.



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## Item 7A: Quantitative and Qualitative Disclosures About Market Risk

The Company holds a diversified portfolio of investments that primarily includes cash, bonds, preferred stocks, residential mortgage-backed securities, commercial mortgages, real estate, and alternative investments. Each of these investments is subject, in varying degree, to market risks that can affect their return and their fair value. A majority of these assets are debt issues of corporations, securitized residential mortgage-backed or other asset-backed securities, U.S. Treasury securities, or U.S. Government Sponsored Enterprises (GSE), and are considered fixed income investments. Thus, the primary market risks affecting the Company's portfolio are interest rate risk, credit risk, and liquidity risk.

The Company's investment portfolio increased from a net unrealized gain position of \$198.2 million in 2011 to a net unrealized gain of \$269.5 million at December 31, 2012. The change was primarily attributable to the improved stability within the overall financial markets, particularly including lower interest rates and tightening credit spreads. Interest rate risk arises from the price sensitivity of investments to changes in interest rates. Interest and dividend income represent the greatest portion of an investment's total return for most fixed income instruments in stable interest rate environments. The changes in the fair market price of such investments are inversely related to changes in market interest rates. As interest rates fall, the interest and dividend streams of existing fixed-rate investments become more valuable and market values rise. As interest rates rise, the opposite effect occurs. In addition, interest rate risk can result in lower interest spreads on products and low interest rate environments can result in reduced investment income. Both of these results can cause reduced earnings. The risk of reduced earnings from low interest rates can be heightened by prolonged periods of lower product spreads and interest rates.

Due to the complex nature of interest rate movements and their uneven effects on the value of fixed income investments, the Company uses industry-recognized computer programs to help consider potential changes in the value of the portfolio. Assuming that changes occur equally over the entire term structure of interest rates or yield curve, it is estimated that a 100 basis point increase in rates would translate to a \$145.7 million loss of fair value for the \$2.8 billion securities portfolio. Conversely, a 100 basis point rate decrease would translate to a \$154.7 million increase in fair value.

Market changes rarely follow a linear pattern in one direction for any length of time. Within any diversified portfolio, an investor will likely find embedded options, both puts and calls, that change the structure of the cash flow stream. Residential mortgage-backed securities are particularly sensitive to interest rate changes. As long-term interest rates fall, homeowners typically become more likely to refinance their mortgage or move up to a larger home, causing a prepayment of the outstanding mortgage principal, which must then be reinvested at a lower rate. Should interest rates rise suddenly, prepayments expected by investors may decrease, extending the duration of a mortgage pool. This represents a further interest rate risk to investors.

As interest rates rise, policyholders may become more likely to surrender policies, take partial withdrawals from policies, or to borrow against cash values, often to meet sudden needs in an inflationary environment or to invest in higher yielding opportunities elsewhere. As interest rates decline, policyholders may become more likely to extend the retention or duration of fixed-rate products previously purchased and seek alternatives to fixed-rate products for new purchases. These policyholder options represent risk to the Company and are difficult to model or quantify with precision, largely due to the complex behavioral reactions individual policyholders may face in changing economic environments. Further, the Company expects that general agent and agent relationships and actions with policyholders may help mitigate the risk of disintermediation, particularly during periods of rapidly rising interest rates or other forms of economic stress. However, the complex behavioral reactions of individual policyholders and the independent, non-exclusive relationship the Company maintains with general agents and agents causes the risk of disintermediation to be a significant factor in the Company's investment risk-taking activities and positions.

This risk of disintermediation may force the Company to liquidate parts of its portfolio at a time when the fair value of fixed income investments is falling. If interest rates fall, the Company may also be forced to invest new cash receipts at levels below the minimum guaranteed rates payable to policyholders, eroding profit margins. The risk of eroding profits is increased during prolonged periods of low interest rates. The impact of policyholder behavior, as discussed above, can be complex and difficult to anticipate, model, or quantify. The Company can usually adapt to small sudden changes in interest rates or even large changes that occur over longer periods of time. However, cash flow may

increase or decrease over the course of the business cycle. Therefore, the Company takes steps to ensure that adequate liquidity is available to meet obligations in a timely manner. To this end, the Company utilizes an asset/liability management program, and the Company maintains lines of credit with commercial banks and other short-term borrowing arrangements with financial institutions.

The Company's investments are also 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. Information about the write-down of



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investment securities is provided in the table of Realized Investment Gains and Losses, under the section Consolidated Results of Operations in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The Company mitigates credit risk by diversifying the investment portfolio across a broad range of issuers, investment sectors and security types, and by limiting the amount invested in any particular entity. With the exception of U.S. Treasury securities and certain GSEs, there is no exposure to any single corporate issuer greater than one percent of assets on a book value basis. The Company also invests in securities collateralized or supported by physical assets, guarantees by insurers or other providers of financial strength, and other sources of secondary or contingent payment. These securities can improve the likelihood of payment according to contractual terms and increase recovery amounts in the case of issuer default, bankruptcy, or restructuring.

The Company currently holds \$238.9 million of foreign bonds, none of which are sovereign debt. The foreign securities do not expose the Company directly to foreign currency risk, as the securities are denominated in U.S. dollars. As a result, the foreign currency risk lies with the issuer of the securities and may expose the issuer to fluctuations in the foreign currency market. The Company has very limited European credit exposure.

As market interest rates fluctuate, so will the value of the Company's investment portfolio and its stockholders' equity. At December 31, 2012, the Company had an unrealized investment gain of \$107.2 million (net of related taxes, and amounts allocable to policyholder account balances, future policy benefits, and DAC), compared to a \$81.1 million gain at year-end 2011. This change was primarily the result of overall improvement in the market value of investment securities.

The Company also invests in certain equity securities and alternative investments, such as hedge funds, that generate equity risk and other forms of market risk. The total fair value of preferred stock investments was \$4.5 million and \$5.1 million at December 31, 2012 and 2011, respectively. The total fair value of all other equity and alternative investments was \$15.5 million and \$31.6 million at the same respective dates. The market risks associated with these investments are managed primarily through diversification and selection of investments that have historically exhibited changes in values that are not highly correlated to the Company's other investments or risk positions. The Company markets certain variable products. The policyholder assumes essentially all the investment earnings risk for the portion of the account balance invested in the separate accounts. However, the Company assesses certain charges based on the policy account values and changes to the account values can affect the Company's earnings. The portion of the policyholder's account balance invested in the fixed general account, if any, is affected by many factors, including the absolute level of interest rates, relative performance of the fixed income and equity markets, spreads between interest yields on investments and rates credited to the policyholder's accounts, and changes in consumer preferences.

#### Asset/Liability Management

The Company's asset/liability management programs and procedures involve the monitoring of asset and liability durations for various product lines, cash flow testing under various interest rate scenarios to evaluate the potential sensitivity of assets and liabilities to interest rate movements, and the continuous rebalancing of assets and liabilities with respect to yield, risk, and cash flow characteristics.

The Company believes its asset/liability management programs and procedures, along with certain product features, provide protection for the Company against the effects of changes in interest rates under various scenarios.

Cash flows and effective durations of the asset and liability portfolios are measured at points in time and are affected by changes in the level and term structure of interest rates, as well as changes in policyholder behavior. Further, durations are managed on an individual product level, and an aggregate portfolio basis. As a result, differences typically exist between the duration, cash flows, and yields of assets versus liabilities on an individual portfolio and aggregate basis. The Company's asset/liability management programs and procedures enable management to monitor the changes, which have varying correlations among certain portfolios, and to make adjustments to asset mix, liability crediting rates, and product terms so as to manage risk and profitability over time.

The Company aggregates similar policyholder liabilities into portfolios and then matches specific investments with these liability portfolios. In 2012 and 2011, all of the Company's portfolios had investment yields that exceeded the crediting rates on the matched liabilities. The Company was not required to invest at levels below minimum

guaranteed rates payable to policyholders in 2012 or 2011. However, the Company periodically elected to purchase certain individual investments with yields less than the minimum guaranteed rates on a portion of the Company's policyholder liabilities, while continuing to ensure that the investment portfolio yields were in excess of the matched liabilities. Such investments are made due to unique characteristics or timing of the investments, and yields available in the market. The Company monitors the risk to portfolio investment margins on an ongoing basis. Should the Company be required to invest at rates that fall below the Company's minimum guaranteed portfolio rates, the Company would assess the facts and conditions available at that time and develop an appropriate plan to suit that environment.

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The Company performs cash flow scenario testing through models of its in force business. These models reflect specific product characteristics and include assumptions based on current and anticipated experience regarding the relationships between short-term and long-term interest rates (i.e., the slope of the yield curve), credit spreads, market liquidity and other factors, including policyholder behavior in certain market conditions. In addition, these models include asset cash flow projections, reflecting interest payments, sinking fund payments, scheduled principal payments, and optional bond calls and prepayments.

The Company has a risk that the asset or liability portfolio performance may differ from forecasted results as a result of unforeseen economic circumstances, estimates or assumptions that prove incorrect, unanticipated policyholder behavior, or other factors. The result of such deviation of actual versus expected performance could include excess or insufficient liquidity in future periods. Excess liquidity, in turn, could result in reduced profitability on one or more product lines. Insufficient liquidity could result in the need to generate liquidity through borrowing, asset sales, or other means. The Company believes that its asset/liability management programs will provide sufficient liquidity to enable it to fulfill its obligation to pay benefits under its various insurance and deposit contracts. On a historical basis, the Company has not needed to liquidate assets to ensure sufficient cash flows. The Company maintains borrowing lines on a secured and unsecured basis to provide additional liquidity, if needed.

Expected Cash Flows

The table below details (in millions) the nature of expected cash flows from the securities portfolio, including the cash flows from residential mortgage-backed securities pools, corporate bonds, and commercial mortgages. Calls and prepayments represent the Company's assumptions of the principal amount expected to return to the Company. Total principal equals invested cash scheduled to return in each year, including maturities, calls, sinking funds, and prepayments.

	2013	2014	2015	2016	2017	There- after	Total Principal	Fair Value
Fixed maturity securities:								
Corporate bonds currently callable	\$11	\$—	\$—	\$—	\$—	\$—	\$11	\$11
Average interest rate	7.33	% —	—	—	—	—	7.33	%
Residential mortgage-backed securities and CMOs	51	40	29	23	19	86	248	258
Average interest rate	5.64	% 5.84	% 5.77	% 5.74	% 5.77	% 5.68	% 5.72	%
All other securities	138	145	190	161	266	1,344	2,244	2,519
Average interest rate	5.40	% 5.50	% 4.89	% 4.83	% 6.62	% 4.59	% 4.98	%
Total fixed maturity securities	200	185	219	184	285	1,430	2,503	2,788
Average interest rate	5.57	% 5.57	% 5.01	% 4.94	% 6.56	% 4.65	% 5.06	%
Mortgage loans	65	63	71	80	72	323	674	722
Average interest rate	6.26	% 6.22	% 6.11	% 6.17	% 6.39	% 5.98	% 6.11	%
Total	\$265	\$248	\$290	\$264	\$357	\$1,753	\$3,177	\$3,510
Average interest rate	5.74	% 5.74	% 5.28	% 5.32	% 6.53	% 4.90	% 5.29	%

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## Item 8. Financial Statements and Supplementary Data

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

Kansas City Life Insurance Company

Consolidated Balance Sheets

	December 31	
	2012	2011
<b>ASSETS</b>		
Investments:		
Fixed maturity securities available for sale, at fair value (amortized cost: 2012 - \$2,520,466; 2011 - \$2,485,692)	\$2,788,141	\$2,682,142
Equity securities available for sale, at fair value (cost: 2012 - \$18,195; 2011 - \$34,951)	20,061	36,689
Mortgage loans	674,034	601,923
Real estate	124,742	127,962
Policy loans	77,133	80,375
Short-term investments	24,902	49,316
Other investments	2,572	3,364
Total investments	3,711,585	3,581,771
Cash	7,026	10,436
Accrued investment income	34,747	34,705
Deferred acquisition costs	176,275	181,564
Reinsurance recoverables	190,613	189,885
Property and equipment	18,343	22,671
Other assets	47,063	60,601
Separate account assets	340,093	316,609
Total assets	\$4,525,745	\$4,398,242
<b>LIABILITIES</b>		
Future policy benefits	\$889,107	\$879,015
Policyholder account balances	2,128,002	2,089,452
Policy and contract claims	29,813	36,511
Other policyholder funds	155,749	152,125
Other liabilities	232,580	213,825
Separate account liabilities	340,093	316,609
Total liabilities	3,775,344	3,687,537
<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	40,969	41,101
Retained earnings	805,730	780,918
Accumulated other comprehensive income	54,094	30,086
Treasury stock, at cost (2012 - 7,463,823 shares; 2011 - 7,187,315 shares)	(173,513	) (164,521
Total stockholders' equity	750,401	710,705
Total liabilities and stockholders' equity	\$4,525,745	\$4,398,242
See accompanying Notes to Consolidated Financial Statements		



Table of ContentsKansas City Life Insurance Company  
Consolidated Statements of Comprehensive Income

	Year Ended December 31		
	2012	2011	2010
<b>REVENUES</b>			
Insurance revenues:			
Net premiums	\$136,089	\$127,338	\$139,811
Contract charges	99,894	101,061	106,019
Total insurance revenues	235,983	228,399	245,830
Investment revenues:			
Net investment income	176,154	177,228	175,859
Net realized investment gains, excluding other-than-temporary impairment losses	20,154	5,151	4,355
Net impairment losses recognized in earnings:			
Total other-than-temporary impairment losses	(2,526)	) (2,952)	) (4,129)
Portion of impairment losses recognized in other comprehensive income	808	943	309
Net other-than-temporary impairment losses recognized in earnings	(1,718)	) (2,009)	) (3,820)
Total investment revenues	194,590	180,370	176,394
Other revenues	9,354	10,274	9,139
Total revenues	439,927	419,043	431,363
<b>BENEFITS AND EXPENSES</b>			
Policyholder benefits	160,178	155,813	182,997
Interest credited to policyholder account balances	82,043	83,446	85,949
Amortization of deferred acquisition costs	28,042	33,966	27,033
Operating expenses	110,169	106,120	100,625
Total benefits and expenses	380,432	379,345	396,604
Income before income tax expense	59,495	39,698	34,759
Income tax expense	19,628	13,565	12,457
NET INCOME	\$39,867	\$26,133	\$22,302
<b>COMPREHENSIVE INCOME, NET OF TAXES</b>			
Change in net unrealized gains on securities available for sale	\$35,088	\$43,266	\$47,691
Change in future policy benefits	(8,562)	) (5,721)	) (4,615)
Change in policyholder account balances	(362)	) (162)	) (214)
Change in benefit plan obligations	(2,156)	) (15,104)	) 1,422
Other comprehensive income	24,008	22,279	44,284
COMPREHENSIVE INCOME	\$63,875	\$48,412	\$66,586
Basic and diluted earnings per share:			
Net income	\$3.59	\$2.29	\$1.95
See accompanying Notes to Consolidated Financial Statements			

Table of ContentsKansas City Life Insurance Company  
Consolidated Statements of Stockholders' Equity

	Year Ended December 31		
	2012	2011	2010
COMMON STOCK, beginning and end of year	\$23,121	\$23,121	\$23,121
ADDITIONAL PAID IN CAPITAL			
Beginning of year	41,101	41,085	41,068
Increase (decrease) of proceeds over cost of treasury stock sold	(132	) 16	17
End of year	40,969	41,101	41,085
RETAINED EARNINGS			
Beginning of year	780,918	767,126	757,225
Net income	39,867	26,133	22,302
Stockholder dividends of \$1.35 per share (2011-\$1.08; 2010-\$1.08)	(15,055	) (12,341	) (12,401
End of year	805,730	780,918	767,126
ACCUMULATED OTHER COMPREHENSIVE INCOME, net of taxes			
Beginning of year	30,086	7,807	(36,477
Other comprehensive income	24,008	22,279	44,284
End of year	54,094	30,086	7,807
TREASURY STOCK, at cost			
Beginning of year	(164,521	) (159,667	) (156,574
Cost of 107,511 shares acquired (2011 - 158,694 shares; 2010 - 99,012 shares)	(3,979	) (4,868	) (3,108
Cost of 19,624 shares sold (2011 - 954 shares; 2010 - 1,026 shares)	1,177	14	15
Immaterial correction (see Note 1)	(6,190	) —	—
End of year	(173,513	) (164,521	) (159,667
TOTAL STOCKHOLDERS' EQUITY	\$750,401	\$710,705	\$679,472
See accompanying Notes to Consolidated Financial Statements			

Table of ContentsKansas City Life Insurance Company  
Consolidated Statements of Cash Flows

	Year Ended December 31		
	2012	2011	2010
<b>OPERATING ACTIVITIES</b>			
Net income	\$39,867	\$26,133	\$22,302
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of investment premium and discount	3,926	3,314	3,263
Depreciation	7,236	3,204	2,786
Acquisition costs capitalized	(36,919)	) (34,140	) (37,017)
Amortization of deferred acquisition costs	28,042	33,966	27,033
Realized investment gains	(18,436)	) (3,142	) (535)
Changes in assets and liabilities:			
Reinsurance recoverables	(728)	) (2,762	) (7,758)
Future policy benefits	(3,081)	) (14,167	) 10,391
Policyholder account balances	(12,127)	) (10,563	) (19,865)
Income taxes payable and deferred	6,255	7,561	21,490
Other, net	1,208	8,504	13,280
Net cash provided	15,243	17,908	35,370
<b>INVESTING ACTIVITIES</b>			
Purchases:			
Fixed maturity securities	(338,277)	) (235,593	) (423,039)
Equity securities	(5,572)	) (106	) (1,471)
Mortgage loans	(178,710)	) (132,877	) (140,847)
Real estate	(37,119)	) (9,548	) (12,238)
Policy loans	(15,148)	) (14,652	) (16,765)
Other investments	(507)	) (2	) (644)
Sales or maturities, calls, and principal paydowns:			
Fixed maturity securities	300,984	290,719	350,110
Equity securities	22,163	1,453	584
Mortgage loans	105,125	85,122	39,262
Real estate	53,480	—	—
Policy loans	18,390	18,558	18,069
Other investments	8	—	858
Net sales (purchases) of short-term investments	24,414	(33,603)	) 122,991
Net acquisition of property and equipment	(793)	) (255	) (406)
Net cash used	(51,562)	) (30,784	) (63,536)



Table of ContentsKansas City Life Insurance Company  
Consolidated Statements of Cash Flows (Continued)

	Year Ended December 31		
	2012	2011	2010
<b>FINANCING ACTIVITIES</b>			
Proceeds from borrowings	\$75,500	\$—	\$8,000
Repayment of borrowings	(75,500	) —	(8,000
Deposits on policyholder account balances	227,832	233,955	238,213
Withdrawals from policyholder account balances	(177,674	) (199,960	) (204,405
Net transfers from separate accounts	5,082	5,282	7,177
Change in other deposits	(4,342	) (4,231	) 3,122
Cash dividends to stockholders	(15,055	) (12,341	) (12,401
Net change in treasury stock	(2,934	) (4,838	) (3,076
Net cash provided	32,909	17,867	28,630
Increase (decrease) in cash	(3,410	) 4,991	464
Cash at beginning of year	10,436	5,445	4,981
Cash at end of year	\$7,026	\$10,436	\$5,445
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest	\$4	\$—	\$1
Income taxes	14,000	8,257	4,000
See accompanying Notes to Consolidated Financial Statements			

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Kansas City Life Insurance Company  
Notes to Consolidated Financial Statements

1. Nature of Operations and Significant Accounting Policies

Business

Kansas City Life Insurance Company is a Missouri domiciled stock life insurance company which, with its subsidiaries, is licensed to sell insurance products in 49 states and the District of Columbia. The Company offers a diversified portfolio of individual insurance, annuity, and group products through three life insurance companies. 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.

Basis of Presentation

The consolidated financial statements and the accompanying notes to the Consolidated Financial Statements have been prepared on the basis of GAAP and include the accounts of Kansas City Life and its subsidiaries, principally Sunset Life and Old American. 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.

Immaterial Correction of Errors

During the second quarter of 2012, the Company identified an error in the presentation of treasury stock held for the benefit of the Company's deferred compensation plans. This treasury stock was previously recorded as a component of other assets but should have been recorded in stockholders' equity as treasury stock. Accordingly, the Company reclassified \$6.2 million (188,621 shares) from other assets to treasury stock. This error had no material impact on net income in the current or prior reporting periods.

During the first quarter of 2012, the Company identified an error related to the amortization period for unrecognized actuarial gains and losses for its pension plan resulting in a reduction to net periodic pension expense of \$2.0 million before applicable income taxes and an after-tax increase of \$1.3 million to net income and stockholders' equity. The excess amortization had been previously recorded during 2011. Please refer to Note 13 - Pensions and Other Postretirement Benefits for additional information.

Management has evaluated these errors both quantitatively and qualitatively, and concluded that these corrections were not material to the consolidated financial statements.

Use of Estimates

The preparation of the 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 at the date of the 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. Included among the material (or potentially material) reported amounts and disclosures that require extensive use of estimates are the fair value of certain invested assets, DAC, VOBA, future policy benefits, policy and contract claim liabilities, pension and other postretirement benefits, and the valuation allowance on deferred income tax assets.

Business Changes

The Company has not had any significant business changes in the three years ended December 31, 2012.

Significant Accounting Policies

Presented below is a summary of significant accounting policies used by the Company.

Investments

Investment income is recognized when earned. Premiums and discounts on fixed maturity securities are amortized over the life of the related security as an adjustment to yield using the effective interest method. Realized gains and losses on the sale of investments are determined on the basis of specific security identification recorded on the trade date. Unrealized gains and losses, net of adjustments to DAC, VOBA, policyholder account balances, future policy benefits, and deferred income taxes are reported as a separate component of accumulated other comprehensive income in stockholders' equity. Unrealized gains and losses represent the difference between amortized cost and fair value on

the valuation date. The adjustments to DAC and VOBA represent changes in the amortization of DAC and VOBA that would have been required as a charge or credit to income had such unrealized amounts been realized. The adjustments to policyholder account balances and future policy benefits represent the increase from using a discount rate that would have been required if such unrealized gains or losses had been realized and the proceeds reinvested at current market interest rates, which were lower than the then-current effective portfolio rate.

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

Investment income on residential mortgage-backed securities is initially based upon yield, cash flow, and prepayment assumptions at the date of purchase. Subsequent revisions in those assumptions are recorded using the retrospective method, except for adjustable rate residential mortgage-backed securities where the prospective method is used. Under the retrospective method, the amortized cost of the security is adjusted to the amount that would have existed had the revised assumptions been in place at the time of purchase. Under the prospective method, future cash flows are estimated and interest income is recognized going forward using the new effective yield to maturity. The adjustments to amortized cost under both methods are recorded as a charge or credit to net investment income. The Company bases its historical results from individual securities and internal assessments of likely future results for these securities. These results are based upon validations and comparisons to similar securities provided by third parties, such as rating agencies.

Valuation of Investments

The Company's principal investments are in fixed maturity securities, mortgage loans, and real estate; all of which are exposed to three primary sources of investment risk: credit, interest rate, and liquidity. The fixed maturity securities, which are all classified as available for sale, are carried at fair value in the Company's Consolidated Balance Sheets, with unrealized gains or losses recorded in accumulated other comprehensive income. The unrealized gains or losses are recorded net of the adjustment to policyholder account balances, future policy benefits, and DAC to reflect what would have been earned had those gains or losses been realized and the proceeds reinvested. For additional information, please see Note 5 – Fair Value Measurements.

Mortgage loans are stated at cost, adjusted for amortization of premium and accrual of discount, less an allowance for potential future losses. A loan is considered impaired if it is probable that all contractual amounts due will not be collected. The allowance for potential future losses on mortgage loans is maintained at a level believed by management to be adequate to absorb potential future credit losses. Management's periodic evaluation and assessment of the adequacy of the allowance is based on known and inherent risks in the portfolio, historical and industry data, current economic conditions and other relevant factors, along with specific risks related to specific loans. Loans in foreclosure and loans considered to be impaired are placed on a non-accrual status.

Real estate consists of directly owned investments and real estate joint ventures. Real estate that is directly owned is carried at depreciated cost. Real estate joint ventures consist primarily of office buildings, industrial warehouses, unimproved land for future development, and low income housing tax credit (LIHTC) investments. Real estate joint ventures are consolidated when required or are valued at cost, adjusted for the Company's equity in earnings.

Policy loans are carried at cost, less principal payments received. Short-term investments are stated at cost, adjusted for amortization of premium and accrual of discount.

Other-than-Temporary Impairments

The Company has a policy and process in place to identify securities and other assets that could potentially have an impairment that is other-than-temporary. This process involves monitoring market events and other items that could impact issuers' credit ratings, business climate, management changes, litigation and government actions, and other similar factors. This process also involves monitoring late payments, downgrades by rating agencies, key financial ratios, financial statements, revenue forecasts, asset quality, and cash flow projections as indicators of credit issues. For additional information, please see Note 4 - Investments.

Future Policy Benefits

The Company establishes liabilities for amounts payable under insurance policies, including traditional life insurance, immediate annuities with life contingencies, supplementary contracts with life contingencies, and accident and health insurance. Generally, amounts are payable over an extended period of time. Liabilities for future policy benefits of traditional life insurance have been computed by a net level premium method based upon estimates at the time of issue for investment yields, mortality, and withdrawals. These estimates include provisions for experience less favorable than initially expected. Mortality assumptions are based on Company experience expressed as a percentage of standard mortality tables. The 2001 Valuation Basic Table and the 1975-1980 Select and Ultimate Basic Table serve as the bases for most mortality assumptions.

Liabilities for future policy benefits of immediate annuities and supplementary contracts with life contingencies are computed by calculating an actuarial present value of future policy benefits, based upon estimates for investment yields and mortality at the time of issue.

Liabilities for future policy benefits of accident and health insurance represent estimates of payments to be made on reported insurance claims, as well as claims incurred but not yet reported. These liabilities are estimated using actuarial analyses and case basis evaluations that are based upon past claims experience, claim trends, and industry experience.

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Kansas City Life Insurance Company

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The following table provides detail about future policy benefits at December 31.

	2012	2011
Life insurance	\$616,355	\$616,397
Immediate annuities and supplementary contracts with life contingencies	231,882	219,134
Total	848,237	835,531
Accident and health insurance	40,870	43,484
Total future policy benefits	\$889,107	\$879,015

## Policyholder Account Balances

Policyholder account balances include universal life insurance, fixed deferred annuity contracts, and investment-type contracts. Liabilities for these policyholder account balances are included without reduction for potential surrender charges. Deferred front-end contract charges reduce policyholder account balance liabilities and increase the other policyholder funds liability. These policyholder account balances are equal to cumulative deposits, less contract charges and withdrawals, plus interest credited. Front-end contract charges are deferred and amortized over the term of the policies. Policyholder benefits incurred in excess of related policyholder account balances are charged to policyholder benefits expense.

Crediting rates for universal life insurance and fixed deferred annuity products ranged from 1.00% to 5.50% in 2012 (2011 – 1.50% to 5.50%; 2010 – 2.00% to 5.50%).

The following table provides detail about policyholder account balances at December 31,

	2012	2011
Universal life insurance	\$943,649	\$950,935
Fixed deferred annuities	1,130,032	1,082,324
Supplementary contracts without life contingencies	54,321	56,193
Policyholder account balances	\$2,128,002	\$2,089,452

## Deferred Acquisition Costs (DAC)

DAC, principally agent commissions and other selling, selection, and issue costs, which are related directly to the successful acquisition of new or renewal insurance contracts, are capitalized as incurred. At least annually, the Company reviews its DAC capitalization policy and the specific items which are capitalized with existing guidance. See Note 3 for discussion of the implementation of new accounting guidance adopted during 2012 related to the costs capitalized. 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 in relation to the estimated gross profits to be realized over the lives of the contracts.

For interest sensitive and variable insurance products, estimated gross profits are composed of net interest income, net realized investment gains and losses, fees, surrender charges, expenses, and mortality gains and losses. At the issuance of policies, projections of estimated gross profits are made which are then replaced by actual gross profits over the lives of the policies. In addition to other factors, emerging experience may lead to a revised outlook for the remaining estimated gross profits. Accordingly, DAC may be recalculated (unlocked) using these new assumptions and any resulting adjustment is included in income. The Company considers the following assumptions to be of significance when projecting future estimated gross profits: mortality, interest rates and spreads, surrender and withdrawal rates, and expense margins.

The DAC asset is adjusted to reflect the impact of unrealized gains and losses on fixed maturity securities available for sale, as described in the Investments section of Note 1.



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Notes to Consolidated Financial Statements--(Continued)

The following table provides information about DAC at December 31.

	2012	2011	2010
Balance at beginning of year	\$181,564	\$192,943	\$209,495
Capitalization of commissions, sales and issue expenses	36,919	34,140	37,017
Gross amortization	(39,786	) (45,730	) (38,896
Accrual of interest	11,744	11,764	11,863
Amortization due to realized investment gains	(61	) (201	) (67
Change in DAC due to unrealized investment gains	(14,105	) (11,352	) (26,469
Balance at end of year	\$176,275	\$181,564	\$192,943

## Value of Business Acquired (VOBA)

When a new block of business is acquired or when an insurance company is purchased, a portion of the purchase price is allocated to a separately identifiable intangible asset, called VOBA. VOBA is established as the actuarially determined present value of future gross profits of the business acquired and is amortized with interest in proportion to future premium revenues or the expected future profits, depending on the type of business acquired. VOBA is reported as a component of other assets with related amortization included in operating expenses. Amortization of VOBA occurs with interest over the anticipated lives of the underlying business to which it relates, initially 15 to 30 years. Similar to DAC, the assumptions regarding future experience can affect the carrying value of VOBA, including interest spreads, mortality, expense margins, and policy and premium persistency experience. Profit expectations are based upon assumptions of future interest spreads, mortality margins, expense margins, and policy and premium persistency experience. These assumptions involve judgment and are compared to actual experience on an ongoing basis. If it is determined that the assumptions related to the profit expectations for interest sensitive and variable insurance products should be revised, the impact of the change is reported in the current period's income as an unlocking adjustment.

The VOBA asset is adjusted to reflect the impact of unrealized gains and losses on fixed maturity securities available for sale, as described in the Investments section of Note 1.

The following table provides information about VOBA at December 31.

	2012	2011	2010
Balance at beginning of year	\$31,545	\$49,271	\$66,114
Gross amortization	(9,635	) (10,673	) (10,432
Accrual of interest	2,595	3,197	3,654
Amortization due to realized investment (gains) losses	(74	) (169	) 58
Change in VOBA due to unrealized investment gains	(3,266	) (10,081	) (10,123
Balance at end of year	\$21,165	\$31,545	\$49,271

The accrual of interest for Old American VOBA was calculated at a 7.0% rate for the accident and health block. In 2012, interest accrued on the GuideOne VOBA was at the rates of 4.2% on the interest sensitive life block, 4.0% on the deferred annuity block, and 5.3% on the traditional life block. The VOBA on a separate acquired block of business used a 7.0% interest rate on the traditional life portion and a 5.4% interest rate on the interest sensitive portion. The interest rates used in the calculation of VOBA are based on rates appropriate at the time of acquisition. The amortization of VOBA was \$1.9 million lower during 2012 compared to 2011, as the traditional life insurance block at the Old American segment became fully amortized at December 31, 2011. The expected amortization of VOBA each year over the next five years, 2013 through 2017, is \$6,908, \$6,054, \$5,536, \$5,069, and \$4,619, respectively.

## Unlocking and Refinements in Estimates

DAC and VOBA are reviewed on an ongoing basis to evaluate whether the unamortized portion exceeds the expected recoverable amounts. If it is determined from emerging experience that the premium margins or expected gross profits are insufficient to amortize DAC and VOBA, then the asset will be adjusted downward with the adjustment recorded



as an expense in the current period. Similarly, if future projections of estimated gross profits indicate improvements, the amortization of DAC and VOBA may be reduced and the balance adjusted.

At least annually, a review is performed of the models and the assumptions used to develop expected future profits, based upon management's current view of future events. Management's view primarily reflects Company experience but can also reflect

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Notes to Consolidated Financial Statements--(Continued)

emerging trends within the industry. Short-term deviations in experience affect the amortization of DAC, deferred revenue liability (DRL), and VOBA in the period, but do not necessarily indicate that a change to the long-term assumptions of future experience is warranted. If it is determined that it is appropriate to change the assumptions related to future experience, then an unlocking adjustment is recognized retrospectively for the block of business being evaluated. Certain assumptions, such as interest spreads and surrender rates, may be interrelated. As such, unlocking adjustments often reflect revisions to multiple assumptions. The DAC, DRL, or VOBA balance is immediately impacted by any assumption changes, with the change reflected through the income statement as an unlocking adjustment. These adjustments can be positive or negative with adjustments reducing amortization limited to amounts previously deferred plus interest accrued through the date of the adjustment.

The Company may consider refinements in estimates due to improved capabilities resulting from administrative or actuarial system enhancements. 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 DAC, VOBA, and DRL in a manner similar to unlocking adjustments.

The following table summarizes the effects of the refinements in estimates on all products and unlocking of assumptions on interest sensitive products in the Consolidated Statements of Comprehensive Income for the years ended December 31.

	DAC	VOBA	DRL	Total
2012				
Unlocking	\$1,259	\$(2,391)	) \$1,761	\$629
Refinement in estimate	175	—	6	181
	\$1,434	\$(2,391)	) \$1,767	\$810
2011				
Unlocking	\$9,722	\$(939)	) \$(1,889)	) \$6,894
Refinement in estimate	(7,954)	) —	153	(7,801)
	\$1,768	\$(939)	) \$(1,736)	) \$(907)
2010				
Unlocking	\$5,831	\$—	\$1,107	\$6,938
Refinement in estimate	1,795	—	(922)	) 873
	\$7,626	\$—	\$185	\$7,811

## Reinsurance

Consistent with the general practice of the life insurance industry, the Company enters into traditional agreements of indemnity reinsurance with other insurance companies to support sales of new products and the in force business. The reinsurance arrangements have taken various forms over the years. The Company has reinsurance in force on all of the following bases: automatic and facultative; yearly renewable term (YRT) and coinsurance; and excess and quota share basis. For additional information pertaining to the Company's significant reinsurers, along with additional information pertaining to reinsurance, please see Note 15 - Reinsurance.

Reinsurance recoverables include amounts related to paid benefits and estimated amounts related to unpaid policy and contract claims, future policy benefits, and policyholder account balances. All insurance related revenues, benefits, and expenses are reported net of reinsurance ceded. Policies and contracts assumed are accounted for in a manner similar to that followed for direct business.

## Recognition of Revenues

Premiums for traditional life insurance products are reported as revenue when due. Premiums on accident and health, disability, and dental insurance are reported as earned ratably over the contract period in proportion to the amount of insurance protection provided.

Deposits related to universal life, fixed deferred annuity contracts, and investment-type products are credited to policyholder account balances. Deposits are not recorded as revenue and are shown as a Financing Activity in the Consolidated Statements of Cash Flows. Revenues from such contracts consist of amounts assessed against policyholder account balances for mortality, policy administration, and surrender charges, and are recognized in the period in which the benefits and services are provided as contract charges in the Consolidated Statements of Comprehensive Income.

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The Company measures its sales or new business production with two components: new premiums recorded and new deposits received. Premiums and deposits are subdivided into two categories: new and renewal. New premiums and deposits are measures of sales or new business production. Renewal premiums and deposits occur as continuing business from existing customers.

**Contract Charges**

Contract charges consist of cost of insurance, expense loads, the amortization of unearned revenues, and surrender charges on policyholder account balances. Cost of insurance relates to charges for mortality. These charges are applied to the excess of the mortality benefit over the account value for universal life policies. Expense loads are amounts that are assessed against the policyholder balance as consideration for origination and maintenance of the contract.

Surrender charges are fees on policyholder account balances upon cancellation or withdrawal of policyholder account balances consistent with policy terms.

An additional component of contract charges is the recognition over time of the DRL for certain fixed and variable universal life policies. This liability arises from front-end loads on such policies and is recognized into the Consolidated Statements of Comprehensive Income in a manner similar to the amortization of DAC.

Contract charges could be impacted by unlocking and refinements in estimates, as discussed previously.

**Guaranteed Minimum Withdrawal Benefits (GMWB)**

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.

**Interest Credited to Policyholder Account Balances**

Interest is credited to policyholder account balances according to terms of the policies or contracts. Interest sensitive life and annuity contracts provide for the payment of interest credited to policyholder account balances, subject to contractual minimum guaranteed rates. Amounts in excess of guarantees are credited at the discretion of the Company and reflect competitive, economic, investment and product considerations. Interest credited shown on the Company's financial statements reflects both the rates declared for interest sensitive products and the amount of the balances to which those rates apply. 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.

**Income Taxes**

The Company and its subsidiaries file a consolidated federal income tax return that includes both life insurance companies and non-life insurance companies.

Deferred income taxes are recorded on the differences between the tax bases of assets and liabilities and the amounts at which they are reported in the consolidated financial statements. Recorded amounts are adjusted to reflect changes in income tax rates and other tax law provisions as they become enacted.

Deferred income tax assets are subject to ongoing evaluation of whether such assets will be realized. The ultimate realization of deferred income tax assets generally depends on the reversal of deferred tax liabilities and the generation of future taxable income and realized gains during the periods in which temporary differences become deductible.

Deferred income taxes include future deductible differences relating to unrealized losses on investment securities. The Company evaluates the character and timing of unrealized gains and losses to determine whether future taxable amounts are sufficient to offset future deductible amounts. A valuation allowance against deferred income tax assets may be required if future taxable income of an appropriate amount and character is not expected.

**Comprehensive Income**

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 reclassification adjustments) net of adjustments to DAC, VOBA, policyholder account balances, and future policy benefits. In addition, other comprehensive income includes the change in the liability for benefit plan obligations. Other comprehensive income reflects these items net of tax. For additional information, please see Note 16 – Comprehensive Income.

**Participating Policies**

The Company has some insurance contracts where the policyholder is entitled to share in the earnings through dividends that reflect the difference between the premium charged and the actual experience. Participating business at year-end 2012 approximated 3% of statutory premiums and 4% of the life insurance in force. The amount of dividends to be paid is determined annually by the Company's Board of Directors. Provision has been made in the liability for future policy benefits to allocate amounts to

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participating policyholders on the basis of dividend scales contemplated at the time the policies were issued. Additional provisions have been made for policyholder dividends in excess of the original scale, which have been declared by the Board of Directors.

2. New Accounting Pronouncements

Accounting Pronouncements Adopted During 2012

In October 2010, the FASB issued guidance that modifies the types of costs incurred by insurance entities that can be capitalized when issuing or renewing insurance contracts. This guidance became effective for interim and annual periods beginning after December 15, 2011, with either prospective or retrospective application permitted. The Company adopted this new guidance prospectively on January 1, 2012. Please see Note 3 - Change in Accounting Principle and Change in Accounting Estimate for additional information.

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 became effective for interim and annual periods beginning after December 15, 2011. The Company adopted this new guidance on January 1, 2012 with no material impact 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 also includes the requirement for reclassification adjustments for items that are reclassified from other comprehensive income to net income to be presented on the face of the financial statements. This guidance does not change the items that must be reported in other comprehensive income nor does it require any disclosures in addition to those previously required. In December 2011, the FASB deferred the effective date for amendments to the presentation of reclassification adjustments. The guidance became effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company adopted this new guidance on January 1, 2012 with no material impact to the consolidated financial statements.

All other new accounting standards and updates of existing standards issued through the date of this filing were considered by management and did not relate to accounting policies and procedures pertinent to the Company at this time.

3. Change in Accounting Principle and Change in Accounting Estimate

Change in Accounting Principle

The Company prospectively adopted Accounting Standards Update (ASU) No. 2010-26, "Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts," effective January 1, 2012. This guidance modifies the types of costs incurred by insurance entities that can be capitalized when issuing or renewing insurance contracts. The guidance defines allowable deferred acquisition costs as incremental or directly related to the successful acquisition of new or renewal contracts. In addition, certain costs related directly to acquisition activities performed by the insurer, such as underwriting and policy issuance, are also deferrable. This guidance also defines the considerations for the deferral of direct-response advertising costs.

Pursuant to this guidance, the Company evaluated the types of acquisition costs it capitalizes. The Company capitalizes agent compensation and benefits and other expenses that are directly related to the successful acquisition of contracts. The Company also capitalizes expenses directly related to activities performed by the Company, such as underwriting, policy issuance, and processing fees incurred in connection with successful contract acquisitions.

The amount of acquisition costs capitalized during 2012 was \$36.9 million. The acquisition costs that would have been capitalized during 2012 if the Company's previous policy had been applied during that period was \$34.0 million. Thus, the adoption of this guidance resulted in an increase of \$2.9 million in the amount of acquisition costs

capitalized during 2012. After consideration of amortization, the net result of the adoption of ASU No. 2010-26 was an increase of \$2.6 million in pretax earnings in 2012.

#### Change in Accounting Estimate

During the third quarter of 2012, the Company completed a change in accounting estimate related to a long-lived asset. This asset concluded its initial depreciation schedule in the third quarter of 2012. The Company reassessed this asset and its ongoing use of it and determined that it has a useful life greater than estimated at the time of initial implementation. The Company has the ability and the intent to hold and use this asset over the reassessed useful life. The Company also established an updated residual value, consistent with longer use of the asset. The Company recalculated the depreciation that would have been recognized to date using the reevaluated useful life and residual value resulting in additional depreciation of \$3.7 million being recorded as an operating

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Notes to Consolidated Financial Statements--(Continued)

expense in the third quarter of 2012. The Company evaluated the impact of the change in future depreciation and determined that this change in accounting estimate will not materially impact future comparisons.

## 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 at December 31, 2012.

	Amortized Cost	Gross Unrealized Gains	Losses	Fair Value
U.S. Treasury securities and obligations of U.S. Government	\$ 121,774	\$ 14,302	\$ 25	\$ 136,051
Federal agencies <sup>1</sup>	22,070	3,999	—	26,069
Federal agency issued residential mortgage-backed securities <sup>1</sup>	83,608	8,381	4	91,985
Subtotal	227,452	26,682	29	254,105
Corporate obligations:				
Industrial	494,615	51,645	377	545,883
Energy	188,790	22,473	14	211,249
Communications and technology	198,332	23,283	15	221,600
Financial	287,854	27,487	1,467	313,874
Consumer	476,913	49,395	70	526,238
Public utilities	246,389	39,840	102	286,127
Subtotal	1,892,893	214,123	2,045	2,104,971
Corporate private-labeled residential mortgage-backed securities	144,852	4,033	754	148,131
Municipal securities	140,843	27,141	—	167,984
Other	106,442	6,494	8,192	104,744
Redeemable preferred stocks	7,984	266	44	8,206
Fixed maturity securities	2,520,466	278,739	11,064	2,788,141
Equity securities	18,195	1,956	90	20,061
Total	\$ 2,538,661	\$ 280,695	\$ 11,154	\$ 2,808,202

<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 amortized cost and fair value of securities by asset class at December 31, 2011.

	Amortized Cost	Gross Unrealized Gains	Losses	Fair Value
U.S. Treasury securities and obligations of U.S. Government	\$ 120,593	\$ 13,856	\$ 12	\$ 134,437
Federal agencies <sup>1</sup>	22,401	3,480	—	25,881
Federal agency issued residential mortgage-backed securities <sup>1</sup>	109,738	9,901	2	119,637
Subtotal	252,732	27,237	14	279,955
Corporate obligations:				
Industrial	444,030	43,710	860	486,880
Energy	152,580	19,131	—	171,711
Communications and technology	184,983	16,566	156	201,393
Financial	308,813	15,155	5,890	318,078
Consumer	452,962	43,788	263	496,487
Public utilities	259,609	38,094	1,366	296,337
Subtotal	1,802,977	176,444	8,535	1,970,886
Corporate private-labeled residential mortgage-backed securities	167,666	1,856	12,620	156,902
Municipal securities	150,267	18,316	61	168,522
Other	100,315	3,576	9,235	94,656
Redeemable preferred stocks	11,735	226	740	11,221
Fixed maturity securities	2,485,692	227,655	31,205	2,682,142
Equity securities	34,951	1,873	135	36,689
Total	\$ 2,520,643	\$ 229,528	\$ 31,340	\$ 2,718,831

<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 at December 31. Expected maturities may differ from these contractual maturities since borrowers may have the right to call or prepay obligations.

	2012		2011	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 108,125	\$ 110,257	\$ 79,651	\$ 81,212
Due after one year through five years	667,743	735,257	599,904	639,706
Due after five years through ten years	972,886	1,086,082	946,752	1,045,645
Due after ten years	459,279	521,714	486,126	532,927
Securities with variable principal payments	304,448	326,625	361,524	371,431
Redeemable preferred stocks	7,985	8,206	11,735	11,221
	\$ 2,520,466	\$ 2,788,141	\$ 2,485,692	\$ 2,682,142

Unrealized Losses on Investments

At the end of each quarter, all securities are reviewed to determine whether impairments exist and whether other-than-temporary impairments should be recorded. This quarterly 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. The Company 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.

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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 amortized 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;
- 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 Comprehensive 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 Comprehensive Income and is reflected in other comprehensive income and accumulated other comprehensive income.

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 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.

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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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 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, an analysis of the fair value of the investment is performed and 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 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 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 are 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 were high quality investments at the time of acquisition, and they 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 and tested 21 and 17 non-U.S. Agency mortgage-backed securities that had such indications at December 31, 2012 and December 31, 2011, respectively. 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 Comprehensive 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. 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 several sectors in recent years, most notably in the non-U.S. Agency mortgage-backed securities market. 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.

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

The following table provides information regarding fixed maturity and equity security investments available for sale with unrealized losses by length of time at December 31, 2012.

	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	\$1,328	\$18	\$661	\$7	\$1,989	\$25
Federal agency issued residential mortgage-backed securities <sup>1</sup>	124	3	292	1	416	4
Subtotal	1,452	21	953	8	2,405	29
Corporate obligations:						
Industrial	28,866	377	—	—	28,866	377
Energy	1,982	14	—	—	1,982	14
Communications and technology	2,709	15	—	—	2,709	15
Financial	—	—	8,241	1,467	8,241	1,467
Consumer	17,143	70	—	—	17,143	70
Public utilities	11,584	102	—	—	11,584	102
Subtotal	62,284	578	8,241	1,467	70,525	2,045
Corporate private-labeled residential mortgage-backed securities	—	—	14,050	754	14,050	754
Municipal securities	—	—	—	—	—	—
Other	—	—	41,895	8,192	41,895	8,192
Redeemable preferred stocks	—	—	1,511	44	1,511	44
Fixed maturity securities	63,736	599	66,650	10,465	130,386	11,064
Equity securities	—	—	273	90	273	90
Total	\$63,736	\$599	\$66,923	\$10,555	\$130,659	\$11,154

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

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

The following table provides information regarding fixed maturity and equity security investments available for sale with unrealized losses by length of time at December 31, 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	\$—	\$—	\$959	\$12	\$959	\$12
Federal agency issued residential mortgage-backed securities <sup>1</sup>	649	—	294	2	943	2
Subtotal	649	—	1,253	14	1,902	14
Corporate obligations:						
Industrial	25,455	860	—	—	25,455	860
Communications and technology	7,239	156	—	—	7,239	156
Financial	51,273	2,107	16,402	3,783	67,675	5,890
Consumer	11,765	119	3,689	144	15,454	263
Public utilities	4,710	344	11,152	1,022	15,862	1,366
Subtotal	100,442	3,586	31,243	4,949	131,685	8,535
Corporate private-labeled residential mortgage-backed securities	41,734	2,668	61,864	9,952	103,598	12,620
Municipal securities	—	—	3,909	61	3,909	61
Other	9,257	921	47,146	8,314	56,403	9,235
Redeemable preferred stocks	2,939	115	3,056	625	5,995	740
Fixed maturity securities	155,021	7,290	148,471	23,915	303,492	31,205
Equity securities	69	104	1,054	31	1,123	135
Total	\$155,090	\$7,394	\$149,525	\$23,946	\$304,615	\$31,340

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

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. At December 31, 2012, the Company had 43 issues in its investment portfolio of fixed maturity and equity securities with unrealized losses. Included in this total, 25 security issues were below cost for less than one year; three security issues were below cost for one year or more and less than three years; and 15 security issues were below cost for three years or more. At December 31, 2011, the Company had 85 issues in its investment portfolio of fixed maturity and equity securities with unrealized losses. Included in this total, 46 security issues were below cost for less than one year; ten security issues were below cost for one year or more and less than three years; and 29 security issues were below cost for three years or more.



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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

The following table provides the distribution of maturities for fixed maturity securities available for sale with unrealized losses at December 31. Expected maturities may differ from these contractual maturities since borrowers may have the right to call or prepay obligations.

	2012		2011	
	Fair	Gross	Fair	Gross
	Value	Unrealized	Value	Unrealized
		Losses		Losses
Fixed maturity securities available for sale:				
Due in one year or less	\$4,141	\$2	\$2,953	\$48
Due after one year through five years	8,038	45	42,416	2,120
Due after five years through ten years	43,335	578	64,772	2,616
Due after ten years	58,895	9,637	82,816	13,060
Total	114,409	10,262	192,957	17,844
Securities with variable principal payments	14,466	758	104,540	12,621
Redeemable preferred stocks	1,511	44	5,995	740
Total	\$130,386	\$11,064	\$303,492	\$31,205

The Company held one non-income producing security with a carrying value of \$1.9 million million at December 31, 2012 (2011 – two securities with a carrying value of \$3.2 million). This security was previously written down due to other-than-temporary impairments and placed on non-accrual status.

The Company did not hold securities of any corporation and its affiliates that exceeded 10% of stockholders' equity at December 31, 2012 or December 31, 2011.

No derivative financial instruments were held during the three years ended December 31, 2012.

The Company is exposed to risk that issuers of securities owned by the Company will default or that interest rates or credit spreads will change and cause a decrease in the value of its investments. With residential mortgage-backed securities, the Company is also exposed to prepayment and extension risks. As interest rates change, the rate at which these securities pay down principal may change. These risks are mitigated by investing in high-grade securities and managing the maturities and cash flows of investments and liabilities.

As an additional separate consideration, 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.

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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 other comprehensive income for the years ended December 31.

	2012	2011
Credit losses on securities held at beginning of year in accumulated other comprehensive income	\$ 13,559	\$ 11,567
Additions for credit losses not previously recognized in other-than-temporary impairment	30	747
Additions for increases in the credit loss for which an other-than-temporary impairment was previously recognized when there was no intent to sell the security before recovery of its amortized cost basis	1,688	1,262
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	(17	) (17
Credit losses on securities held at the end of year in accumulated other comprehensive income	\$ 15,260	\$ 13,559

The following table provides the net unrealized gains (losses) reported in accumulated other comprehensive income (loss) on the Company's investments in securities available for sale, at December 31.

	2012	2011	2010
Net unrealized gains	\$ 269,541	\$ 198,188	\$ 110,191
Amounts resulting from:			
DAC and VOBA	(74,342	) (56,971	) (35,538
Future policy benefits	(29,075	) (15,903	) (7,101
Policyholder account balances	(1,135	) (578	) (329
Deferred income taxes	(57,745	) (43,657	) (23,528
Total	\$ 107,244	\$ 81,079	\$ 43,695

## Investment Revenues

The following table provides investment revenues by major category for the years ended December 31.

	2012	2011	2010
Net investment income:			
Fixed maturity securities	\$ 132,578	\$ 136,534	\$ 140,600
Equity securities	1,684	267	1,636
Mortgage loans	38,189	38,089	31,261
Real estate	9,475	7,685	6,840
Policy loans	5,433	5,626	5,827
Short-term investments	7	45	177
Other	244	486	652
Total	187,610	188,732	186,993
Less investment expenses	(11,456	) (11,504	) (11,134
Net investment income	\$ 176,154	\$ 177,228	\$ 175,859

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

## Realized Gains (Losses)

The following table provides realized investment gains (losses) by major category for the years ended December 31.

	2012	2011	2010
Realized investment gains (losses):			
Fixed maturity securities	\$1,407	\$3,409	\$542
Equity securities	(165	) 4	2
Real estate	18,046	—	—
Mortgage loans	(717	) 99	—
	18,571	3,512	544
Amortization of DAC and VOBA	(135	) (370	) (9
	\$18,436	\$3,142	\$535

The following table provides detail concerning realized investment gains and losses for the three years ended December 31.

	2012	2011	2010
Gross gains resulting from:			
Sales of investment securities	\$2,670	\$3,945	\$2,545
Investment securities called and other	3,806	3,519	2,139
Sales of real estate	18,884	—	—
Total gross gains	25,360	7,464	4,684
Gross losses resulting from:			
Sales of investment securities	(2,651	) (1,666	) (67
Investment securities called and other	(865	) (376	) (253
Mortgage loans	(220	) (3	) —
Impairment losses on real estate	(838	) —	—
Total gross losses	(4,574	) (2,045	) (320
Change in allowance for potential future losses on mortgage loans	(497	) 102	—
Amortization of DAC and VOBA	(135	) (370	) (9
Net realized investment gains, excluding other-than-temporary impairment losses	20,154	5,151	4,355
Net impairment losses recognized in earnings:			
Other-than-temporary impairment losses on fixed maturity and equity securities	(2,526	) (2,952	) (4,129
Portion of loss recognized in other comprehensive income	808	943	309
Net other-than-temporary impairment losses recognized in earnings	(1,718	) (2,009	) (3,820
Net realized investment gains	\$18,436	\$3,142	\$535

## Proceeds From Sales of Investment Securities

The table below details proceeds from the sale of fixed maturity and equity securities, excluding maturities and calls, for the three years ended December 31.

	2012	2011	2010
Proceeds	\$99,371	\$61,494	\$82,025



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Notes to Consolidated Financial Statements--(Continued)

## Mortgage Loans

Investments in mortgage loans totaled \$674.0 million at December 31, 2012 (\$601.9 million - December 31, 2011). The Company's mortgage loans are mostly secured by commercial real estate and are stated at cost, adjusted for amortization of premium and accrual of discount, less an allowance for potential future losses. This allowance is maintained at a level believed by management to be adequate to absorb estimated credit losses and was \$3.3 million at December 31, 2012 (\$2.8 million - December 31, 2011). Management's periodic evaluation and assessment of the adequacy of the allowance is based on known and inherent risks in the portfolio, historical experience, industry data, current economic conditions, and other relevant factors. Please see Note 6 - Financing Receivables for additional information. Four mortgage loans have been foreclosed upon and transferred to real estate investments during the past three years. Two of the foreclosed loans resulted in recognition of impairment losses to the Company, as their fair values were less than the carrying values. Also, there were three delinquent mortgage loans at December 31, 2012 (three at December 31, 2011), although payment was subsequently received on one loan in January 2013 to bring this loan current. A fifth mortgage default occurred in the third quarter of 2012, and this loan is in the process of foreclosure. The Company does not hold mortgage loans to any single borrower that exceed 5% of stockholders' equity.

At December 31, 2012, the Company had 18% of its invested assets in commercial mortgage loans, up from 17% at December 31, 2011. New commercial loans were \$178.7 million, \$132.9 million and \$140.8 million for 2012, 2011 and 2010, respectively. The level of new commercial mortgage loans in any year is influenced by market conditions, as the Company responds to changes in interest rates, available spreads, and borrower demand.

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 92 new loans to the portfolio during 2012 and 76 or 83% of these loans had some amount of recourse requirement. A total of 40 new loans or \$122.4 million were purchased from institutional lenders during 2012. At December 31, 2012, 35% of the Company's commercial mortgage portfolio had been acquired rather than originated by the Company. The purchased loans are generally 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. The average loan to value ratio for the overall portfolio was 47% at December 31, 2012, up from 46% at December 31, 2011. These ratios are based upon the current balance of loans relative to the appraisal of value at the time the loan was originated or acquired. The average loan balance was approximately \$1.6 million at December 31, 2012 and December 31, 2011. The Company has certain mortgage loans that had an unamortized premium balance of \$3.6 million, as of December 31, 2012 (\$0.8 million - December 31, 2011).

The following table identifies the gross mortgage loan principal outstanding and the allowance for potential future losses at December 31.

	2012	2011
Principal outstanding	\$677,380	\$604,772
Allowance for potential future losses	(3,346	) (2,849
Carrying value	\$674,034	\$601,923

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Notes to Consolidated Financial Statements--(Continued)

The following table summarizes the amount of mortgage loans held by the Company at December 31, 2012 and 2011, segregated by year of origination. Purchased loans are shown in the year acquired by the Company, although the individual loans may have been initially originated in prior years.

	2012	% of Total	2011	% of Total	
Prior to 2002	\$4,122	1	% \$11,669	2	%
2002	12,715	2	% 16,768	3	%
2003	32,136	5	% 42,112	7	%
2004	19,699	3	% 29,966	5	%
2005	32,666	5	% 54,802	9	%
2006	39,321	6	% 42,676	7	%
2007	31,484	5	% 35,323	6	%
2008	35,747	5	% 44,285	7	%
2009	41,691	6	% 50,574	8	%
2010	90,236	13	% 133,684	22	%
2011	130,590	19	% 142,913	24	%
2012	206,973	30	% —	—	%
Total	\$677,380	100	% \$604,772	100	%

The following table identifies mortgage loans by geographic location at December 31.

	2012	% of Total	2011	% of Total	
Pacific	\$183,198	27	% \$138,529	23	%
West north central	106,004	16	% 130,481	22	%
West south central	110,336	16	% 98,036	16	%
Mountain	95,626	14	% 82,029	14	%
South atlantic	61,815	9	% 63,125	10	%
Middle atlantic	48,523	7	% 42,112	7	%
East north central	55,938	8	% 30,482	5	%
East south central	15,940	3	% 19,978	3	%
	\$677,380	100	% \$604,772	100	%

The following table identifies the concentration of mortgage loans by state greater than 5% at December 31.

	2012	% of Total	2011	% of Total	
California	\$156,032	23	% \$117,261	19	%
Texas	100,307	15	% 84,724	14	%
Minnesota	63,402	9	% 64,952	11	%
Florida	36,521	5	% 31,310	5	%
All others	321,118	48	% 306,525	51	%
	\$677,380	100	% \$604,772	100	%

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Notes to Consolidated Financial Statements--(Continued)

The following table identifies mortgage loans by property type at December 31. The Other category consists of apartments and retail properties.

	2012	%	2011	%	
		Total		Total	
Industrial	\$298,611	44	% \$251,839	42	%
Office	261,075	39	% 243,885	40	%
Medical	48,824	7	% 43,089	7	%
Other	68,870	10	% 65,959	11	%
	\$677,380	100	% \$604,772	100	%

The table below identifies mortgage loans by maturity at December 31.

	2012	%	2011	%	
		of Total		of Total	
Due in one year or less	\$29,663	4	% \$2,356	—	%
Due after one year through five years	195,336	29	% 153,822	25	%
Due after five years through ten years	282,453	42	% 255,615	42	%
Due after ten years	169,928	25	% 192,979	33	%
	\$677,380	100	% \$604,772	100	%

The table below identifies the commercial mortgage portfolio by current loan balance at years ending December 31.

	2012	% of	2011	% of	
		Total		Total	
\$5 million or greater	\$136,396	20	% \$89,352	15	%
\$4 million to less than \$5 million	48,041	7	% 36,625	6	%
\$3 million to less than \$4 million	58,692	9	% 78,899	13	%
\$2 million to less than \$3 million	146,279	21	% 124,636	21	%
\$1 million to less than \$2 million	181,745	27	% 182,467	30	%
Less than \$1 million	106,227	16	% 92,793	15	%
	\$677,380	100	% \$604,772	100	%

The table below identifies the commercial mortgage portfolio by current loan balance as a percentage of value at the time of origination at December 31.

	2012	% of	2011	% of	
		Total		Total	
70% or greater	\$56,611	8	% \$34,010	6	%
50% to 69%	383,573	57	% 315,633	52	%
Less than 50%	237,196	35	% 255,129	42	%
	\$677,380	100	% \$604,772	100	%

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 any 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 structural information specific to each

property, as well as the potential for earthquake loss if the property lies within areas believed by the Company to be seismically active submarkets. The Company does not expect catastrophe or earthquake damage or economic downturn in the



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Notes to Consolidated Financial Statements--(Continued)

acific region that may occur 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.

The Company may refinance commercial mortgage loans prior to contractual maturity as a means of originating new loans that meet the Company's underwriting and pricing parameters. The Company refinanced loans with outstanding balances of \$31.6 million and \$0.8 million during the years ended December 31, 2012 and 2011, respectively.

In the normal course of business, the Company commits to fund commercial mortgage loans generally up to 120 days in advance. These commitments typically 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 retains the commitment fee. For additional information, please see Note 21 - Commitments.

At December 31, 2012, the Company had a construction-to-permanent loan commitment in the amount of \$2.8 million, and \$2.5 million had been disbursed on this loan. At completion and fulfillment of occupancy requirements, the construction loan will convert to a long-term, fixed-rate permanent loan.

**Real Estate**

Investments in real estate totaled \$124.7 million at December 31, 2012 (\$128.0 million at December 31, 2011). The table below provides information concerning the Company's real estate investments by major category at December 31.

	2012	2011
Land	\$23,051	\$18,914
Buildings	84,142	81,568
Less accumulated depreciation	(28,322	) (29,431
Real estate, commercial	78,871	71,051
Real estate, joint ventures	45,871	56,911
Total	\$124,742	\$127,962

Investment real estate is depreciated on a straight-line basis over periods ranging from 3 to 60 years. The Company had \$53.5 million in real estate sales during 2012.

The Company had non-income producing real estate of \$11.3 million, consisting of vacant properties and properties under development, at December 31, 2012 (2011 - \$10.5 million).

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

5. Fair Value Measurements

Under 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 at 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.

The Company categorizes its financial assets and liabilities measured at fair value in 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 all 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.

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 subsequent paragraphs.

Cash and Short-Term Financial Assets

Short-term financial assets include cash and other short-term investments. Cash is categorized as Level 1. Other short-term assets are invested in institutional money market funds. These assets are categorized as Level 2, as the valuation is based upon the net asset value (NAV) of the fund.

Loans

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.

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.

Mortgage loans are categorized as Level 3 in the fair value hierarchy.

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. Policy loans are categorized as Level 3.

Separate Accounts

The separate account assets and liabilities, which are equal, are recorded at fair value based upon NAV. They are categorized as Level 2 in the fair value hierarchy, as the Company receives independent prices from external pricing sources to determine the 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 of 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. These liabilities are categorized as Level 3.



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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

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 it 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 their 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.

Determination of Fair Value

The determination of the fair value of the Company's fixed maturity and equity securities is the responsibility of the Company's investment accounting group, which reports to the Principal Accounting Officer. This group manages and creates the policies and processes used to determine the fair value for these assets. This group employs third-party pricing services and obtains selected support from the Company's portfolio managers in order to achieve results for this multi-tiered process. All prices are reviewed by the investment accounting group. The financial reporting group, the Principal Accounting Officer, and the Chief Financial Officer also review the fair value methodologies and the fair values that are obtained each quarter. The results of these reviews are made known to the Company's Disclosure Committee and to the Company's Audit Committee. In addition, any significant policy or process changes made during the quarter are also discussed with the Company's Audit Committee.

The Company utilizes external independent third-party pricing services to determine the majority of its fair values on investment securities available for sale. At December 31, 2012, approximately 96% of the carrying value of these investments was from external pricing services, 2% was from brokers, and 2% was derived from internal matrices and calculations. 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 reasonableness and 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.

Generally, the Company pursues and utilizes only one broker quote per security. In doing so, the Company solicits only brokers which 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 may 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. At December 31, 2012, the Company obtained prices for five securities from brokers and internally determined the prices for 19 securities. At December 31, 2011, the Company obtained prices for five securities from brokers and internally determined prices for 15 securities.

Each quarter, the Company evaluates the prices received from third-party security pricing services and independent brokers to ensure that the prices represent a reasonable estimate of the fair value within the macro-economic environment, sector factors, and overall pricing trends and expectations. 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. Finally, the Company also performs additional evaluations when individual prices fall outside tolerance

levels when comparing prices received from third-party pricing services. At December 31, 2012, the Company had minimal occurrences where it used a price other than identified in its pricing policy, and the impact was not material to the consolidated financial statements.

Fair value measurements for assets and liabilities where there exists limited or no observable market data are calculated using the Company's own estimates and are categorized as Level 3. 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 valuation 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.

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

The Company's own estimates of fair value of fixed maturity and equity securities may be 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.

The determination of the value of the Company's liabilities that are reported at fair value in the financial statements is the responsibility of the Company's valuation actuary group, which reports to the Company's Senior Vice President and Actuary. This group manages and creates the policies and processes used to determine the fair value for these liabilities. Methodologies used include internal assumptions and third-party inputs to derive a value, including a risk-neutral option pricing model that incorporates a third-party-developed index that is consistent with the attributes of the product and provides for an approximate match of the volatility measure with the expected life of the underlying contracts. The fair value methodologies and the fair values are reviewed by the Senior Vice President and Actuary, the Principal Accounting Officer, and the Chief Financial Officer. The results of these reviews are made known to the Company's Disclosure Committee and to the Company's Audit Committee. In addition, any significant policy or process changes made are also discussed with the Company's Audit Committee.

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

## Categories Reported at Fair Value

The following tables present categories reported at fair value on a recurring basis December 31,

	2012				
	Level 1	Level 2	Level 3	Total	
Assets:					
U.S. Treasury securities and obligations of U.S. Government	\$ 12,698	\$ 120,544	\$ 2,809	\$ 136,051	
Federal agencies <sup>1</sup>	—	26,069	—	26,069	
Federal agency issued residential mortgage-backed securities <sup>1</sup>	—	91,985	—	91,985	
Subtotal	12,698	238,598	2,809	254,105	
Corporate obligations:					
Industrial	—	542,561	3,322	545,883	
Energy	—	208,887	2,362	211,249	
Communications and technology	—	221,600	—	221,600	
Financial	—	302,690	11,184	313,874	
Consumer	—	509,953	16,285	526,238	
Public utilities	—	286,127	—	286,127	
Subtotal	—	2,071,818	33,153	2,104,971	
Corporate private-labeled residential mortgage-backed securities	—	148,131	—	148,131	
Municipal securities	—	163,661	4,323	167,984	
Other	—	98,896	5,848	104,744	
Redeemable preferred stocks	8,206	—	—	8,206	
Fixed maturity securities	20,904	2,721,104	46,133	2,788,141	
Equity securities	1,336	17,470	1,255	20,061	
Total	\$ 22,240	\$ 2,738,574	\$ 47,388	\$ 2,808,202	
Percent of total	1	% 97	% 2	% 100	%
Liabilities:					
Other policyholder funds					
Guaranteed minimum withdrawal benefits	\$—	\$—	\$ (1,080)	) \$ (1,080)	)
Total	\$—	\$—	\$ (1,080)	) \$ (1,080)	)

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

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

	2011				
	Level 1	Level 2	Level 3	Total	
Assets:					
U.S. Treasury securities and obligations of U.S. Government	\$12,876	\$118,130	\$3,431	\$134,437	
Federal agencies <sup>1</sup>	—	25,881	—	25,881	
Federal agency issued residential mortgage-backed securities <sup>1</sup>	—	119,637	—	119,637	
Subtotal	12,876	263,648	3,431	279,955	
Corporate obligations:					
Industrial	—	486,380	500	486,880	
Energy	—	169,342	2,369	171,711	
Communications and technology	—	201,393	—	201,393	
Financial	—	307,464	10,614	318,078	
Consumer	—	474,553	21,934	496,487	
Public utilities	—	296,337	—	296,337	
Subtotal	—	1,935,469	35,417	1,970,886	
Corporate private-labeled residential mortgage-backed securities	—	156,902	—	156,902	
Municipal securities	—	163,611	4,911	168,522	
Other	—	94,656	—	94,656	
Redeemable preferred stocks	11,221	—	—	11,221	
Fixed maturity securities	24,097	2,614,286	43,759	2,682,142	
Equity securities	2,216	33,350	1,123	36,689	
Total	\$26,313	\$2,647,636	\$44,882	\$2,718,831	
Percent of total	1	% 97	% 2	% 100	%
Liabilities:					
Other policyholder funds					
Guaranteed minimum withdrawal benefits	\$—	\$—	\$(187)	\$(187)	)
Total	\$—	\$—	\$(187)	\$(187)	)

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



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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

The following tables present the fair value of fixed maturity and equity securities available for sale by pricing source and fair value hierarchy level at December 31.

	2012			
	Level 1	Level 2	Level 3	Total
Fixed maturity securities available for sale:				
Priced from external pricing services	\$20,904	\$2,676,943	\$—	\$2,697,847
Priced from independent broker quotations	—	44,161	—	44,161
Priced from internal matrices and calculations	—	—	46,133	46,133
Subtotal	20,904	2,721,104	46,133	2,788,141
Equity securities available for sale:				
Priced from external pricing services	1,336	7,254	—	8,590
Priced from independent broker quotations	—	—	—	—
Priced from internal matrices and calculations	—	10,216	1,255	11,471
Subtotal	1,336	17,470	1,255	20,061
Total	\$22,240	\$2,738,574	\$47,388	\$2,808,202
Percent of total	1	% 97	% 2	% 100
				%
	2011			
	Level 1	Level 2	Level 3	Total
Fixed maturity securities available for sale:				
Priced from external pricing services	\$24,097	\$2,582,617	\$—	\$2,606,714
Priced from independent broker quotations	—	31,669	—	31,669
Priced from internal matrices and calculations	—	—	43,759	43,759
Subtotal	24,097	2,614,286	43,759	2,682,142
Equity securities available for sale:				
Priced from external pricing services	2,216	7,444	—	9,660
Priced from independent broker quotations	—	—	—	—
Priced from internal matrices and calculations	—	25,906	1,123	27,029
Subtotal	2,216	33,350	1,123	36,689
Total	\$26,313	\$2,647,636	\$44,882	\$2,718,831
Percent of total	1	% 97	% 2	% 100
				%

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

The changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the years ended December 31 are summarized below:

	2012			Liabilities	
	Assets	Equity securities	Total	GMWB	
	Fixed maturity securities available for sale	available for sale			
Beginning balance	\$43,759	\$1,123	\$44,882	\$(187	)
Included in earnings	109	—	109	(1,228	)
Included in other comprehensive income	(160	) 132	(28	) —	
Purchases, issuances, sales and other dispositions:					
Purchases	—	—	—	—	
Issuances	—	—	—	1,592	
Sales	—	—	—	—	
Other dispositions	(5,406	) —	(5,406	) (1,257	)
Transfers into Level 3	7,831	—	7,831	—	
Transfers out of Level 3	—	—	—	—	
Ending balance	\$46,133	\$1,255	\$47,388	\$(1,080	)
Net unrealized gains	\$(172	) \$132	\$(40	)	
	2011			Liabilities	
	Assets	Equity securities	Total	GMWB	
	Fixed maturity securities available for sale	available for sale			
Beginning balance	\$55,801	\$1,180	\$56,981	\$(2,799	)
Included in earnings	11	92	103	2,500	
Included in other comprehensive income	1,385	51	1,436	—	
Purchases, issuances, sales and other dispositions:					
Purchases	—	—	—	—	
Issuances	—	—	—	163	
Sales	—	—	—	—	
Other dispositions	(2,977	) (200	) (3,177	) (51	)
Transfers into Level 3	8,640	—	8,640	—	
Transfers out of Level 3	(19,101	) —	(19,101	) —	
Ending balance	\$43,759	\$1,123	\$44,882	\$(187	)
Net unrealized gains	\$1,401	\$105	\$1,506		

The Company did not exclude any realized or unrealized gains or losses on items transferred into Level 3 in any of the periods presented. 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 transfers between Level 1 and Level 2 during the years ended December 31, 2012 and 2011.



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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

The following table presents quantitative information about material Level 3 fair value measurements as of December 31, 2012.

	Fair Value	Valuation Technique	Unobservable Inputs	Range (in basis points)	Weighted Average of Range
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Fixed maturity securities	\$46,133	Market comparable	Spread adjustment	69-387	179
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The Company's primary category of Level 3 fair values is fixed maturity securities, totaling \$46.1 million as of December 31, 2012. These assets are valued using comparable security valuations through the unobservable input of estimated discount spreads. Specifically, the Company reviews the values and discount spreads on similar securities for which such information is observable in the market. Estimates of increased discount spreads are then determined based upon the characteristics of the securities being evaluated. The Company estimates that an increased spread of 10 basis points on each of the Level 3 securities would reduce the reported fair value by \$0.2 million as of December 31, 2012.

Other assets and liabilities categorized as Level 3 for purposes of fair value determination are not material to the Company's financial statements, and the sensitivities of such valuations to unobservable inputs are also believed to not be material.

The table below is a summary of fair value estimates at December 31 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 below do not represent, and should not be construed to represent, the underlying value to the Company.

	2012 Carrying Value	Fair Value	2011 Carrying Value	Fair Value
<b>Assets:</b>				
<b>Investments:</b>				
Fixed maturity securities available for sale	\$2,788,141	\$2,788,141	\$2,682,142	\$2,682,142
Equity securities available for sale	20,061	20,061	36,689	36,689
Mortgage loans	674,034	722,098	601,923	642,905
Policy loans	77,133	77,133	80,375	80,375
Short-term financial assets	31,928	31,928	59,752	59,752
Separate account assets	340,093	340,093	316,609	316,609
<b>Liabilities:</b>				
Individual and group annuities	1,130,032	1,108,987	1,082,324	1,062,407
Supplementary contracts without life contingencies	54,321	53,389	56,193	54,824
Separate account liabilities	340,093	340,093	316,609	316,609
Other policyholder funds - GMWB	(1,080	) (1,080	) (187	) (187

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

## 6. 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 assets in the Consolidated Balance Sheets.

The table below identifies the Company's financing receivables by classification amount at December 31.

	2012	2011
Receivables:		
Agent receivables, net (allowance 2012 - \$2,261; 2011 - \$2,226)	\$1,697	\$1,708
Investment-related financing receivables:		
Mortgage loans, net (allowance 2012 - \$3,346; 2011 - \$2,849)	674,034	601,923
Total financing receivables	\$675,731	\$603,631

The following table details the activity of the allowance for uncollectible accounts on agent receivables at December 31.

	2012	2011
Beginning of year	\$2,226	\$644
Additions	229	1,724
Deductions	(194	) (142
End of period	\$2,261	\$2,226

The following table details the mortgage loan portfolio as collectively or individually evaluated for impairment at December 31.

	2012	2011
Mortgage loans collectively evaluated for impairment	\$622,381	\$603,952
Mortgage loans individually evaluated for impairment	54,999	820
Allowance for potential future losses	(3,346	) (2,849
Carrying value	\$674,034	\$601,923

The following table details the activity of the allowance for potential future losses on mortgage loans at December 31.

	2012	2011
Beginning of year	\$2,849	\$3,410
Provision	497	—
Deductions	—	(561
End of period	\$3,346	\$2,849

## Agent Receivables

The Company has agent receivables which are classified as financing receivables and which are reduced by an allowance for doubtful accounts. These trade receivables from agents are long-term in nature and are specifically assessed as to the collectability of each receivable. The Company's gross agent receivables totaled \$4.0 million as of December 31, 2012 and the Company had an allowance for doubtful accounts totaling \$2.3 million. Gross agent receivables totaled \$3.9 million with an allowance for doubtful accounts of \$2.2 million at December 31, 2011. The Company had no material troubled debt that was restructured or modified during any of the periods presented. The Company has two types of agent receivables including:

Agent specific loans. At December 31, 2012, these loans totaled \$1.1 million with an allowance for doubtful accounts of \$0.3 million. As of December 31, 2011, agent specific loans totaled \$0.8 million with an allowance for doubtful accounts of \$0.2 million.

Various agent commission advances and other commission receivables. Gross agent receivables in this category totaled \$2.9 million, with an allowance for doubtful accounts of \$2.0 million as of December 31, 2012. Gross agent receivables totaled \$3.1 million and the allowance for doubtful accounts was \$2.0 million as of December 31, 2011.



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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

## Mortgage Loans

The Company considers its mortgage loan portfolio to be long-term financing receivables. Mortgage loans are stated at cost, adjusted for amortization of premium and accrual of discount, less 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 on 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 Note 4 - Investments, as are geographic distributions for both regional and significant state concentrations. These measures are also supplemented with various other analytics to provide additional information concerning potential impairment of mortgage loans and management's assessment of financing receivables.

The following table presents an aging schedule for delinquent payments for both principal and interest at December 31, 2012 and December 31, 2011, by property type.

	Book Value	Amount of Payments Past Due			Total
		30-59 Days	60-89 Days	> 90 Days	
December 31, 2012					
Industrial	\$—	\$—	\$—	\$—	\$—
Office	3,071	9	—	66	75
Medical	2,982	—	—	135	135
Other	—	—	—	—	—
Total	\$6,053	\$9	\$—	\$201	\$210
December 31, 2011					
Industrial	\$—	\$—	\$—	\$—	\$—
Office	816	13	—	—	13
Medical	7,019	75	—	—	75
Other	—	—	—	—	—
Total	\$7,835	\$88	\$—	\$—	\$88

As of December 31, 2012, there were three mortgage loans that were 30 days or more past due, including one 90 days past due and one 120 days past due. The loan that was 120 days past due is in the process of foreclosure.

Subsequently, payment was received on two of the three delinquent loans and one was brought current in January 2013. At December 31, 2011, there were three mortgage loans that were 30 days past due. Subsequently, payment was received on all of these loans and they were brought current in January 2012.

The allowance for potential future 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. The Company assesses the amount it maintains in the mortgage loan allowance through an assessment of what the Company believes are relevant factors at both the macro-environmental level and specific loan basis. A loan is considered impaired if it is probable that contractual amounts due will not be collected.

The Company's allowance for credit losses was \$3.3 million at December 31, 2012 and \$2.8 million at December 31, 2011.

The allowance for potential future losses is monitored and evaluated at multiple levels with a process that includes, but is not limited to, the factors presented below. Generally, the Company establishes the allowance for potential future losses using the collectively evaluated impairment methodology for an overall portfolio level and then specifically identifies an allowance for

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

potential future losses on loans that contain elevated risk profiles. If the Company determines through its evaluation that a loan has an elevated specific risk profile, it then individually assesses the loan's risk profile and assigns a specific allowance value based on many factors, including those identified below.

Macro-environmental and elevated risk profile considerations:

• Current industry conditions that are affecting the market, including rental and vacancy rates;

• Perceived market liquidity;

• Analysis of the markets and sub-markets in which the Company has mortgage loans;

• Analysis of industry historical loss and delinquency experience,

• Other factors that the Company may perceive as important or critical given its portfolio; and

• Analysis of the Company's loan portfolio based on loan size concentrations, geographic concentrations, property type concentrations, maturity concentrations, origination loan-to-value concentrations, and borrower concentrations.

Specific mortgage loan level considerations:

• The payment history of each borrower;

• Negative reports from property inspectors; and

• Each loan's property financial statement including net operating income, debt service coverage, and occupancy level.

The Company has not acquired any mortgage loans with deteriorated credit quality during the years presented.

As part of the Company's process of monitoring impairments on loans, there are a number of significant risks and uncertainties inherent in this process. 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.

The allowance for potential future losses increased \$0.5 million during 2012 due to the Company's evaluation of the portfolio's risk profile and expected ongoing performance.

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

Over the past three years, the Company has had five mortgage loan maturity defaults. One loan was foreclosed in the first quarter of 2012, two in the fourth quarter of 2011, and one in the fourth quarter of 2010. The foreclosure in the first quarter of 2012 resulted in an impairment of \$0.2 million. One of the 2011 loan defaults resulted in an impairment of \$0.5 million. The second loan default in 2011 and the 2010 loan default did not result in an impairment based upon the Company's assessment of fair value of the property being greater than the loan value. The fifth loan default, which occurred in the third quarter of 2012, is currently in the process of foreclosure. The Company had no troubled loans that were restructured or modified in 2012, 2011, or 2010.



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Notes to Consolidated Financial Statements--(Continued)

## 7. 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 corporations 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 Comprehensive Income.

Investments in the affordable housing 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 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 Comprehensive 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.

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 had not been consolidated at December 31, 2012 and December 31, 2011. The table includes investments in seven real estate joint ventures and 26 affordable housing real estate joint ventures at December 31, 2012 and investments in eleven real estate joint ventures and 27 affordable housing real estate joint ventures at December 31, 2011.

	2012		2011	
	Carrying Amount	Maximum Exposure to Loss	Carrying Amount	Maximum Exposure to Loss
Real estate joint ventures	\$22,440	\$22,440	\$35,551	\$35,551
Affordable housing real estate joint ventures	22,704	60,527	20,749	61,124
Total	\$45,144	\$82,967	\$56,300	\$96,675

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.

At December 31, 2012 and 2011, the Company had unfunded commitments of \$1.3 million and \$7.0 million, respectively. In 2012, there were \$0.3 million of mortgage loan commitments outstanding to the real estate joint venture VIEs and \$0.6 million in 2011. Unfunded equity commitments for the development of properties owned were \$1.0 million and \$6.4 million in 2012 and 2011, respectively. The loan commitments are included in Note 21 to Consolidated Financial Statements. The Company also has contingent commitments to fund additional equity contributions for 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.

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In addition, the maximum exposure to loss on affordable housing joint ventures at December 31, 2012 and 2011 includes \$14.1 million and \$13.2 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.

## 8. Property and Equipment

Property and equipment are stated at cost and depreciated over estimated useful lives using the straight-line method. The home office is depreciated over 25 to 50 years and furniture and equipment is depreciated over 3 to 10 years. The table below provides information at December 31.

	2012	2011
Land	\$766	\$766
Home office complex	20,828	20,776
Furniture and equipment	45,308	45,558
	66,902	67,100
Accumulated depreciation	(48,559	) (44,429
	\$18,343	\$22,671

During 2012, the Company completed a change in accounting estimate related to a long-lived asset. This asset concluded its initial depreciation schedule in the third quarter of 2012. The Company reassessed this asset and its ongoing use and determined that it has a useful life greater than estimated at the time of its initial implementation. The Company also established an updated residual value, consistent with a longer use of the asset. Please see Note 3 - Change in Accounting Principle and Change in Accounting Estimate for additional information. Depreciation expense totaled \$5.1 million in 2012 (2011 - \$1.5 million; 2010 - \$1.5 million).

## 9. 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 bear 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 Comprehensive 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 following table provides a reconciliation of activity within separate account liabilities at December 31.

	2012	2011	2010
Balance at beginning of year	\$316,609	\$339,029	\$312,824
Deposits on variable policyholder contracts	33,748	33,139	36,062
Transfers to general account	(5,082	) (5,282	) (7,177
Investment performance	43,399	(2,180	) 43,096
Policyholder benefits and withdrawals	(35,799	) (35,285	) (33,066
Contract charges	(12,782	) (12,812	) (12,710
Balance at end of year	\$340,093	\$316,609	\$339,029

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 \$102.5 million at December 31, 2012 (2011 - \$86.6 million) and the guarantee liability was \$(1.1) million at December 31, 2012 (2011 - \$(0.2))

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million). The value of the GMWB rider is recorded at fair value. The change in this value is included in policyholder benefits in the Consolidated Statements of Comprehensive 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 total separate account assets were \$340.1 million at December 31, 2012 (2011 - \$316.6 million). Variable universal life and variable annuity assets comprised 29% and 71% of this amount, respectively in both 2012 and 2011. 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 contracts guarantees the death benefit for specified periods of time, regardless of investment performance, provided cumulative premium requirements are met. The GMDB rider for variable annuity contracts guarantees the death benefit for specified periods of time, regardless of investment performance.

At December 31, 2012, separate account balances for variable annuity contracts were \$243.1 million. The total reserve held for variable annuity GMDB was \$0.1 million (December 31, 2011 - \$0.2 million). Additional information related to the GMDB and related separate account balances and net amount at risk (the amount by which the GMDB exceeds the account balance) as of December 31, 2012 and 2011 is provided below:

	2012		2011	
	Separate Account Balance	Net Amount at Risk	Separate Account Balance	Net Amount at Risk
Return of net deposits	\$195,557	\$1,374	\$190,710	\$4,147
Return of the greater of the highest anniversary contract value or net deposits	7,816	53	4,602	236
Return of the greater of every fifth year highest anniversary contract value or net deposits	5,714	70	6,065	264
Return of the greater of net deposits accumulated annually at 5% or the highest anniversary contract value	33,991	2,725	23,494	3,373
Total	\$243,078	\$4,222	\$224,871	\$8,020

The following table presents the GMDB for the variable annuity incurred and paid death benefits for the three years ended December 31.

	2012	2011	2010
Variable annuity incurred death benefits	\$2,296	\$1,145	\$1,955
Variable annuity paid death benefits	\$2,029	\$1,016	\$1,808

The following table presents the aggregate fair value of assets by major investment asset category supporting the variable annuity separate accounts with guaranteed benefits at December 31.

	2012	2011	2010
Money market	\$5,408	\$5,325	\$6,732
Fixed income	42,086	42,004	42,665
Balanced	47,673	43,795	47,028
International equity	25,384	25,401	26,833
Intermediate equity	95,487	80,755	86,661
Aggressive equity	27,040	27,591	30,703
Total	\$243,078	\$224,871	\$240,622





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Notes to Consolidated Financial Statements--(Continued)

## 10. Unpaid Accident and Health Claims Liability

The liability for unpaid accident and health claims is included with policy and contract claims on the Consolidated Balance Sheets. Claim adjustment expenditures are expensed as incurred and were not material in any year presented. Activity in the liability follows.

	2012	2011	2010
Gross liability at beginning of year	\$5,927	\$7,483	\$8,408
Less reinsurance recoverable	(3,250	) (4,071	) (4,554
Net liability at beginning of year	2,677	3,412	3,854
Incurred benefits related to:			
Current year	21,354	22,920	27,471
Prior years <sup>1</sup>	236	(500	) (471
Total incurred benefits	21,590	22,420	27,000
Paid benefits related to:			
Current year	18,667	20,289	24,114
Prior years	2,881	2,866	3,328
Total paid benefits	21,548	23,155	27,442
Net liability at end of year	2,719	2,677	3,412
Reinsurance recoverable	4,056	3,250	4,071
Gross liability at end of year	\$6,775	\$5,927	\$7,483

<sup>1</sup> The incurred benefits related to prior years' unpaid accident and health claims reflect the change in these liabilities.

## 11. Notes Payable

The Company had no notes payable at December 31, 2012 or December 31, 2011.

As a member of the FHLB with a capital investment of \$4.7 million, the Company has the ability to borrow on a collateralized basis from the FHLB. The Company received dividends on the capital investment in the FHLB equal to \$0.1 million during 2012 (2011 - \$0.1 million; 2010 - \$0.1 million).

The Company has unsecured revolving lines of credit of \$60.0 million with two major commercial banks with no balances outstanding at December 31, 2012 and 2011, and which are at variable interest rates based upon short-term indices. These lines of credit will expire in June of 2013. The Company anticipates renewing these lines as they come due.

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## 12. Income Taxes

The following tables provide information about income taxes and a reconciliation of the federal income tax rate to the Company's effective income tax rate for the years ended December 31.

	2012	2011	2010
Current income tax expense	\$18,926	\$10,011	\$4,872
Deferred income tax expense	702	3,554	7,585
Total income tax expense	\$19,628	\$13,565	\$12,457

	2012		2011		2010	
Federal income tax rate	35	%	35	%	35	%
Tax credits, net of equity adjustment	(1	)%	—	%	5	%
Permanent differences	(1	)%	(1	)%	(5	)%
Prior year taxes	—	%	—	%	1	%
Effective income tax rate	33	%	34	%	36	%

Presented below are tax effects of temporary differences that result in significant deferred tax assets and liabilities at December 31.

	2012	2011	
Deferred tax assets:			
Future policy benefits	\$26,319	\$22,816	
Employee retirement benefits	33,296	29,636	
Tax carryovers	418	218	
Other	2,418	3,745	
Deferred tax assets	62,451	56,415	
Deferred tax liabilities:			
Basis differences between tax and GAAP accounting for investments	9,853	9,036	
Unrealized investment gains	94,339	69,366	
Capitalization of deferred acquisition costs, net of amortization	27,706	28,782	
Value of business acquired	7,408	11,041	
Property and equipment, net	5,606	7,022	
Deferred tax liabilities	144,912	125,247	
Net deferred tax liability	82,461	68,832	
Current tax liability (receivable)	1,996	(261	)
Income taxes payable	\$84,457	\$68,571	

A valuation allowance must be established for any portion of the deferred tax asset which is believed not to be realizable. Management reviews the need for a valuation allowance based on the Company's anticipated future earnings, reversal of future taxable differences, the available carryback and carryforward periods, tax planning strategies that are prudent and feasible, and the ability and intent to hold securities until their recovery. In management's opinion, it is more likely than not that the Company will realize the benefit of its deferred taxes. The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction and various state jurisdictions. In general, the Company is no longer subject to U.S. federal, state or local income tax examinations by tax authorities for years prior to 2009. The Company is not currently under examination by the Internal Revenue Service.



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Tax positions are evaluated at the reporting date to determine whether an unrecognized tax benefit should be recorded. The Company did not have any unrecognized tax benefits at December 31, 2012, 2011, or 2010.

The Company recognizes interest and penalties accrued related to unrecognized tax benefits in income tax expense (benefit). In 2012 and 2011, the Company did not recognize any expense (benefit) related to interest and penalties. During the year ended December 31, 2010, the Company recognized expense (benefit) of approximately (\$0.7) million in interest and penalties. The Company did not have any accrued interest and penalties at December 31, 2012 or December 31, 2011.

The income tax expense is recorded in various places in the Company's financial statements, as detailed below, for the years ended December 31.

	2012	2011	2010
Income tax expense	\$19,628	\$13,565	\$12,457
Stockholders' equity:			
Related to:			
Change in net unrealized gains on securities available for sale	24,974	30,799	38,488
Effect on DAC and VOBA	(6,080)	) (7,501	) (12,808)
Change in future policy benefits	(4,611)	) (3,081	) (2,485)
Change in policyholder account balances	(195)	) (87	) (116)
Change in benefit plan obligations	(1,161)	) (8,133	) 765
Total income tax expense included in financial statements	\$32,555	\$25,562	\$36,301

**13. Pensions and Other Postretirement Benefits**

The Company has pension and other postretirement benefit plans covering substantially all its employees for which the measurement date is December 31.

The Kansas City Life Cash Balance Pension Plan (the Plan) was amended effective December 31, 2010 to provide that participants' accrued benefits will be frozen at, and that no further benefits or accruals will be earned after, December 31, 2010. Although participants will no longer accrue additional benefits under the Plan at December 31, 2010, participants will continue to earn years of service for vesting purposes under the Plan with respect to their benefits accrued through December 31, 2010. In addition, the cash balance account will continue to earn annual interest. Plan benefits are based on a cash balance account consisting of credits to the account based upon an employee's years of service, compensation and interest credits on account balances calculated using the greater of the average 30-year Treasury bond rate for November of each year or 5.5%. The benefits expected to be paid in each year from 2013 through 2017 are \$10.7 million, \$10.0 million, \$10.3 million, \$9.1 million, and \$9.4 million, respectively. The aggregate benefits expected to be paid in the five years from 2018 through 2022 are \$48.3 million. The expected benefits to be paid are based on the same assumptions used to measure the Company's benefit obligation at December 31, 2012 and are the actuarial present value of the vested benefits to which the employee is currently entitled but based upon the expected date of separation or retirement. The 2013 contribution for the plan has not been determined.

The asset allocation of the fair value of pension plan assets compared to the target allocation range at December 31 was:

	2012	2011	Target Allocation
Debt securities	40	% 34	% 26% -42%
Equity securities	60	% 66	% 56% -76%

Cash equivalents — % — % 0% -2%

Certain of the Company's pension plan assets consist of investments in pooled separate accounts offered by the Plan. Net asset value (NAV) of the separate accounts is calculated in a manner consistent with GAAP for investment companies and is determinative of their fair value. Several of the separate accounts invest in publicly quoted mutual funds or actively managed stocks. The fair value of the underlying mutual funds or stock is used to determine the NAV of the separate account, which is not publicly quoted. Some of the separate accounts also invest in fixed income securities. The fair value of the underlying securities is based on quoted prices of similar assets and used to determine the NAV of the separate account. Sale of plan assets may be at values less than

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NAV. Certain redemption restrictions may apply to specific stock and bond funds, including written notices prior to the withdrawal of funds and a potential redemption fee on certain withdrawals.

Hedge fund investments are recorded at net asset value. The Plan's hedge funds invest primarily in other investment funds. The valuation policies of the hedge funds provide that the value of investments in other investment funds be stated at fair value based on the net asset value of the other investment funds and certain redemption restrictions may apply, including a forty-five day prior written notice to withdraw funds.

Plan fiduciaries set investment policies and strategies and oversee its investment allocation, which includes selecting investment managers, commissioning periodic asset-liability studies, and setting long-term strategic targets.

Long-term strategic investment objectives include preserving the funded status of the plan and balancing risk and return. Target allocation ranges are guidelines, not limitations, and occasionally plan fiduciaries will approve allocations above or below a target range. The Plan does not expect to return any plan assets to the Company during 2013.

The current assumption for the expected long-term rate of return on plan assets is 8.0%. This assumption is determined by analyzing: 1) historical average returns achieved by asset allocation and active management; 2) historical data on the volatility of returns; 3) current yields available in the marketplace; 4) actual returns on plan assets; and 5) current and anticipated future allocation among asset classes. The asset classes used for this analysis are domestic and international equities, investment grade corporate bonds, alternative assets, and cash. The overall rate is derived as a weighted average of the estimated long-term returns on the asset classes represented in the investment portfolio of the plan. Effective January 1, 2013, the Company decreased the assumption for the expected long-term rate of return on plan assets to be 7.7%

The assumed discount rates used to determine the benefit obligation for pension benefits and postretirement benefits are 3.47% and 4.03%, respectively. The discount rates were determined by reference to the Citigroup Pension Liability Yield Curve on December 31, 2012. Specifically, the spot rate curve represents the rates on zero coupon securities of the quality and type included in the pension index at various maturities. By discounting benefit cash flows at these rates, a notional amount equal to the fair value of a cash flow defeasing portfolio of bonds was determined. The discount rate for benefits was calculated as a single rate giving the same discounted value as the notional amount.

The postretirement medical plans for eligible employees, agents, and their dependents are contributory with contributions adjusted annually. The benefits expected to be paid in each year from 2013 through 2014 are \$0.9 million each year, \$1.0 million for 2015 and \$1.1 million for 2016 and 2017. The aggregate benefits expected to be paid in the five years from 2018 through 2022 are \$6.7 million. The expected benefits to be paid are based on the same assumptions used to measure the Company's benefit obligation at December 31, 2012. The 2013 contribution for the plan is estimated to be \$0.9 million. The Company pays these medical costs as they become due and the plan incorporates cost-sharing features. 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.

The postretirement life insurance plan is non-contributory with level annual payments over the participants' expected service periods. The plan covers only those employees with at least one year of service at December 31, 1997. The benefits in this plan are frozen, using the employees' years of service and compensation at December 31, 1997.

Non-contributory defined contribution retirement plans for eligible general agents and sales agents provide supplemental payments based upon earned agency first year individual life and annuity commissions. Contributions to these plans in 2012 were \$0.1 million (2011 - \$0.1 million; 2010 - \$0.1 million). Non-contributory deferred compensation plans for eligible agents based upon earned first year commissions are also offered. Contributions to these plans in 2012 were \$0.5 million (2011 - \$0.5 million; 2010 - \$0.3 million).

Savings plans for eligible employees and agents match employee and agent contributions up to 8% of salary and 2.5% of agents' prior year paid commissions, respectively. Contributions to the plan in 2012 were \$3.2 million (2011 – \$3.3 million; 2010 – \$1.2 million). Effective January 1, 2011, the plan was amended to increase the employer match from 6% to 8%. The Company may contribute an additional profit sharing amount up to 4% of salary for eligible employees, depending upon corporate profits. In 2012, the Company made a contribution to the plan under the profit sharing determination of 4% of salary for eligible employees, which totaled \$1.3 million. In 2011 and 2010 the Company made no profit sharing contributions.

A non-contributory trustee employee stock ownership plan covers substantially all salaried employees. No contributions have been made to this plan since 1992.

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The Company recognizes the funded status of its defined pension and postretirement plans, measured as the difference between plan assets at fair value and the projected benefit obligation, on the Consolidated Balance Sheets. Changes in the funded status that arise during the period, but are not recognized as components of net periodic benefit cost, are recognized within other comprehensive income net of taxes.

The following tables provide information regarding pension benefits and other benefits for the years ended December 31.

	Pension Benefits		Other Benefits	
	2012	2011	2012	2011
Change in projected benefit obligation:				
Benefit obligation at beginning of year	\$ 153,094	\$ 143,204	\$ 35,425	\$ 27,768
Service cost	—	—	879	676
Interest cost	5,796	6,775	1,529	1,529
Plan participants' contributions	—	—	556	636
Curtailments and plan changes	—	1,347	—	—
Actuarial (gain) loss	9,844	11,497	(567	) 6,379
Benefits paid	(9,533	) (9,729	) (1,419	) (1,563
Benefit obligation at end of year	\$ 159,201	\$ 153,094	\$ 36,403	\$ 35,425
Change in plan assets:				
Fair value of plan assets at beginning of year	\$ 113,931	\$ 117,092	\$ 586	\$ 619
Reduction of plan assets	—	—	(586	) —
Return on plan assets	14,723	566	—	32
Plan participants' contributions	—	—	556	636
Company contributions	6,032	6,002	863	862
Benefits paid	(9,533	) (9,729	) (1,419	) (1,563
Fair value of plan assets at end of year	\$ 125,153	\$ 113,931	\$ —	\$ 586
Unfunded status at end of year	\$ 34,048	\$ 39,163	\$ 36,403	\$ 34,839
Amounts recognized in accumulated other comprehensive income:				
Net loss	\$ 76,472	\$ 72,595	\$ 6,000	\$ 6,813
Prior service credit	—	—	(705	) (957
Total accumulated other comprehensive income	\$ 76,472	\$ 72,595	\$ 5,295	\$ 5,856
	Pension Benefits		Other Benefits	
	2012	2011	2012	2011
Other changes in plan assets and benefit obligations recognized in other comprehensive income:				
Unrecognized actuarial net (gain) loss	\$ 4,010	\$ 20,100	\$ (566	) \$ 6,382
Amortization of net loss	(133	) (3,476	) (247	) (21
Amortization of prior service credit	—	—	252	252
Total (gain) loss recognized in other comprehensive income	\$ 3,877	\$ 16,624	\$ (561	) \$ 6,613



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	Pension Benefits		Other Benefits		
	2012	2011	2012	2011	
Plans with underfunded accumulated benefit obligation:					
Projected benefit obligation	\$ 159,201	\$ 153,094	\$—	\$—	
Accumulated benefit obligation	159,201	153,094	—	—	
Fair value of plan assets	125,153	113,931	—	—	
Weighted average assumptions used to determine benefit obligations at December 31:					
Discount rate	3.47	% 3.96	% 4.03	% 4.46	%
Expected return on plan assets	8.00	% 8.00	% —	5.50	%

Weighted average assumptions used to determine net periodic benefit cost for years ended December 31:

Discount rate	3.96	% 5.02	% 4.46	% 5.59	%
Expected return on plan assets	8.00	% 8.00	% —	5.50	%

The following table presents the fair value of each major category of pension plan and other postretirement assets at December 31.

	Pension Plan		Other Benefits	
	2012	2011	2012	2011
Cash and cash equivalents	\$7	\$75	\$—	\$586
Equity securities	—	4,972	—	—
Investment funds:				
Stock and bond funds	84,266	69,381	—	—
Money market funds	1,315	3,716	—	—
Hedge funds	16,272	15,238	—	—
Fixed maturity securities:				
U.S. Treasury securities and obligations of U.S. Government	2,315	2,317	—	—
Corporate obligations	20,559	17,913	—	—
Mineral rights	62	66	—	—
Real estate	19	19	—	—
Other	338	234	—	—
Fair value of assets at end of year	\$ 125,153	\$ 113,931	\$—	\$ 586

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The following tables disclose the level within the fair value hierarchy, as described in Note 5 - Fair Value Measurements, in which the pension plan and other postretirement assets fall.

	Pension Plan			Total
	Level 1	Level 2	Level 3	
Assets, at fair value as of December 31, 2012:				
Equity securities	\$—	\$—	\$—	\$—
Investment funds:				
Stock and bond funds	—	84,266	—	84,266
Money market funds	1,315	—	—	1,315
Hedge funds	—	16,272	—	16,272
Fixed maturity securities:				
U.S. Treasury securities and obligations of U.S. Government	—	2,315	—	2,315
Corporate obligations	—	20,435	124	20,559
Other assets	345	—	81	426
Total	\$1,660	\$123,288	\$205	\$125,153

	Other Benefits			Total
	Level 1	Level 2	Level 3	
Cash and cash equivalents	\$—	\$—	\$—	\$—
Total	\$—	\$—	\$—	\$—

	Pension Plan			Total
	Level 1	Level 2	Level 3	
Assets, at fair value as of December 31, 2011:				
Equity securities	\$4,972	\$—	\$—	\$4,972
Investment funds:				
Stock and bond funds	—	69,381	—	69,381
Money market funds	3,716	—	—	3,716
Hedge funds	—	15,238	—	15,238
Fixed maturity securities:				
U.S. Treasury securities and obligations of U.S. Government	—	2,317	—	2,317
Corporate obligations	—	16,632	1,281	17,913
Other assets	309	—	85	394
Total	\$8,997	\$103,568	\$1,366	\$113,931

	Other Benefits			Total
	Level 1	Level 2	Level 3	
Cash and cash equivalents	\$586	\$—	\$—	\$586
Total	\$586	\$—	\$—	\$586

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The following table discloses the changes in Level 3 plan assets measured at fair value on a recurring basis for the years ended December 31.

	Pension Plan		Other Benefits	
	2012	2011	2012	2011
Beginning balance	\$1,366	\$1,168	\$—	\$—
Gains (losses) realized and unrealized	(5	) 89	—	—
Transfers in	—	109	—	—
Transfers out	(1,156	) —	—	—
Ending balance	\$205	\$1,366	\$—	\$—

The following table provides the components of net periodic benefit cost for the years ended December 31.

	Pension Benefits			Other Benefits			
	2012	2011	2010	2012	2011	2010	
Service cost	\$—	\$—	\$2,115	\$879	\$676	\$594	
Interest cost	5,796	6,775	7,554	1,529	1,529	1,432	
Expected return on plan assets	(8,889	) (9,141	) (8,413	) —	(34	) (34	)
Amortization of:							
Unrecognized actuarial net loss	133	3,476	3,821	247	21	16	
Unrecognized prior service credit	—	—	(602	) (252	) (252	) (252	)
Net periodic benefit cost	(2,960	) 1,110	4,475	2,403	1,940	1,756	
Total recognized in other comprehensive income	3,877	16,624	(1,041	) (561	) 6,613	(1,146	)
Total recognized in net periodic benefit cost and other comprehensive income	\$917	\$17,734	\$3,434	\$1,842	\$8,553	\$610	

The following table provides the estimated net loss and prior service credit for the pension plan and other postretirement plans that will be amortized from accumulated other comprehensive income into net periodic benefit cost in 2013.

	Pension Benefits	Other Benefits	
Actuarial net loss	\$2,393	\$234	
Prior service credit	—	(252	)

The assumed growth rate of health care costs has a significant effect on the benefit amounts reported, as the table below demonstrates.

	One Percentage Point Change in the Growth Rate		
	Increase	Decrease	
Service and interest cost components	\$583	\$(450	)
Postretirement benefit obligation	6,980	(5,487	)

For measurement purposes, the annual increase in the per capita cost of covered health care benefits was assumed to be 8.5%, decreasing gradually to 5.5% in 2025 and thereafter.

During the first quarter of 2012, the Company identified an error related to the amortization period for unrecognized actuarial gains and losses for its pension plan. The Company determined that upon curtailment of the plan on January 1, 2011, the status

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of the plan participants should have changed from active to inactive. The amortization period was corrected from the average remaining service period of plan participants, approximately ten years, to the average remaining life expectancy of plan participants, approximately 26 years. The Company has recognized a \$2.0 million pre-tax benefit during 2012 related to the reversal of amortization recorded during 2011.

## 14. 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, multiplied by 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. In addition, all payments are lump sum with no deferrals allowed. The Company does not make payments in shares, warrants, or options.

The following table provides information about the outstanding three-year intervals at December 31, 2012.

Defined Measurement Period	Number of Units	Grant Price
2010-2012	223,969	\$30.04
2011-2013	200,060	\$32.45
2012-2014	206,389	\$31.70
2013-2015*	198,583	\$37.86

\*Effective January 1, 2013.

No payments were made during 2012, 2011, or 2010 for the three-year intervals ended December 31, 2011, 2010, and 2009, respectively. The cost of compensation charged as an operating expense during 2012 was \$2.2 million, net of tax. The cost of compensation charged as an operating expense during both 2011 and 2010 was \$0.3 million, net of tax.

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

## 15. Reinsurance

The table below provides information about reinsurance for the years ended December 31.

	2012	2011	2010
Life insurance in force (in millions) :			
Direct	\$27,515	\$27,926	\$28,329
Ceded	(13,622	) (13,978	) (14,116
Assumed	1,187	1,276	1,379
Net	\$15,080	\$15,224	\$15,592
Premiums:			
Life insurance:			
Direct	\$138,544	\$130,004	\$142,235
Ceded	(44,760	) (46,315	) (46,133
Assumed	2,758	3,164	3,285
Net	\$96,542	\$86,853	\$99,387
Accident and health:			
Direct	\$52,090	\$51,842	\$49,267
Ceded	(12,543	) (11,357	) (8,843
Net	\$39,547	\$40,485	\$40,424

Old American has a coinsurance agreement that reinsures certain whole life policies issued by Old American prior to December 1, 1986. These policies had a face value of \$29.6 million at December 31, 2012 (2011 - \$32.9 million). The reserve for future policy benefits ceded under this agreement at December 31, 2012 was \$16.7 million (2011 - \$18.3 million).

Kansas City Life acquired a block of traditional life and universal life products in 1997. Investments equal to the statutory policy reserves are held in a trust to secure payment of the estimated liabilities relating to the policies. At December 31, 2012, the block had \$1.2 billion of life insurance in force (2011 - \$1.3 billion). The block generated life insurance premiums of \$2.6 million in 2012 (2011 - \$2.8 million; 2010 - \$3.0 million) and had reinsurance ceded premiums of \$0.9 million in 2012 (2011 - \$0.8 million; 2010 - \$0.8 million).

Sunset Life entered into a yearly renewable term reinsurance agreement January 1, 2002, whereby it ceded 80% of its retained mortality risk on traditional and universal life policies. At December 31, 2012, the insurance in force ceded approximated \$1.1 billion (2011 - \$1.3 billion) and premiums totaled \$7.7 million (2011 - \$8.9 million; 2010 - \$8.9 million).

Reinsurance recoverables were \$190.6 million at year end 2012, consisting of reserves ceded of \$177.1 million and claims ceded of \$13.5 million. Reinsurance recoverables were \$189.9 million at year end 2011, consisting of reserves ceded of \$176.7 million and claims ceded of \$13.2 million.

The maximum retention on any one life during 2011 and 2010 was three hundred fifty thousand dollars for ordinary life plans and one hundred thousand dollars for group coverage. Effective January 1, 2012, the Company increased its maximum retention limit to five hundred thousand dollars on individual life products.

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

The following table reflects the Company's reinsurance partners whose reinsurance recoverable was 5% or greater of the Company's total reinsurance recoverable at December 31, 2012, along with their A. M. Best credit rating.

	A. M. Best Rating	Reinsurance Recoverable	% of Recoverable	
TransAmerica Life Insurance Company	A+	\$42,771	22	%
Security Life of Denver	A	26,054	14	%
RGA Reinsurance Company	A+	18,638	10	%
Employers Reassurance Corporation	A-	16,521	9	%
Union Security Insurance Company	A-	12,738	7	%
Swiss Re America Corporation	A+	10,047	5	%
UNUM Life Insurance Company of America	A	10,047	5	%
Lewer Life Insurance Company	B	9,878	5	%
Lincoln National Life Insurance Company	A+	9,466	5	%
Swiss Re Life & Health America, Inc	A+	9,227	5	%
Other (19 Companies)		25,226	13	%
Total		\$190,613	100	%

A contingent liability exists with respect to reinsurance, which may become a liability of the Company in the unlikely event that the reinsurers should be unable to meet obligations assumed under reinsurance contracts. The solvency of reinsurers is reviewed annually.

The Company monitors several factors that it considers relevant to satisfy itself as to the ongoing ability of a reinsurer to meet the obligations of the reinsurance agreements. These factors include the credit rating of the reinsurer, the financial strength of the reinsurer, significant changes or events of the reinsurer, and any other factors that the Company believes relevant. If the Company believes that any reinsurer would not be able to satisfy its obligations with the Company, a separate contingency reserve may be established. At year-end 2012 and 2011, no reinsurer met these conditions.

## 16. Comprehensive Income

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, future policy benefits, 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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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

The table below provides information about comprehensive income for the years ended December 31.

	Pre-Tax Amount	Tax (Expense) or Benefit	Net-of-Tax Amount
2012:			
Net unrealized gains (losses) arising during the year:			
Fixed maturity securities	\$72,768	\$(25,469)	) \$47,299
Equity securities	(173)	) 61	(112)
Less reclassification adjustments:			
Net realized investment gains, excluding impairment losses	2,961	(1,036)	) 1,925
Other-than-temporary impairment losses recognized in earnings	(2,526)	) 884	(1,642)
Other-than-temporary impairment losses recognized in other comprehensive income	808	(282)	) 526
Net unrealized gains excluding impairment losses	71,352	(24,974)	) 46,378
Change in benefit plan obligations	(3,317)	) 1,161	(2,156)
Effect on DAC and VOBA	(17,371)	) 6,080	(11,291)
Future policy benefits	(13,172)	) 4,611	(8,561)
Policyholder account balances	(557)	) 195	(362)
Other comprehensive income	\$36,935	\$(12,927)	) \$24,008
Net income			39,867
Comprehensive income			\$63,875
	Pre-Tax Amount	Tax (Expense) or Benefit	Net-of-Tax Amount
2011:			
Net unrealized gains (losses) arising during the year:			
Fixed maturity securities	\$91,750	\$(32,113)	) \$59,637
Equity securities	(340)	) 119	(221)
Less reclassification adjustments:			
Net realized investment gains, excluding impairment losses	5,422	(1,898)	) 3,524
Other-than-temporary impairment losses recognized in earnings	(2,952)	) 1,033	(1,919)
Other-than-temporary impairment losses recognized in other comprehensive income	943	(330)	) 613
Net unrealized gains excluding impairment losses	87,997	(30,799)	) 57,198
Change in benefit plan obligations	(23,237)	) 8,133	(15,104)
Effect on DAC and VOBA	(21,433)	) 7,501	(13,932)
Future policy benefits	(8,802)	) 3,081	(5,721)
Policyholder account balances	(249)	) 87	(162)
Other comprehensive income	\$34,276	\$(11,997)	) \$22,279
Net income			26,133
Comprehensive income			\$48,412



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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

	Pre-Tax Amount	Tax (Expense) or Benefit	Net-of-Tax Amount
2010:			
Net unrealized gains (losses) arising during the year			
Fixed maturity securities	\$ 109,950	\$(38,483 )	\$ 71,467
Equity securities	558	(195 )	363
Less reclassification adjustments:			
Net realized investment gains, excluding impairment losses	4,364	(1,527 )	2,837
Other-than-temporary impairment losses recognized in earnings	(4,129 )	1,445 )	(2,684 )
Other-than-temporary impairment losses recognized in other comprehensive income	309	(108 )	201
Net unrealized gains excluding impairment losses	109,964	(38,488 )	71,476
Change in benefit plan obligations	2,187	(765 )	1,422
Effect on DAC and VOBA	(36,593 )	12,808 )	(23,785 )
Future policy benefits	(7,100 )	2,485 )	(4,615 )
Policyholder account balances	(330 )	116 )	(214 )
Other comprehensive income	\$ 68,128	\$(23,844 )	\$ 44,284
Net income			22,302
Comprehensive income			\$ 66,586

The following table provides accumulated balances related to each component of accumulated other comprehensive income at December 31.

	Unrealized Gain (Loss) on Non-Impaired Securities	Unrealized Gain (Loss) on Impaired Securities	Benefit Plan Obligations	DAC/ VOBA Impact	Future Policy Benefits	Policyholder Account Balances	Tax Effect	Total
2012:								
Beginning of year	\$ 213,800	\$ (15,612 )	\$(78,451 )	\$(56,971 )	\$(15,903 )	\$(578 )	\$(16,199 )	\$ 30,086
Other comprehensive income	54,654	16,698	(3,317 )	(17,371 )	(13,172 )	(557 )	(12,927 )	24,008
End of year	\$ 268,454	\$ 1,086	\$(81,768 )	\$(74,342 )	\$(29,075 )	\$(1,135 )	\$(29,126 )	\$ 54,094
2011:								
Beginning of year	\$ 122,422	\$ (12,231 )	\$(55,214 )	\$(35,538 )	\$(7,101 )	\$(329 )	\$(4,202 )	\$ 7,807
Other comprehensive income	91,378	(3,381 )	(23,237 )	(21,433 )	(8,802 )	(249 )	(11,997 )	22,279
End of year	\$ 213,800	\$ (15,612 )	\$(78,451 )	\$(56,971 )	\$(15,903 )	\$(578 )	\$(16,199 )	\$ 30,086

## 17. Earnings 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 years reported. The average number of shares outstanding during 2012 was 11,095,777 shares (2011 - 11,419,931 shares; 2010 - 11,486,306 shares). The number of shares outstanding at year-end 2012 was 11,032,857 (2011 - 11,309,365).



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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

18. 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 Insurance 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.

Insurance revenues, as shown in the Consolidated Statements of Comprehensive Income, consist of premiums and contract charges, less reinsurance ceded. Insurance revenues are defined as "customer revenues" for segment reporting purposes. Other revenues consist primarily of supplementary contract considerations, policyholder dividends left with the Company to accumulate, income received on the sale of low income housing tax credits by a subsidiary of the Company, and fees charged on products and sales from the Company's broker-dealer subsidiary. Customer revenues are added to other revenues, net investment income, and realized investment gains (losses) to reconcile to the Company's total revenues. Benefits and expenses are specifically and directly identified and recorded by segment. Certain expenses may also be allocated as necessary.

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.

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

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.

	Individual Insurance	Group Insurance	Old American	Intercompany Eliminations <sup>1</sup>	Total
2012:					
Insurance revenues (customer revenues)	\$ 116,779	\$ 48,823	\$ 70,773	\$(392 )	\$ 235,983
Net investment income	163,706	524	11,924	—	176,154
Realized investment gains (losses)	19,032	—	(596 )	—	18,436
Other revenues	9,196	145	13	—	9,354
Total revenues	308,713	49,492	82,114	(392 )	439,927
Policyholder benefits	86,627	26,803	46,748	—	160,178
Interest credited to policyholder account balances	82,043	—	—	—	82,043
Amortization of deferred acquisition costs	14,712	—	13,330	—	28,042
Operating expenses	70,711	23,699	16,151	(392 )	110,169
Total benefits and expenses	254,093	50,502	76,229	(392 )	380,432
Income (loss) before income tax expense (benefit)	54,620	(1,010 )	5,885	—	59,495
Income tax expense (benefit)	17,762	(354 )	2,220	—	19,628
Segment net income (loss)	\$ 36,858	\$(656 )	\$ 3,665	\$—	\$ 39,867
Segment assets	\$ 4,140,048	\$ 8,793	\$ 376,904	\$—	\$ 4,525,745
Interest expense	4	—	—	—	4

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 Comprehensive Income.

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

	Individual Insurance	Group Insurance	Old American	Intercompany Eliminations <sup>1</sup>	Total
2011:					
Insurance revenues (customer revenues)	\$111,381	\$49,684	\$67,869	\$(535)	\$228,399
Net investment income	164,595	547	12,086	—	177,228
Realized investment gains (losses)	3,282	—	(140)	) —	3,142
Other revenues	10,110	149	15	—	10,274
Total revenues	289,368	50,380	79,830	(535)	419,043
Policyholder benefits	81,859	27,777	46,177	—	155,813
Interest credited to policyholder account balances	83,446	—	—	—	83,446
Amortization of deferred acquisition costs	21,645	—	12,321	—	33,966
Operating expenses	63,700	23,675	19,280	(535)	106,120
Total benefits and expenses	250,650	51,452	77,778	(535)	379,345
Income (loss) before income tax expense (benefit)	38,718	(1,072)	) 2,052	—	39,698
Income tax expense (benefit)	13,107	(375)	) 833	—	13,565
Segment net income (loss)	\$25,611	\$(697)	) \$1,219	\$—	\$26,133
Segment assets	\$4,018,545	\$9,161	\$370,536	\$—	\$4,398,242
Interest expense	—	—	—	—	—

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 Comprehensive Income.

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

	Individual Insurance	Group Insurance	Old American	Intercompany Eliminations <sup>1</sup>	Total
2010:					
Insurance revenues (customer revenues)	\$131,774	\$49,355	\$65,229	\$(528)	\$245,830
Net investment income	162,997	553	12,309	—	175,859
Realized investment gains	202	—	333	—	535
Other revenues	8,978	156	5	—	9,139
Total revenues	303,951	50,064	77,876	(528)	431,363
Policyholder benefits	106,523	32,131	44,343	—	182,997
Interest credited to policyholder account balances	85,949	—	—	—	85,949
Amortization of deferred acquisition costs	14,976	—	12,057	—	27,033
Operating expenses	60,141	21,917	19,095	(528)	100,625
Total benefits and expenses	267,589	54,048	75,495	(528)	396,604
Income (loss) before income tax expense (benefit)	36,362	(3,984)	2,381	—	34,759
Income tax expense (benefit)	12,855	(1,394)	996	—	12,457
Segment net income (loss)	\$23,507	\$(2,590)	\$1,385	\$—	\$22,302
Segment assets	\$3,956,721	\$10,268	\$366,113	\$—	\$4,333,102
Interest expense	1	—	—	—	1

Elimination entries to remove intercompany transactions for life and accident and health insurance that the

<sup>1</sup> 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 Comprehensive Income.

The following table provides information about the Company's customer revenues, net of reinsurance, for the years ended December 31.

	2012	2011	2010
Customer revenues by line of business:			
Traditional individual insurance products, net	\$87,266	\$77,654	\$90,456
Interest sensitive products	84,904	86,112	90,568
Variable life insurance and annuities	14,990	14,949	15,451
Group life and accident and health products, net	48,823	49,684	49,355
Insurance revenues	\$235,983	\$228,399	\$245,830

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

## 19. Quarterly Consolidated Financial Data (unaudited)

The unaudited quarterly results of operations for the years ended December 31, 2012 and 2011 are summarized in the table below.

	First	Second	Third	Fourth
2012:				
Total revenues	\$ 119,908	\$ 106,757	\$ 104,260	\$ 109,002
Net income	19,441	8,397	4,132	7,897
Per common share, basic and diluted	1.72	0.78	0.38	0.71
2011:				
Total revenues	\$ 108,459	\$ 103,823	\$ 103,271	\$ 103,490
Net income	4,791	11,173	4,466	5,703
Per common share, basic and diluted	0.42	0.97	0.39	0.51

## 20. Statutory Information and Stockholder Dividends Restriction

The table below provides Kansas City Life's net gain from operations, net income, and capital and surplus (stockholders' equity) on the statutory basis used to report to regulatory authorities for the years ended December 31.

	2012	2011	2010
Net gain from operations	\$ 32,102	\$ 26,856	\$ 13,400
Net income	46,474	22,639	12,748
Capital and surplus	327,444	307,153	322,459

Stockholder dividends may not exceed statutory unassigned surplus. Additionally, under Missouri law, the Company must have the prior approval of the Missouri Director of Insurance in order to pay dividends in any consecutive twelve-month period exceeding the greater of statutory net gain from operations for the preceding year or 10% of statutory stockholders' equity at the end of the preceding year. Kansas City Life, as the parent company, believes it has sufficient cash resources, independent of dividends paid by its affiliates, to satisfy its own stockholder dividend payments. In addition, the Company believes that individually each of the insurance enterprises has sufficient cash flows to satisfy the anticipated cash dividends that are expected to be declared.

For Kansas City Life, the maximum stockholder dividends payable without prior approval in 2013 is \$32.7 million, 10% of 2012 capital and surplus. For Old American and Sunset Life, the maximum stockholder dividends payable without prior approval in 2013 is \$2.4 million and \$6.5 million, respectively, which is the statutory net gain from operations for the preceding year for each company. Each of the individual insurance enterprises believes that the statutory limitations impose no practical restrictions on any of its dividend payment plans.

On a statutory basis, insurance companies are monitored and evaluated by state insurance departments as to the financial adequacy of statutory capital and surplus in relation to each company's risks. One such measure is through the risk-based capital (RBC) guidelines. RBC requirements are intended to be used by insurance regulators as an early warning tool to identify deteriorating or weakly capitalized insurance companies for the purpose of initiating regulatory action. RBC guidelines consist of target statutory surplus levels based on the relationship of statutory

capital and surplus to the sum of weighted risk exposures. The RBC calculation determines both an authorized control level and a total adjusted capital prepared on the RBC basis. Generally, regulatory action is at 150% of the authorized control level. Each of the three insurance companies was well in excess of the control level at December 31, 2012. Kansas City Life's RBC was approximately 825%, Old American was approximately 750%, and Sunset Life was approximately 825%.

The Company is required to deposit a defined amount of assets with state regulatory authorities. Such assets had a statutory carrying value of \$12.7 million at December 31, 2012 (2011 - \$12.9 million; 2010 - \$12.0 million).



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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

21. Commitments

In the normal course of business, the Company has open purchase and sale commitments. At December 31, 2012, the Company had purchase commitments to fund mortgage loans and affordable housing projects of \$8.6 million and one construction-to-permanent loan of \$0.3 million that is subject to the borrower's performance, and \$5.3 million for the development of real estate investments.

Subsequent to December 31, 2012 the Company entered into commitments to fund additional mortgage loans of \$12.9 million and \$10.4 million for the acquisition and development of real estate investments.

22. Contingent Liabilities

The Company and its subsidiaries are, from time to time, involved in litigation, both as a defendant and as a plaintiff. The life insurance industry, including the Company and its insurance 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.

The Company's broker-dealer and investment advisor subsidiary is involved in a business that involves a substantial risk of liability. Legal and other proceedings involving financial services firms, including the Company's subsidiary, continue to have a significant impact on the industry. Significant matters over the last few years have included registered representative activity and certain types of securities products (particularly private placements and real estate investment products).

The Company and its subsidiaries are subject to regular reviews and inspections by state and federal regulatory authorities. State insurance examiners may, from time to time, conduct examinations or investigations into industry practices and into customer complaints. A regulatory violation discovered during a review, inspection, or investigation could result in a wide range of remedies that could include the imposition of sanctions against the Company, its subsidiaries, or its employees.

Certain securities policies, contracts, and annuities offered by the Company and its broker-dealer and investment advisor subsidiary are subject to regulation under the federal securities laws administered by the SEC. Federal securities laws contain regulatory restrictions and criminal, administrative, and private remedial provisions. From time to time, the SEC and the Financial Industry Regulatory Authority ("FINRA") examine or investigate the activities of broker-dealers and investment advisors, including the Company's affiliated broker-dealer and investment advisor subsidiary. These examinations often focus on the activities of registered principals, registered representatives and registered investment advisors doing business through that entity. It is possible that the results of any examination may lead to changes in systems or procedures, payments of fines and penalties, payments to customers, or a combination thereof, any of which could have a material adverse effect on the Company's financial condition or results of operations.

The life insurance industry has been the subject of significant regulatory and legal activities regarding the use of the U.S. Social Security Administration's Death Master File ("Death Master File") in the claims process. The focus of the activity has related to the industry's compliance with state unclaimed property and escheatment laws. Certain states have proposed, and many other states are considering, new legislation and regulations related to unclaimed life insurance benefits and the use of the Death Master File in the claims process. It is possible that audits and/or the enactment of new state laws could result in identifying payments to beneficiaries more quickly than under the current legislative and regulatory standards established for life insurance claims or may provide for additional escheatment of funds deemed abandoned under state laws. The audits could also result in administrative penalties. Given the legal and regulatory uncertainty in this area, it is also possible that life insurers, including the Company, may be subject to claims concerning their business practices. West Virginia, for example, has initiated litigation against a large number of life insurance companies, including Old American, under the abandoned property laws of that state. Based on its analysis to date, the Company believes that it has sufficiently reviewed its existing business and has adequately reserved for any contingency from any change in statute or regulation. Additional costs that cannot be reasonably estimated as of the date of this filing are possible as a result of ongoing regulatory developments and other future requirements related to this matter. Any resulting additional payments or costs could be significant and could have a

material adverse effect on the Company's financial condition or results of operations.

In addition to the specific items 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 regulatory matters, legal actions, and other claims would not have a material effect on the Company's business, results of operations, or financial position.

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements--(Continued)

In accordance with applicable accounting guidelines, the Company establishes 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, often 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.

While the Company makes every effort to appropriately accrue liability for litigation and other legal proceedings, the outcome of such matters (including any amount of settlement, judgment or fine) is inherently difficult to predict. This difficulty arises from the need to gather all relevant facts (which may or may not be available) and to apply those facts to complex legal principles. Based on currently available information, the Company does not believe that any litigation, proceeding or other matter to which it is a party or otherwise involved will have a material adverse effect on its financial position, the results of its operations, or its cash flows. However, an adverse development or an increase in associated legal fees could be material in a particular period depending, in part, on the Company's operating results in that period.

23. 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.

24. Subsequent Events

On January 28, 2013, the Kansas City Life Board of Directors declared a quarterly dividend of \$0.27 per share, paid on February 13, 2013 to stockholders of record on February 7, 2013.

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## Schedule I

Kansas City Life Insurance Company and Subsidiaries

Summary of Investments – Other Than Investments in Related Parties

December 31, 2012

Type of Investment	Cost	Fair Value	Amount Recognized in Consolidated Balance Sheets
Fixed maturity securities, available for sale:			
Bonds:			
United States government and government agencies and authorities	\$ 143,844	\$ 162,120	\$ 162,120
Residential mortgage-backed securities	228,460	240,116	240,116
Public utilities	246,389	286,127	286,127
Corporate	1,646,504	1,818,844	1,818,844
All other bonds	247,285	272,728	272,728
Redeemable preferred stocks	7,984	8,206	8,206
Total	\$2,520,466	\$2,788,141	\$2,788,141
Equity securities, available for sale:			
Common stocks	15,331	15,537	15,537
Perpetual preferred stocks	2,864	4,524	4,524
Total	\$18,195	\$20,061	\$20,061
Mortgage loans	674,034		674,034
Real estate	124,742		124,742
Policy loans	77,133		77,133
Short-term investments	24,902		24,902
Other investments	2,572		2,572
Total investments	\$3,442,044		\$3,711,585
See accompanying Report of Independent Registered Public Accounting Firm			

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## Schedule II

Kansas City Life Insurance Company

Condensed Financial Information of Registrant

Balance Sheets

	December 31,	
	2012	2011
<b>ASSETS</b>		
Investments:		
Fixed maturity securities available for sale, at fair value	\$2,301,142	\$2,190,627
Equity securities available for sale, at fair value:		
Investment in unconsolidated subsidiaries	175,683	172,643
Other	13,321	30,124
Mortgage loans	563,931	506,386
Real estate	122,337	125,012
Policy loans	58,115	60,689
Short-term investments	20,664	37,864
Total investments	3,255,193	3,123,345
Cash	4,316	5,318
Accrued investment income	28,722	28,423
Deferred acquisition costs	77,030	86,927
Reinsurance recoverables	131,186	124,147
Property and equipment	18,313	22,663
Other assets	44,486	58,386
Separate account assets	340,093	316,609
Total assets	\$3,899,339	\$3,765,818
<b>LIABILITIES</b>		
Future policy benefits	\$606,877	\$593,723
Policyholder account balances	1,853,439	1,812,224
Policy and contract claims	20,822	26,573
Other policyholder funds	138,747	134,201
Other liabilities	188,960	171,783
Separate account liabilities	340,093	316,609
Total liabilities	3,148,938	3,055,113
<b>STOCKHOLDERS' EQUITY</b>		
Common stock, par value \$1.25 per share	23,121	23,121
Authorized 36,000,000 shares, issued 18,496,680 shares		
Additional paid in capital	40,969	41,101
Retained earnings	805,730	780,918
Accumulated other comprehensive income	54,094	30,086
Treasury stock, at cost (2012-7,463,823 shares; 2011 - 7,187,315 shares)	(173,513)	(164,521)
Total stockholders' equity	750,401	710,705
Total liabilities and stockholders' equity	\$3,899,339	\$3,765,818
See accompanying Report of Independent Registered Public Accounting Firm		



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## Schedule II

(continued)

Kansas City Life Insurance Company  
Condensed Financial Information of Registrant  
Statements of Comprehensive Income

	Year Ended December 31		
	2012	2011	2010
<b>REVENUES</b>			
Insurance revenues:			
Net premiums	\$73,480	\$69,027	\$84,038
Contract charges	85,662	86,199	89,990
Total insurance revenues	159,142	155,226	174,028
Investment revenues:			
Net investment income	144,701	144,754	142,327
Net realized investment gains, excluding other-than-temporary impairment losses	21,365	4,906	2,953
Net impairment losses recognized in earnings:			
Total other-than-temporary impairment losses	(1,582	) (2,035	) (3,481
Portion of impairment losses recognized in other comprehensive income	600	676	262
Net other-than-temporary impairment losses recognized in earnings	(982	) (1,359	) (3,219
Total investment revenues	165,084	148,301	142,061
Other revenues	4,358	4,654	4,662
Total revenues	328,584	308,181	320,751
<b>BENEFITS AND EXPENSES</b>			
Policyholder benefits	108,853	109,598	135,077
Interest credited to policyholder account balances	70,546	71,737	73,640
Amortization of deferred acquisition costs	14,184	14,242	11,156
Operating expenses	85,836	78,679	74,447
Total benefits and expenses	279,419	274,256	294,320
Income before income tax expense and equity in undistributed net income of subsidiaries	49,165	33,925	26,431
Income tax expense	16,308	11,960	9,799
Income before equity in undistributed net income of subsidiaries	32,857	21,965	16,632
Equity in undistributed net income of subsidiaries	7,010	4,168	5,670
<b>NET INCOME</b>	<b>\$39,867</b>	<b>\$26,133</b>	<b>\$22,302</b>
<b>COMPREHENSIVE INCOME, NET OF TAXES</b>			
Change in net unrealized gains on securities available for sale	\$28,171	\$36,382	\$36,683
Change in future policy benefits	(8,105	) (5,463	) (4,416
Change in policyholder account balances	(347	) (159	) (210
Change in benefit plan obligations	(2,156	) (15,104	) 1,422
Other comprehensive income of subsidiaries	6,445	6,623	10,805
Other comprehensive income	24,008	22,279	44,284
<b>COMPREHENSIVE INCOME</b>	<b>\$63,875</b>	<b>\$48,412</b>	<b>\$66,586</b>
See accompanying Report of Independent Registered Public Accounting Firm			





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## Schedule II

(continued)

Kansas City Life Insurance Company

Condensed Financial Information of Registrant

Statements of Cash Flows

	Year Ended December 31		
	2012	2011	2010
<b>OPERATING ACTIVITIES</b>			
Net income	\$39,867	\$26,133	\$22,302
Equity in undistributed net income of subsidiaries	(7,010	) (4,168	) (5,670
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of investment premium and discount	3,507	2,860	2,579
Depreciation	7,236	3,204	2,786
Acquisition costs capitalized	(17,226	) (16,552	) (19,712
Amortization of deferred acquisition costs	14,184	14,242	11,156
Realized investment (gains) losses	(20,383	) (3,547	) 266
Changes in assets and liabilities:			
Reinsurance recoverables	(7,039	) (7,735	) (11,599
Future policy benefits	686	(10,389	) 12,521
Policyholder account balances	(8,534	) (2,429	) (14,273
Income taxes payable and deferred	4,711	7,087	20,420
Other, net	3,489	4,223	9,152
Net cash provided	13,488	12,929	29,928
<b>INVESTING ACTIVITIES</b>			
Purchases:			
Fixed maturity securities	(298,758	) (203,583	) (360,579
Equity securities	(3,897	) (104	) (1,270
Mortgage loans	(148,725	) (99,208	) (132,085
Real estate	(37,119	) (9,548	) (12,238
Policy loans	(11,231	) (10,655	) (11,953
Sales or maturities, calls, and principal paydowns:			
Fixed maturity securities	246,817	213,069	286,579
Equity securities	24,481	1,348	4,537
Mortgage loans	90,217	81,523	38,706
Real estate	53,459	—	—
Policy loans	13,805	14,139	13,797
Net sales (purchases) of short-term investments	17,200	(26,812	) 106,916
Net acquisition of property and equipment	(771	) (260	) (403
Net cash used	(54,522	) (40,091	) (67,993
See accompanying Report of Independent Registered Public Accounting Firm			

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## Schedule II

(continued)

Kansas City Life Insurance Company  
Condensed Financial Information of Registrant  
Statements of Cash Flows (Continued)

	Year Ended December 31		
	2012	2011	2010
<b>FINANCING ACTIVITIES</b>			
Proceeds from borrowings	\$65,000	\$—	\$5,000
Repayment of borrowings	(65,000	) —	(5,000
Deposits on policyholder account balances	208,589	211,888	216,794
Withdrawals from policyholder account balances	(159,712	) (175,329	) (180,169
Net transfers from separate accounts	5,082	5,282	7,177
Change in other deposits	(2,653	) (2,521	) 2,954
Cash dividends to stockholders	(15,055	) (12,341	) (12,401
Dividends from subsidiaries	6,715	6,455	7,645
Net change in treasury stock	(2,934	) (4,838	) (3,076
Net cash provided	40,032	28,596	38,924
Increase (decrease) in cash	(1,002	) 1,434	859
Cash at beginning of year	5,318	3,884	3,025
Cash at end of year	\$4,316	\$5,318	\$3,884
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest	\$3	\$—	\$1
Income taxes	12,050	7,882	1,655
See accompanying Report of Independent Registered Public Accounting Firm			

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## Schedule III

## Kansas City Life Insurance Company and Subsidiaries

## Supplementary Insurance Information

Segment	Deferred acquisition costs	Future policy benefits, policyholder account balances, and policy and contract claims	Unearned premiums	Other policyholder funds
December 31, 2012:				
Individual	\$80,912	\$2,771,940	\$321	\$150,479
Group	—	32,885	1,228	—
Old American	95,363	242,097	144	3,577
Total	\$176,275	\$3,046,922	\$1,693	\$154,056
December 31, 2011:				
Individual	\$92,498	\$2,730,561	\$332	\$147,239
Group	—	30,198	724	—
Old American	89,066	244,219	163	3,667
Total	\$181,564	\$3,004,978	\$1,219	\$150,906

See accompanying Report of Independent Registered Public Accounting Firm

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## Schedule III

(continued)

Kansas City Life Insurance Company and Subsidiaries  
Supplementary Insurance Information

Segment	Premium revenue <sup>2</sup>	Net investment income <sup>3</sup>	Policyholder benefits and interest credited to policyholder account balances	Amortization of deferred policy acquisition costs	Operating expenses <sup>4</sup>
Year Ended December 31, 2012:					
Individual	\$ 16,885	\$ 163,706	\$ 168,670	\$ 14,712	\$ 70,711
Group	48,823	524	26,803	—	23,699
Old American	70,773	11,924	46,748	13,330	16,151
Intercompany eliminations <sup>1</sup>	(392)	) —	—	—	(392)
Total	\$ 136,089	\$ 176,154	\$ 242,221	\$ 28,042	\$ 110,169
Year Ended December 31, 2011:					
Individual	\$ 10,320	\$ 164,595	\$ 165,305	\$ 21,645	\$ 63,700
Group	49,684	547	27,777	—	23,675
Old American	67,869	12,086	46,177	12,321	19,280
Intercompany eliminations <sup>1</sup>	(535)	) —	—	—	(535)
Total	\$ 127,338	\$ 177,228	\$ 239,259	\$ 33,966	\$ 106,120
Year Ended December 31, 2010:					
Individual	\$ 25,755	\$ 162,997	\$ 192,472	\$ 14,976	\$ 60,141
Group	49,355	553	32,131	—	21,917
Old American	65,229	12,309	44,343	12,057	19,095
Intercompany eliminations <sup>1</sup>	(528)	) —	—	—	(528)
Total	\$ 139,811	\$ 175,859	\$ 268,946	\$ 27,033	\$ 100,625

Elimination entries to remove intercompany transactions for life and accident and health insurance that the

<sup>1</sup> 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 Comprehensive Income.

<sup>2</sup> Premium revenue includes direct premiums and premiums from reinsurance assumed, reduced by premiums on reinsurance ceded.

<sup>3</sup> Separate investment portfolios are maintained for each of the three life insurance companies. However, investment income is allocated to the Group Insurance segment based upon its cash flows and future policy benefit liabilities.

<sup>4</sup> Operating expenses are allocated to the segments based upon internal cost studies, which are consistent with industry cost methodologies.

See accompanying Report of Independent Registered Public Accounting Firm

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## Schedule IV

## Kansas City Life Insurance Company and Subsidiaries

## Reinsurance Information

## Years Ended December 31

	Life Insurance Premiums			Accident and Health Premiums			
	2012	2011	2010	2012	2011	2010	
Direct:							
Individual	\$56,001	\$50,584	\$65,337	\$285	\$405	\$529	
Group	10,971	10,701	10,676	51,030	50,507	47,608	
Old American	71,781	69,044	66,540	958	1,140	1,340	
Intercompany Eliminations <sup>1</sup>	(209 )	(325 )	(318 )	(183 )	(210 )	(210 )	
Total	138,544	130,004	142,235	52,090	51,842	49,267	
Ceded:							
Individual	(41,700 )	(43,300 )	(42,757 )	(459 )	(533 )	(639 )	
Group	(1,713 )	(1,454 )	(1,613 )	(11,465 )	(10,070 )	(7,316 )	
Old American	(1,347 )	(1,561 )	(1,763 )	(619 )	(754 )	(888 )	
Total	(44,760 )	(46,315 )	(46,133 )	(12,543 )	(11,357 )	(8,843 )	
Assumed:							
Individual	2,758	3,164	3,285	—	—	—	
Group	—	—	—	—	—	—	
Old American	—	—	—	—	—	—	
Total	2,758	3,164	3,285	—	—	—	
Net	\$96,542	\$86,853	\$99,387	\$39,547	\$40,485	\$40,424	
% of Assumed to Net	3	% 4	% 3	% —	% —	% —	%

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 to arrive at Consolidated Statements of Comprehensive Income.

For additional information see Note 15 - Reinsurance in the Notes to Consolidated Financial Statements.

See accompanying Report of Independent Registered Public Accounting Firm

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## Schedule IV

(continued)

Kansas City Life Insurance Company and Subsidiaries

Reinsurance Information

Years Ended December 31

	Life Insurance In Force			
	2012	2011	2010	
	(in millions)			
Direct:				
Individual	\$23,122	\$23,438	\$23,849	
Group	3,396	3,530	3,549	
Old American	997	958	931	
Total	27,515	27,926	28,329	
Ceded:				
Individual	(13,078 )	(13,428 )	(13,653 )	
Group	(514 )	(517 )	(426 )	
Old American	(30 )	(33 )	(37 )	
Total	(13,622 )	(13,978 )	(14,116 )	
Assumed:				
Individual	1,187	1,276	1,379	
Group	—	—	—	
Old American	—	—	—	
Total	1,187	1,276	1,379	
Net	\$15,080	\$15,224	\$15,592	
% of Assumed to Net	8	% 8	% 9	%

All other information required by this Schedule is shown in Note 15 - Reinsurance in the Notes to Consolidated Financial Statements.

See accompanying Report of Independent Registered Public Accounting Firm

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Schedule V

Kansas City Life Insurance Company and Subsidiaries

Valuation and Qualifying Accounts

	Year Ended December 31		
	2012	2011	2010
Mortgage loan allowance for loss:			
Beginning of year	\$2,849	\$3,410	\$3,410
Additions	497	—	—
Deductions	—	(561	) —
End of year	\$3,346	\$2,849	\$3,410
Allowance for uncollectible accounts:			
Beginning of year	\$2,226	\$644	\$1,306
Additions	229	1,724	227
Deductions	(194	) (142	) (889
End of year	\$2,261	\$2,226	\$644

Please see Note 6 – Financing Receivables for additional information.

See accompanying Report of Independent Registered Public Accounting Firm

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Report of Independent Registered Public Accounting Firm  
The Board of Directors and Stockholders  
Kansas City Life Insurance Company

We have audited the accompanying consolidated balance sheets of Kansas City Life Insurance Company and subsidiaries (the Company) as of December 31, 2012 and 2011, and the related consolidated statements of comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2012. In connection with our audits of the consolidated financial statements, we also have audited financial statement schedules I to V. We also have audited the Company's internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these consolidated financial statements and financial statement schedules, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Assessment of Internal Control Over Financial Reporting. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedules and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Kansas City Life Insurance Company and subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein. Also in our opinion, Kansas City Life Insurance Company and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control - Integrated Framework issued by



the Committee of Sponsoring Organizations of the Treadway Commission.

As discussed in Note 3 to the consolidated financial statements, effective January 1, 2012, the Company modified the types of costs incurred that can be capitalized when issuing or renewing insurance contracts due to the prospective adoption of Financial Accounting Standards Board Accounting Standards Update (ASU) No. 2010-26, Accounting for Costs associated with Acquiring or Renewing Insurance Contracts.

/s/ KPMG LLP

Kansas City, Missouri

February 28, 2013

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Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

None.

Item 9A. 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 and Chief Financial Officer, also conducted an evaluation of the Company's internal control over financial reporting to determine whether any changes 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. The independent registered public accounting firm that audited the financial statements included in the annual report containing the disclosure required by this Item has issued an attestation report on the registrant's internal control over financial reporting.

**Management's Assessment of Internal Control Over Financial Reporting**

Management of Kansas City Life Insurance Company and subsidiaries (the Company) is responsible for establishing and maintaining effective internal control over financial reporting. Management of the Company has conducted an assessment of the Company's internal control over financial reporting at December 31, 2012 based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based upon that assessment, Management concluded that the Company's internal control over financial reporting was effective at December 31, 2012.

**Limitations on the Effectiveness of Controls**

The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. The Company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives, and may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to a future period are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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Item 9B. Other Information

3520 Broadway, Kansas City, MO 64111

Contact:

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

For Immediate Release: February 28, 2013, press release reporting financial results for the fourth quarter of 2012.

**Kansas City Life Announces Fourth Quarter 2012 Results**

Kansas City Life Insurance Company recorded net income of \$7.9 million or \$0.71 per share in the fourth quarter of 2012, a \$2.2 million or \$0.20 per share increase versus the same quarter in the prior year. The increase in earnings was primarily due to increases in realized investment gains and insurance revenues, as well as reduced amortization of deferred acquisition costs (DAC) and lower operating expenses. These improvements were partially offset by an increase in policyholder benefits and income tax expense.

Net income for the twelve months was \$39.9 million or \$3.59 per share, an increase of \$13.7 million or \$1.30 per share compared to 2011. This increase was largely due from an increase in realized investment gains of \$15.3 million. Other significant factors for the year included an increase in insurance revenues, a reduction in interest credited to policyholder account balances, and a decrease in amortization of DAC. These were partially offset by increases in operating expenses, policyholder benefits, and income tax expense.

Total investment revenues, which combines net investment income and net realized gains, increased \$1.0 million or 2% for the fourth quarter and \$14.2 million or 8% for the year. These increases were the result of realized gains that the Company earned during the year, as several real estate properties were sold during both the fourth quarter and earlier in the year. Net investment income was flat for the fourth quarter but decreased \$1.0 million or 1% for the year, as the decrease in yields more than offset an increase in average invested assets. Both the quarter and twelve months were negatively affected by lower yields on fixed-rate investments.

Insurance revenues combine both premiums, net of reinsurance ceded, and contract charges for the Company's insurance products. Net premiums increased 19% for the fourth quarter, primarily reflecting improvements in both immediate annuity and traditional insurance products. Immediate annuity sales increased \$3.9 million in the fourth quarter and \$5.3 million for the year, compared with the same periods one year earlier. The traditional products continue to reflect positive sales results from Old American Insurance Company, which increased sales 7% in the fourth quarter and 5% for the twelve months, compared with the prior year.

New deposits from the Company's interest sensitive products increased 15% in the fourth quarter. However, these deposits decreased 3% for the year. New variable annuity sales increased \$2.4 million and more than doubled in the fourth quarter, and new universal life sales increased \$1.0 million or 47% in the same period. New variable annuity and universal life sales each increased 11% for the year, while new fixed deferred annuity deposits decreased 8% versus the prior year.

Policyholder benefits increased \$7.8 million or 24% in the fourth quarter and \$4.4 million or 3% for the year. The largest factor in the change was an increase in immediate annuity sales for both the fourth quarter and year. The sale of immediate annuity products requires the corresponding establishment of policy reserves on a virtual one-for-one basis. Also contributing to the increases was a reduction in reserves in the fourth quarter of 2011, related to the release of reserves for non-guaranteed interest on certain products. These unfavorable changes in policyholder benefits were partially offset in both periods by reduced reserves on the Company's guaranteed minimum withdrawal benefits, associated with variable annuity products, and reduced death benefits paid, net of reinsurance.

The amortization of DAC decreased \$4.2 million or 35% in the fourth quarter and \$5.9 million or 17% for the twelve months. These decreases were primarily the result of changes in 2011 for refinements in estimates and unlocking of assumptions regarding universal life and traditional products.

Finally, operating expenses decreased \$1.0 million or 3% in the quarter but increased \$4.0 million or 4% for the year. The decrease in operating expenses in the fourth quarter was largely due to a decrease in employee benefits and the reduction in the allowance for uncollectible receivables. However, operating expenses increased for the year,

reflecting higher depreciation expense, increased employee salary and benefit costs, and increased legal fees. On January 28, 2012, the Kansas City Life Board of Directors declared a quarterly dividend of \$0.27 per share that was paid on February 13, 2013 to stockholders of record on February 7, 2013.

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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 \$439.9 million in 2012, and assets and life insurance in force were \$4.5 billion and \$28.7 billion, respectively, as of December 31, 2012. The Company operates in 49 states and the District of Columbia. For more information, please visit [www.kclife.com](http://www.kclife.com).

## Condensed Consolidated Income Statement

(amounts in thousands, except share data)

	Quarter ended December 31		Year ended December 31	
	2012	2011	2012	2011
Revenues	\$109,002	\$103,490	\$439,927	\$419,043
Net income	\$7,897	\$5,703	\$39,867	\$26,133
Net income per share, basic and diluted	\$0.71	\$0.51	\$3.59	\$2.29
Dividends paid	\$0.54	\$0.27	\$1.35	\$1.08
Average number of shares outstanding	11,046,815	11,318,348	11,095,777	11,419,931

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PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by Item 10 is incorporated into Part III of this Annual Report on Form 10-K by reference to the Company's definitive Proxy Statement for the Annual Meeting of Stockholders scheduled to be held on April 18, 2013.

The Company has adopted a Code of Ethics for Officers, Directors and Employees. Copies are available on the Company's website at [www.kclife.com](http://www.kclife.com) and a copy may be obtained without charge upon written request to the Company Secretary, 3520 Broadway, Kansas City, MO 64111.

Item 11. Executive Compensation

The information required by Item 11 is incorporated into Part III of this Annual Report on Form 10-K by reference to the Company's definitive Proxy Statement for the Annual Meeting of Stockholders scheduled to be held on April 18, 2013.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by Item 12 is incorporated into Part III of this Annual Report on Form 10-K by reference to the Company's definitive Proxy Statement for the Annual Meeting of Stockholders scheduled to be held on April 18, 2013.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by Item 13 is incorporated into Part III of this Annual Report on Form 10-K by reference to the Company's definitive Proxy Statement for the Annual Meeting of Stockholders scheduled to be held on April 18, 2013.

Item 14. Principal Accounting Fees and Services

The information required by Item 14 is incorporated into Part III of this Annual Report on Form 10-K by reference to the Company's definitive Proxy Statement for the Annual Meeting of Stockholders scheduled to be held on April 18, 2013.

PART IV

Item 15. Exhibits, Financial Statement Schedules

	Page Number
(a)(1) Financial Statements (See Item 8: Financial Statements and Supplementary Data)	<u>66</u>

(a)(2) Supplementary Data and Financial Statement Schedules  
Schedules are included at the following pages:

	Page Number
I - Summary of Investments—Other than Investments in Related Parties, December 31, 2012	<u>125</u>
II - Condensed Financial Information of Registrant, Years ended December 31, 2012, 2011 and 2010	<u>126</u>
III - Supplementary Insurance Information, Years ended December 31, 2012, 2011 and 2010	<u>130</u>
IV - Reinsurance Information, Years ended December 31, 2012, 2011 and 2010	<u>132</u>
V - Valuation and Qualifying Accounts, Years ended December 31, 2012, 2011 and 2010	<u>134</u>

All other schedules are omitted as the required information is inapplicable or the information is presented in the financial statements or related notes.

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(b)Exhibits

Exhibit  
Number:

Basic Documents:

- 3(a) Articles of Incorporation (as Restated in 1986 and Amended in 1999). [Filed as Exhibit 3(a) to the Company's 10-Q for the quarter ended September 30, 1999 and incorporated herein by reference]
- 3(b) Bylaws as Amended and Restated October 29, 2007. [Filed as Exhibits 3.1 and 3.2 to the Company's 8-K for October 30, 2007 and incorporated herein by reference]
- 4(a) Specimen copy of Stock Certificate. [Filed as Exhibit 4(a) to the Company's 10-Q for the quarter ended September 30, 1999 and incorporated herein by reference]
- 10(a) Kansas City Life Deferred Compensation Plan, as amended and restated effective July 2, 2012.
- 10(b) Kansas City Life Insurance Company Savings and Profit Sharing Plan, as amended and restated effective January 1, 2012.
- 10(c) Seventeenth Amendment, Kansas City Life Employee Stock Plan. [Filed as Exhibit 10(c) to the Company's 2011 10-K and incorporated herein by reference]
- 10(d) Fourth Amendment, Kansas City Life Excess Benefit Plan. [Filed as Exhibit 10(d) to the Company's 2010 10-K and incorporated herein by reference]
- 10(e) The Coinsurance Agreement between Kansas City Life Insurance Company and Transamerica Occidental Life Insurance Company of Cedar Rapids, Iowa effective January 19, 2005. [Filed as Exhibit 10(e) to the Company's 2009 10-K/A and incorporated herein by reference]
- 10(f) The Automatic YRT Reinsurance Agreement between Sunset Life Insurance Company of America and RGA Reinsurance Company effective January 1, 2002. [Filed as Exhibit 10(f) to the Company's 2009 10-K/A and incorporated herein by reference]
- 10(g) The Automatic and Facultative Reinsurance Agreement (Coinsurance Basis) between Kansas City Life Insurance Company and Security Life of Denver Insurance Company effective May 1, 2002. [Filed as Exhibit 10(g) to the Company's 2009 10-K/A and incorporated herein by reference]
- 10(h) The Automatic and Facultative Coinsurance Reinsurance Agreement between Kansas City Life Insurance Company and RGA Reinsurance Company effective May 1, 2002. [Filed as Exhibit 10(h) to the Company's 2009 10-K/A and incorporated herein by reference]
- 10(i) The Coinsurance Life Reinsurance Agreement between Old American Insurance Company and Employers Reassurance Corporation effective December 1, 1989. [Filed as Exhibit 10(i) to the Company's 2009 10-K/A and incorporated herein by reference]
- 10(j) Kansas City Life Insurance Company Voting Agreement. [Filed in the Company's 8-K on November 3, 2004 and incorporated herein by reference]
- 10(k)

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Kansas City Life Insurance Company Annual Incentive Plan Agreement. [Filed as Exhibit 10(k) to the Company's 2011 10-K and incorporated herein by reference]

10(l) Kansas City Life Insurance Company Long Term Incentive Plan Agreement. [Filed as Exhibit 10(l) to the Company's 2009 10-K/A and incorporated herein by reference]

10(m) Kansas City Life Insurance Company Severance Plan. [Filed as Exhibit 10(m) to the Company's 2010 10-K and incorporated herein by reference]

10(n) Kansas City Life Insurance Company Cash Balance Pension Plan and Amendment dated January 28, 2011. [Filed as Exhibit 10(n) to the Company's 2011 10-K and incorporated herein by reference]

10(o) Kansas City Life Insurance Company Employee Medical Plan. [Filed as Exhibit 10(o) to the Company's 2011 10-K and incorporated herein by reference]

14 Kansas City Life Insurance Company Code of Ethics for Officers, Directors and Employees.

21 Subsidiaries.

23 Consent of Independent Registered Public Accounting Firm.

31(a) Section 302 Certification.

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31(b)	Section 302 Certification.
32(a)	Section 1350 Certification.
99(a)	Prospectus for Kansas City Life Insurance Company Savings and Profit Sharing Plan. [Filed as Exhibit 99(e) to the Company's 10-K Report for 2009 and incorporated herein by reference]
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

<sup>1</sup> Certain portions of this Exhibit have been omitted pursuant to an application for confidential treatment filed with the Securities and Exchange Commission.

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Signatures

Pursuant to the requirements of Section 13 or 15(d) 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

By: /s/ David A. Laird  
David A. Laird  
Vice President and Controller  
(Principal Accounting Officer)

Date: February 28, 2013

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

By: /s/ R. Philip Bixby  
R. Philip Bixby  
Director; President, Chief  
Executive Officer and Chairman  
of the Board  
(Principal Executive Officer)

By: /s/ Tracy W. Knapp  
Tracy W. Knapp  
Director; Senior Vice President, Finance  
(Principal Financial Officer)

By: /s/ Walter E. Bixby  
Walter E. Bixby  
Director and Vice Chairman of the Board

By: /s/ William A. Schalekamp  
William A. Schalekamp  
Director

By: /s/ John C. Cozad  
John C. Cozad  
Director

By: /s/ Cecil R. Miller  
Cecil R. Miller  
Director

By: /s/ Kevin G. Barth  
Kevin G. Barth  
Director

By: /s/ Michael Braude  
Michael Braude  
Director

By: /s/ Mark A. Milton  
Mark A. Milton  
Director; Senior Vice President, Actuary

Date: February 28, 2013