

KANSAS CITY LIFE INSURANCE CO

Form 10-Q

July 30, 2014

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

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

For the quarterly period ended June 30, 2014 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

Not Applicable  
(Former name, former address and former fiscal year, if changed since last report)

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

Yes  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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

Yes  No

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

Common Stock: \$1.25 par 10,967,987 shares

Class Outstanding June 30, 2014



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KANSAS CITY LIFE INSURANCE COMPANY

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## Part I. Financial Information

## Item 1. Financial Statements

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

Kansas City Life Insurance Company

Consolidated Balance Sheets

|                                                                            | June 30<br>2014<br>(Unaudited) | December 31<br>2013 |
|----------------------------------------------------------------------------|--------------------------------|---------------------|
| <b>ASSETS</b>                                                              |                                |                     |
| Investments:                                                               |                                |                     |
| Fixed maturity securities available for sale, at fair value                | \$2,762,031                    | \$2,618,620         |
| Equity securities available for sale, at fair value                        | 24,732                         | 23,116              |
| Mortgage loans                                                             | 572,831                        | 629,256             |
| Real estate                                                                | 142,102                        | 142,536             |
| Policy loans                                                               | 83,223                         | 83,518              |
| Short-term investments                                                     | 35,660                         | 40,712              |
| Other investments                                                          | 7,526                          | 12,517              |
| Total investments                                                          | 3,628,105                      | 3,550,275           |
| Cash                                                                       | 8,566                          | 8,197               |
| Accrued investment income                                                  | 34,160                         | 33,795              |
| Deferred acquisition costs                                                 | 245,728                        | 256,386             |
| Reinsurance recoverables                                                   | 193,765                        | 191,055             |
| Property and equipment                                                     | 17,295                         | 17,524              |
| Other assets                                                               | 58,967                         | 64,018              |
| Separate account assets                                                    | 410,700                        | 393,416             |
| Total assets                                                               | \$4,597,286                    | \$4,514,666         |
| <b>LIABILITIES</b>                                                         |                                |                     |
| Future policy benefits                                                     | \$926,526                      | \$910,228           |
| Policyholder account balances                                              | 2,091,954                      | 2,096,212           |
| Policy and contract claims                                                 | 37,545                         | 36,783              |
| Other policyholder funds                                                   | 161,865                        | 160,421             |
| Other liabilities                                                          | 203,832                        | 192,202             |
| Separate account liabilities                                               | 410,700                        | 393,416             |
| Total liabilities                                                          | 3,832,422                      | 3,789,262           |
| <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                                                 | 40,998                         | 40,989              |
| Retained earnings                                                          | 831,443                        | 823,408             |
| Accumulated other comprehensive income                                     | 45,637                         | 14,170              |
| Treasury stock, at cost (2014 - 7,528,693 shares; 2013 - 7,527,841 shares) | (176,335)                      | (176,284)           |
| Total stockholders' equity                                                 | 764,864                        | 725,404             |
| Total liabilities and stockholders' equity                                 | \$4,597,286                    | \$4,514,666         |
| See accompanying Notes to Consolidated Financial Statements                |                                |                     |



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Consolidated Statements of Comprehensive Income

|                                                                                 | Quarter Ended   |                   | Six Months Ended |                   |
|---------------------------------------------------------------------------------|-----------------|-------------------|------------------|-------------------|
|                                                                                 | June 30         |                   | June 30          |                   |
|                                                                                 | 2014            | 2013              | 2014             | 2013              |
|                                                                                 | (Unaudited)     |                   | (Unaudited)      |                   |
| <b>REVENUES</b>                                                                 |                 |                   |                  |                   |
| Insurance revenues:                                                             |                 |                   |                  |                   |
| Net premiums                                                                    | \$41,334        | \$43,350          | \$83,121         | \$97,766          |
| Contract charges                                                                | 30,834          | 30,611            | 59,632           | 54,959            |
| Total insurance revenues                                                        | 72,168          | 73,961            | 142,753          | 152,725           |
| Investment revenues:                                                            |                 |                   |                  |                   |
| Net investment income                                                           | 41,351          | 42,878            | 82,042           | 85,288            |
| Net realized investment gains, excluding other-than-temporary impairment losses | 784             | 1,732             | 2,449            | 2,178             |
| Net impairment losses recognized in earnings:                                   |                 |                   |                  |                   |
| Total other-than-temporary impairment losses                                    | (243            | ) (272            | ) (456           | ) (459            |
| Portion of impairment losses recognized in other comprehensive income (loss)    | 136             | 41                | 187              | 99                |
| Net other-than-temporary impairment losses recognized in earnings               | (107            | ) (231            | ) (269           | ) (360            |
| Total investment revenues                                                       | 42,028          | 44,379            | 84,222           | 87,106            |
| Other revenues                                                                  | 2,343           | 2,558             | 4,676            | 4,791             |
| Total revenues                                                                  | 116,539         | 120,898           | 231,651          | 244,622           |
| <b>BENEFITS AND EXPENSES</b>                                                    |                 |                   |                  |                   |
| Policyholder benefits                                                           | 50,153          | 47,585            | 102,907          | 108,733           |
| Interest credited to policyholder account balances                              | 19,260          | 19,865            | 38,206           | 39,528            |
| Amortization of deferred acquisition costs                                      | 12,529          | 10,904            | 21,357           | 19,769            |
| Operating expenses                                                              | 22,113          | 26,504            | 48,733           | 53,008            |
| Total benefits and expenses                                                     | 104,055         | 104,858           | 211,203          | 221,038           |
| Income before income tax expense                                                | 12,484          | 16,040            | 20,448           | 23,584            |
| Income tax expense                                                              | 4,027           | 5,189             | 6,489            | 7,545             |
| <b>NET INCOME</b>                                                               | <b>\$8,457</b>  | <b>\$10,851</b>   | <b>\$13,959</b>  | <b>\$16,039</b>   |
| <b>COMPREHENSIVE INCOME (LOSS), NET OF TAXES</b>                                |                 |                   |                  |                   |
| Change in net unrealized gains on securities available for sale                 | \$18,908        | \$(53,348)        | \$38,273         | \$(43,875)        |
| Change in future policy benefits                                                | (2,929)         | ) 6,637           | (6,562)          | ) 6,924           |
| Change in policyholder account balances                                         | (113)           | ) 310             | (244)            | ) 322             |
| Change in benefit plan obligations                                              | —               | 5,010             | —                | 5,010             |
| Other comprehensive income (loss)                                               | 15,866          | (41,391)          | 31,467           | (31,619)          |
| <b>COMPREHENSIVE INCOME (LOSS)</b>                                              | <b>\$24,323</b> | <b>\$(30,540)</b> | <b>\$45,426</b>  | <b>\$(15,580)</b> |

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Basic and diluted earnings per share:

|            |        |        |        |        |
|------------|--------|--------|--------|--------|
| Net income | \$0.77 | \$0.98 | \$1.27 | \$1.45 |
|------------|--------|--------|--------|--------|

See accompanying Notes to Consolidated Financial Statements

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Consolidated Statement of Stockholders' Equity

|                                                             | Six Months Ended<br>June 30, 2014<br>(Unaudited) |   |
|-------------------------------------------------------------|--------------------------------------------------|---|
| COMMON STOCK, beginning and end of period                   | \$23,121                                         |   |
| ADDITIONAL PAID IN CAPITAL                                  |                                                  |   |
| Beginning of year                                           | 40,989                                           |   |
| Excess of proceeds over cost of treasury stock sold         | 9                                                |   |
| End of period                                               | 40,998                                           |   |
| RETAINED EARNINGS                                           |                                                  |   |
| Beginning of year                                           | 823,408                                          |   |
| Net income                                                  | 13,959                                           |   |
| Stockholder dividends of \$0.54 per share                   | (5,924                                           | ) |
| End of period                                               | 831,443                                          |   |
| ACCUMULATED OTHER COMPREHENSIVE INCOME                      |                                                  |   |
| Beginning of year                                           | 14,170                                           |   |
| Other comprehensive income                                  | 31,467                                           |   |
| End of period                                               | 45,637                                           |   |
| TREASURY STOCK, at cost                                     |                                                  |   |
| Beginning of year                                           | (176,284                                         | ) |
| Cost of 1,140 shares acquired                               | (55                                              | ) |
| Cost of 288 shares sold                                     | 4                                                |   |
| End of period                                               | (176,335                                         | ) |
| TOTAL STOCKHOLDERS' EQUITY                                  | \$764,864                                        |   |
| See accompanying Notes to Consolidated Financial Statements |                                                  |   |



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Consolidated Statements of Cash Flows

|                                                                                   | Six Months Ended June 30 |            |
|-----------------------------------------------------------------------------------|--------------------------|------------|
|                                                                                   | 2014                     | 2013       |
|                                                                                   | (Unaudited)              |            |
| <b>OPERATING ACTIVITIES</b>                                                       |                          |            |
| Net income                                                                        | \$13,959                 | \$16,039   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |            |
| Amortization of investment premium and discount                                   | 2,097                    | 2,042      |
| Depreciation                                                                      | 2,240                    | 2,094      |
| Acquisition costs capitalized                                                     | (17,761                  | ) (18,661  |
| Amortization of deferred acquisition costs                                        | 21,357                   | 19,769     |
| Realized investment gains                                                         | (2,180                   | ) (1,818   |
| Changes in assets and liabilities:                                                |                          |            |
| Reinsurance recoverables                                                          | (2,710                   | ) (3,541   |
| Future policy benefits                                                            | 6,202                    | 20,303     |
| Policyholder account balances                                                     | (8,135                   | ) (15,993  |
| Income taxes payable and deferred                                                 | 490                      | 545        |
| Other, net                                                                        | 305                      | 1,092      |
| Net cash provided                                                                 | 15,864                   | 21,871     |
| <b>INVESTING ACTIVITIES</b>                                                       |                          |            |
| Purchases:                                                                        |                          |            |
| Fixed maturity securities                                                         | (194,874                 | ) (106,941 |
| Equity securities                                                                 | (89                      | ) (13,212  |
| Mortgage loans                                                                    | (9,592                   | ) (30,291  |
| Real estate                                                                       | (4,120                   | ) (17,549  |
| Policy loans                                                                      | (5,751                   | ) (5,670   |
| Sales or maturities, calls, and principal paydowns:                               |                          |            |
| Fixed maturity securities                                                         | 115,230                  | 138,414    |
| Equity securities                                                                 | 15                       | 1,459      |
| Mortgage loans                                                                    | 63,261                   | 51,104     |
| Real estate                                                                       | 4,723                    | 368        |
| Policy loans                                                                      | 6,046                    | 8,005      |
| Other investments                                                                 | 5,000                    | —          |
| Net sales of short-term investments                                               | 5,052                    | 6,751      |
| Acquisition of property and equipment                                             | (605                     | ) (351     |
| Reinsurance transaction                                                           | —                        | (34,279    |
| Net cash used                                                                     | (15,704                  | ) (2,192   |

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Consolidated Statements of Cash Flows (Continued)

|                                                             | Six Months Ended June 30 |            |
|-------------------------------------------------------------|--------------------------|------------|
|                                                             | 2014                     | 2013       |
|                                                             | (Unaudited)              |            |
| <b>FINANCING ACTIVITIES</b>                                 |                          |            |
| Deposits on policyholder account balances                   | \$129,853                | \$116,485  |
| Withdrawals from policyholder account balances              | (131,261                 | ) (133,369 |
| Net transfers from (to) separate accounts                   | 3,791                    | (1,734     |
| Change in other deposits                                    | 3,792                    | 5,156      |
| Cash dividends to stockholders                              | (5,924                   | ) (5,951   |
| Net change in treasury stock                                | (42                      | ) (380     |
| Net cash provided (used)                                    | 209                      | (19,793    |
| Increase (decrease) in cash                                 | 369                      | (114       |
| Cash at beginning of year                                   | 8,197                    | 7,026      |
| Cash at end of period                                       | \$8,566                  | \$6,912    |
| Supplemental disclosure of cash flow information:           |                          |            |
| Cash paid during the period for:                            |                          |            |
| Income taxes                                                | \$6,000                  | \$7,000    |
| See accompanying Notes to Consolidated Financial Statements |                          |            |

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements (Unaudited)

1. Nature of Operations and Significant Accounting Policies

Basis of Presentation

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

The unaudited interim consolidated financial statements have been prepared on the basis of U.S. generally accepted accounting principles (GAAP) for interim financial reporting with the instructions to Form 10-Q and Regulations S-K, S-X, and other applicable regulations. Accordingly, they do not include all of the disclosures required by GAAP for complete financial statements. As such, these unaudited interim consolidated financial statements should be read in conjunction with the Company's 2013 Form 10-K, as filed with the Securities and Exchange Commission on February 26, 2014. Management believes that the disclosures are adequate to make the information presented not misleading, and all normal and recurring adjustments necessary to present fairly the financial position at June 30, 2014 and the results of operations for all periods presented have been made. The results of operations for any interim period are not necessarily indicative of the Company's operating results for a full year. Significant intercompany transactions have been eliminated in consolidation and certain immaterial reclassifications have been made to prior period results to conform with the current period's presentation.

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

Immaterial Correction of Error

During the third quarter of 2013, the Company identified an immaterial correction of an error in the presentation of net premiums and policyholder benefits that resulted from the incorrect recognition of premiums related to the conversion of fixed deferred annuity contracts to immediate annuities with life contingencies. The impact of the correction was an equal and offsetting increase to both net premiums and policyholder benefits. The error resulted in no impact to net income, earnings per share, stockholders' equity, or cash flows. Related to the immaterial correction, the Company understated the presentation of net premiums and policyholder benefits by \$15.7 million in the first quarter of 2013 and \$8.4 million in the second quarter of 2013. The numbers reported have been corrected to reflect these adjustments. The error was insignificant to any previous periods presented.

Reinsurance Transaction

In April 2013, the Company acquired a closed block of variable life insurance policies and variable annuity contracts through reinsurance and servicing agreements from American Family Life Insurance Company (American Family). Under the reinsurance agreement, the Company assumed 100% of the separate account liabilities on a modified coinsurance basis and 100% of the general account liabilities on a coinsurance basis. The transaction also involved ongoing servicing arrangements with American Family during the period that such policies and contracts were transitioned to administration by the Company. This block is included as a component of the Individual Insurance segment. For additional information, please refer to the Company's 2013 Form 10-K.

Significant Accounting Policies

For a full discussion of the Company's significant accounting policies, please refer to the Company's 2013 Form 10-K. No significant updates or changes to these policies occurred during the six months ended June 30, 2014.

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Kansas City Life Insurance Company

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

2. New Accounting Pronouncements

Accounting Pronouncements Issued During 2014, Not Yet Adopted

In January 2014, the Financial Accounting Standards Board (FASB) issued guidance regarding accounting for investments in qualified affordable housing projects. The amendments modify the conditions that a reporting entity must meet to be eligible to use a method other than the equity or cost methods to account for qualified affordable housing project investments. The guidance is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Company is currently evaluating this guidance and its materiality to the consolidated financial statements.

In May 2014, the FASB issued guidance regarding accounting for revenue recognition that identifies the accounting treatment for an entity's contracts with customers. Certain contracts, including insurance contracts, are specifically excluded from this guidance. This guidance is effective for public entities for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. The Company is currently evaluating this guidance, but it does not believe that there will be a 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 or were not expected to have a material impact to the consolidated financial statements.

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

## 3. 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 June 30, 2014.

|                                                                              | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Losses   | Fair<br>Value |
|------------------------------------------------------------------------------|-------------------|------------------------------|----------|---------------|
| U.S. Treasury securities and obligations of<br>U.S. Government               | \$167,934         | \$9,174                      | \$349    | \$176,759     |
| Federal agencies <sup>1</sup>                                                | 19,762            | 2,671                        | —        | 22,433        |
| Federal agency issued<br>residential mortgage-backed securities <sup>1</sup> | 49,654            | 5,022                        | 3        | 54,673        |
| Subtotal                                                                     | 237,350           | 16,867                       | 352      | 253,865       |
| Corporate obligations:                                                       |                   |                              |          |               |
| Industrial                                                                   | 530,680           | 35,725                       | 1,566    | 564,839       |
| Energy                                                                       | 226,948           | 18,709                       | 986      | 244,671       |
| Communications and technology                                                | 220,565           | 18,365                       | 267      | 238,663       |
| Financial                                                                    | 275,267           | 21,123                       | 996      | 295,394       |
| Consumer                                                                     | 501,278           | 31,471                       | 1,521    | 531,228       |
| Public utilities                                                             | 232,300           | 28,101                       | 240      | 260,161       |
| Subtotal                                                                     | 1,987,038         | 153,494                      | 5,576    | 2,134,956     |
| Corporate private-labeled residential<br>mortgage-backed securities          | 101,715           | 4,579                        | 110      | 106,184       |
| Municipal securities                                                         | 135,153           | 19,082                       | 15       | 154,220       |
| Other                                                                        | 93,945            | 4,814                        | 2,953    | 95,806        |
| Redeemable preferred stocks                                                  | 17,490            | 275                          | 765      | 17,000        |
| Fixed maturity securities                                                    | 2,572,691         | 199,111                      | 9,771    | 2,762,031     |
| Equity securities                                                            | 23,714            | 1,866                        | 848      | 24,732        |
| Total                                                                        | \$2,596,405       | \$200,977                    | \$10,619 | \$2,786,763   |

<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) (Unaudited)

The following table provides amortized cost and fair value of securities by asset class at December 31, 2013.

|                                                                           | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Losses    | Fair<br>Value |
|---------------------------------------------------------------------------|-------------------|------------------------------|-----------|---------------|
| U.S. Treasury securities and obligations of U.S. Government               | \$ 134,198        | \$ 6,653                     | \$ 1,831  | \$ 139,020    |
| Federal agencies <sup>1</sup>                                             | 19,756            | 2,312                        | —         | 22,068        |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | 56,738            | 5,392                        | 2         | 62,128        |
| Subtotal                                                                  | 210,692           | 14,357                       | 1,833     | 223,216       |
| Corporate obligations:                                                    |                   |                              |           |               |
| Industrial                                                                | 515,395           | 27,051                       | 7,667     | 534,779       |
| Energy                                                                    | 211,115           | 15,462                       | 3,832     | 222,745       |
| Communications and technology                                             | 222,277           | 12,938                       | 1,672     | 233,543       |
| Financial                                                                 | 266,693           | 18,824                       | 2,040     | 283,477       |
| Consumer                                                                  | 473,627           | 25,936                       | 5,807     | 493,756       |
| Public utilities                                                          | 228,551           | 24,780                       | 954       | 252,377       |
| Subtotal                                                                  | 1,917,658         | 124,991                      | 21,972    | 2,020,677     |
| Corporate private-labeled residential mortgage-backed securities          | 114,219           | 3,179                        | 916       | 116,482       |
| Municipal securities                                                      | 138,136           | 9,488                        | 5         | 147,619       |
| Other                                                                     | 97,769            | 4,422                        | 4,317     | 97,874        |
| Redeemable preferred stocks                                               | 15,144            | —                            | 2,392     | 12,752        |
| Fixed maturity securities                                                 | 2,493,618         | 156,437                      | 31,435    | 2,618,620     |
| Equity securities                                                         | 23,691            | 1,871                        | 2,446     | 23,116        |
| Total                                                                     | \$ 2,517,309      | \$ 158,308                   | \$ 33,881 | \$ 2,641,736  |

<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 June 30, 2014. Expected maturities may differ from these contractual maturities since borrowers may have the right to call or prepay obligations.

|                                             | Amortized<br>Cost | Fair<br>Value |
|---------------------------------------------|-------------------|---------------|
| Due in one year or less                     | \$ 111,316        | \$ 114,061    |
| Due after one year through five years       | 739,389           | 815,907       |
| Due after five years through ten years      | 1,030,927         | 1,077,725     |
| Due after ten years                         | 454,374           | 503,032       |
| Securities with variable principal payments | 219,195           | 234,306       |
| Redeemable preferred stocks                 | 17,490            | 17,000        |
| Total                                       | \$ 2,572,691      | \$ 2,762,031  |

No material derivative financial instruments were held during the first six months of 2014 or 2013.



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Kansas City Life Insurance Company

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

## 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. For additional information on the Company's process and considerations, as well as related accounting when other-than-temporary impairments are identified, please refer to Note 4 - Investments of the Company's 2013 Form 10-K.

The following table provides information regarding fixed maturity and equity security investments available for sale with unrealized losses by length of time at June 30, 2014.

|                                                                           | 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               | \$9,009             | \$53              | \$9,779             | \$296             | \$18,788   | \$349             |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | 68                  | 2                 | 287                 | 1                 | 355        | 3                 |
| Subtotal                                                                  | 9,077               | 55                | 10,066              | 297               | 19,143     | 352               |
| Corporate obligations:                                                    |                     |                   |                     |                   |            |                   |
| Industrial                                                                | 5,808               | 5                 | 59,461              | 1,561             | 65,269     | 1,566             |
| Energy                                                                    | 1,996               | 3                 | 41,439              | 983               | 43,435     | 986               |
| Communications and technology                                             | —                   | —                 | 14,732              | 267               | 14,732     | 267               |
| Financial                                                                 | 4,960               | 40                | 15,941              | 956               | 20,901     | 996               |
| Consumer                                                                  | 12,560              | 70                | 57,209              | 1,451             | 69,769     | 1,521             |
| Public utilities                                                          | —                   | —                 | 6,756               | 240               | 6,756      | 240               |
| Subtotal                                                                  | 25,324              | 118               | 195,538             | 5,458             | 220,862    | 5,576             |
| Corporate private-labeled residential mortgage-backed securities          | 15,009              | 110               | —                   | —                 | 15,009     | 110               |
| Municipal securities                                                      | 3,029               | 15                | —                   | —                 | 3,029      | 15                |
| Other                                                                     | 1,277               | 111               | 38,070              | 2,842             | 39,347     | 2,953             |
| Redeemable preferred stocks                                               | 1,009               | 3                 | 9,374               | 762               | 10,383     | 765               |
| Fixed maturity securities                                                 | 54,725              | 412               | 253,048             | 9,359             | 307,773    | 9,771             |
| Equity securities                                                         | 11                  | 11                | 11,455              | 837               | 11,466     | 848               |
| Total                                                                     | \$54,736            | \$423             | \$264,503           | \$10,196          | \$319,239  | \$10,619          |

<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) (Unaudited)

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, 2013.

|                                                                           | 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               | \$44,951            | \$ 1,795          | \$749               | \$36              | \$45,700   | \$ 1,831          |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | 37                  | —                 | 288                 | 2                 | 325        | 2                 |
| Subtotal                                                                  | 44,988              | 1,795             | 1,037               | 38                | 46,025     | 1,833             |
| Corporate obligations:                                                    |                     |                   |                     |                   |            |                   |
| Industrial                                                                | 146,454             | 5,718             | 22,071              | 1,949             | 168,525    | 7,667             |
| Energy                                                                    | 70,015              | 3,366             | 5,518               | 466               | 75,533     | 3,832             |
| Communications and technology                                             | 43,477              | 1,672             | —                   | —                 | 43,477     | 1,672             |
| Financial                                                                 | 25,300              | 866               | 4,680               | 1,174             | 29,980     | 2,040             |
| Consumer                                                                  | 136,745             | 5,807             | —                   | —                 | 136,745    | 5,807             |
| Public utilities                                                          | 17,476              | 575               | 3,617               | 379               | 21,093     | 954               |
| Subtotal                                                                  | 439,467             | 18,004            | 35,886              | 3,968             | 475,353    | 21,972            |
| Corporate private-labeled residential mortgage-backed securities          | 33,179              | 916               | —                   | —                 | 33,179     | 916               |
| Municipal securities                                                      | 2,044               | 5                 | —                   | —                 | 2,044      | 5                 |
| Other                                                                     | 16,691              | 726               | 39,900              | 3,591             | 56,591     | 4,317             |
| Redeemable preferred stocks                                               | 12,752              | 2,392             | —                   | —                 | 12,752     | 2,392             |
| Fixed maturity securities                                                 | 549,121             | 23,838            | 76,823              | 7,597             | 625,944    | 31,435            |
| Equity securities                                                         | 9,731               | 2,404             | 131                 | 42                | 9,862      | 2,446             |
| Total                                                                     | \$558,852           | \$26,242          | \$76,954            | \$7,639           | \$635,806  | \$33,881          |

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

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 June 30, 2014, the Company had 96 positions in its investment portfolio of fixed maturity and equity securities with unrealized losses. Included in this total, 22 security positions were below cost for less than one year; 64 security positions were below cost for one year or more and less than three years; and ten security positions were below cost for three years or more. At December 31, 2013, the Company had 195 positions in its investment portfolio of fixed maturity and equity securities with unrealized losses. Included in this total, 173 security positions were below cost for less than one year; twelve security positions were below cost for one year or more and less than three years; and ten security positions were below cost for three years or more. The securities having unrealized losses for three years or more include mortgage-backed securities, where discounted future cash flow calculations are the primary determinant of impairment; asset-backed securities, which continue to perform as expected but are not actively traded and market values are discounted significantly due to illiquidity; and variable-rate securities, where interest rates and spreads to indices are significant factors in market pricing.

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Kansas City Life Insurance Company

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The following table provides the distribution of maturities for fixed maturity securities available for sale with unrealized losses at June 30, 2014 and December 31, 2013. Expected maturities may differ from these contractual maturities since borrowers may have the right to call or prepay obligations.

|                                               | June 30, 2014 |                         | December 31, 2013 |                         |
|-----------------------------------------------|---------------|-------------------------|-------------------|-------------------------|
|                                               | Fair Value    | Gross Unrealized Losses | Fair Value        | Gross Unrealized Losses |
| Fixed maturity securities available for sale: |               |                         |                   |                         |
| Due in one year or less                       | \$5,252       | \$41                    | \$—               | \$—                     |
| Due after one year through five years         | 4,090         | 14                      | 29,812            | 268                     |
| Due after five years through ten years        | 218,309       | 4,902                   | 417,859           | 20,118                  |
| Due after ten years                           | 54,359        | 3,936                   | 132,018           | 7,740                   |
| Total                                         | 282,010       | 8,893                   | 579,689           | 28,126                  |
| Securities with variable principal payments   | 15,380        | 113                     | 33,503            | 917                     |
| Redeemable preferred stocks                   | 10,383        | 765                     | 12,752            | 2,392                   |
| Total                                         | \$307,773     | \$9,771                 | \$625,944         | \$31,435                |

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 (loss).

|                                                                                                                                                                                                             | Quarter Ended   |          | Six Months Ended |          |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------|----------|------------------|----------|
|                                                                                                                                                                                                             | June 30<br>2014 | 2013     | June 30<br>2014  | 2013     |
| Credit losses on securities held at beginning of the period in accumulated other comprehensive income                                                                                                       | \$16,532        | \$15,384 | \$16,375         | \$15,260 |
| Additions for credit losses not previously recognized in other-than-temporary impairment                                                                                                                    | —               | —        | 4                | 27       |
| 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 | 107             | 231      | 265              | 333      |
| Reductions for securities sold during the period                                                                                                                                                            | —               | —        | —                | —        |
| Reductions for securities previously recognized in other comprehensive income (loss) 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                                                                                 | (5 )            | (4 )     | (10 )            | (9 )     |
| Credit losses on securities held at the end of the period in accumulated other comprehensive income                                                                                                         | \$16,634        | \$15,611 | \$16,634         | \$15,611 |

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## Realized Gains (Losses)

The following table provides detail concerning realized investment gains and losses for the second quarters and six months ended June 30, 2014 and 2013.

|                                                                                 | Quarter Ended |         | Six Months Ended |         |
|---------------------------------------------------------------------------------|---------------|---------|------------------|---------|
|                                                                                 | June 30       |         | June 30          |         |
|                                                                                 | 2014          | 2013    | 2014             | 2013    |
| Gross gains resulting from:                                                     |               |         |                  |         |
| Sales of investment securities                                                  | \$433         | \$50    | \$611            | \$118   |
| Investment securities called and other                                          | 367           | 1,789   | 1,662            | 2,515   |
| Real estate                                                                     | —             | 20      | 339              | 20      |
| Total gross gains                                                               | 800           | 1,859   | 2,612            | 2,653   |
| Gross losses resulting from:                                                    |               |         |                  |         |
| Investment securities called and other                                          | (57)          | (178)   | (311)            | (360)   |
| Sale of real estate and joint venture                                           | —             | —       | —                | (89)    |
| Mortgage loans                                                                  | (66)          | (36)    | (90)             | (36)    |
| Total gross losses                                                              | (123)         | (214)   | (401)            | (485)   |
| Change in allowance for potential future losses on mortgage loans               | 124           | 92      | 296              | 38      |
| Amortization of DAC and VOBA                                                    | (17)          | (5)     | (58)             | (28)    |
| Net realized investment gains, excluding other-than-temporary impairment losses | 784           | 1,732   | 2,449            | 2,178   |
| Net impairment losses recognized in earnings:                                   |               |         |                  |         |
| Other-than-temporary impairment losses on fixed maturity and equity securities  | (243)         | (272)   | (456)            | (459)   |
| Portion of loss recognized in other comprehensive income (loss)                 | 136           | 41      | 187              | 99      |
| Net other-than-temporary impairment losses recognized in earnings               | (107)         | (231)   | (269)            | (360)   |
| Net realized investment gains                                                   | \$677         | \$1,501 | \$2,180          | \$1,818 |

## 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 second quarters and six months ended June 30, 2014 and 2013.

|          | Quarter Ended |         | Six Months Ended |         |
|----------|---------------|---------|------------------|---------|
|          | June 30       |         | June 30          |         |
|          | 2014          | 2013    | 2014             | 2013    |
| Proceeds | \$8,269       | \$5,065 | \$12,643         | \$9,130 |

## Mortgage Loans

The Company invests in commercial mortgage loans that are 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 \$3.0 million at June 30, 2014 and \$3.3 million at December 31, 2013. The Company had 16% of its total investments in commercial mortgage loans at June 30, 2014, down from 18% at December 31, 2013. 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 average loan to value ratio for the overall portfolio was 46% at June 30, 2014, compared to 47% at December 31, 2013. 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.

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The following table identifies the gross mortgage loan principal outstanding and the allowance for potential future losses at June 30, 2014 and December 31, 2013.

|                                       | June 30<br>2014 |   | December 31<br>2013 |   |
|---------------------------------------|-----------------|---|---------------------|---|
| Principal outstanding                 | \$575,786       |   | \$632,507           |   |
| Allowance for potential future losses | (2,955          | ) | (3,251              | ) |
| Carrying value                        | \$572,831       |   | \$629,256           |   |

The following table summarizes the amount of mortgage loans held by the Company at June 30, 2014 and December 31, 2013, 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.

|               | June 30<br>2014 | %<br>of Total |   | December 31<br>2013 | %<br>of Total |   |
|---------------|-----------------|---------------|---|---------------------|---------------|---|
| Prior to 2005 | \$33,748        | 6             | % | \$41,324            | 6             | % |
| 2005          | 26,060          | 4             | % | 28,111              | 4             | % |
| 2006          | 20,004          | 3             | % | 24,744              | 4             | % |
| 2007          | 22,821          | 4             | % | 27,009              | 4             | % |
| 2008          | 26,069          | 5             | % | 28,051              | 4             | % |
| 2009          | 25,681          | 4             | % | 37,723              | 6             | % |
| 2010          | 57,296          | 10            | % | 61,236              | 10            | % |
| 2011          | 96,759          | 17            | % | 118,459             | 19            | % |
| 2012          | 171,559         | 30            | % | 184,749             | 29            | % |
| 2013          | 79,713          | 14            | % | 81,101              | 14            | % |
| 2014          | 16,076          | 3             | % | —                   | —             | % |
| Total         | \$575,786       | 100           | % | \$632,507           | 100           | % |

The following table identifies mortgage loans by geographic location at June 30, 2014 and December 31, 2013.

|                    | June 30<br>2014 | %<br>of Total |   | December 31<br>2013 | %<br>of Total |   |
|--------------------|-----------------|---------------|---|---------------------|---------------|---|
| Pacific            | \$166,793       | 29            | % | \$181,690           | 29            | % |
| West north central | 81,864          | 14            | % | 91,687              | 14            | % |
| West south central | 95,826          | 17            | % | 101,019             | 16            | % |
| Mountain           | 71,140          | 12            | % | 78,116              | 12            | % |
| South Atlantic     | 61,471          | 11            | % | 66,686              | 11            | % |
| Middle Atlantic    | 22,615          | 4             | % | 31,495              | 5             | % |
| East north central | 50,747          | 9             | % | 57,395              | 9             | % |
| East south central | 25,330          | 4             | % | 24,419              | 4             | % |
| Total              | \$575,786       | 100           | % | \$632,507           | 100           | % |

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Kansas City Life Insurance Company

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

The following table identifies the concentration of mortgage loans by state greater than 5% of total at June 30, 2014 and December 31, 2013.

|            | June 30<br>2014 | %<br>of Total |   | December 31<br>2013 | %<br>of Total |   |
|------------|-----------------|---------------|---|---------------------|---------------|---|
| California | \$ 140,309      | 24            | % | \$ 149,065          | 24            | % |
| Texas      | 91,527          | 16            | % | 95,205              | 15            | % |
| Minnesota  | 57,794          | 10            | % | 64,464              | 10            | % |
| Florida    | 31,276          | 5             | % | 34,334              | 5             | % |
| All others | 254,880         | 45            | % | 289,439             | 46            | % |
| Total      | \$575,786       | 100           | % | \$632,507           | 100           | % |

The following table identifies mortgage loans by property type at June 30, 2014 and December 31, 2013. The Other category consists largely of apartments and retail properties.

|            | June 30<br>2014 | %<br>of Total |   | December 31<br>2013 | %<br>of Total |   |
|------------|-----------------|---------------|---|---------------------|---------------|---|
| Industrial | \$303,247       | 53            | % | \$328,478           | 52            | % |
| Office     | 166,556         | 29            | % | 184,529             | 29            | % |
| Medical    | 31,389          | 5             | % | 39,531              | 6             | % |
| Other      | 74,594          | 13            | % | 79,969              | 13            | % |
| Total      | \$575,786       | 100           | % | \$632,507           | 100           | % |

The table below identifies mortgage loans by maturity at June 30, 2014 and December 31, 2013.

|                                        | June 30<br>2014 | %<br>of Total |   | December 31<br>2013 | %<br>of Total |   |
|----------------------------------------|-----------------|---------------|---|---------------------|---------------|---|
| Due in one year or less                | \$22,260        | 4             | % | \$22,464            | 4             | % |
| Due after one year through five years  | 135,326         | 24            | % | 169,146             | 27            | % |
| Due after five years through ten years | 193,733         | 33            | % | 244,667             | 38            | % |
| Due after ten years                    | 224,467         | 39            | % | 196,230             | 31            | % |
| Total                                  | \$575,786       | 100           | % | \$632,507           | 100           | % |

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 three loans with an outstanding balance of \$3.5 million during the quarter ended June 30, 2014 and one loan with an outstanding balance of \$1.4 million during the quarter ended June 30, 2013. The Company refinanced five loans with outstanding balances of \$6.7 million during the six months ended June 30, 2014 and five loans with outstanding balances of \$7.7 million during the six months ended June 30, 2013.

In the normal course of business, the Company generally commits to fund commercial mortgage loans 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 15 - Commitments.

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

4. Fair Value Measurements

Under GAAP, fair value represents the price that would be received to sell an asset or paid to transfer a liability (exit price) 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 unadjusted 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. There are no restrictions on withdrawal of these funds.

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.

Other Invested Assets

Included in other invested assets is an institutional alternative strategies fund that is recorded at fair value. These assets are categorized as Level 2, as the valuation of these funds is based on values provided by the issuer and represent amounts at which the Company could transact with the issuer. Certain redemption restrictions may apply on this fund, including advance written notice to withdraw funds.

Separate Accounts

The separate account assets and liabilities, which are equal, are recorded at fair value based upon NAV of the underlying investment holdings as derived from closing prices on a national exchange or as provided by the issuer. This is the value at which a policyholder could transact with the issuer on the date. Separate accounts are categorized as Level 2.





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Liabilities

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

The fair values of supplementary contracts and annuities 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. The Company has not estimated the fair value of the liabilities under contracts that involve significant mortality or morbidity risks, as these liabilities fall within the definition of insurance contracts. Insurance contracts are excluded from financial instruments that require disclosures of fair value.

Guaranteed Minimum Withdrawal Benefits (GMWB) Included in Other Policyholder Funds

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.

Determination of Fair Value

The Company utilizes external third-party pricing services to determine the majority of its fair values on investment securities available for sale. At June 30, 2014 and December 31, 2013, approximately 97% of the carrying value of these investments was from external pricing services, 1% 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.

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 third-party pricing services or brokers, where possible; a review of third-party pricing service methodologies; back testing; in-depth specific analytics on randomly selected issues; 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. 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.

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.

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## Categories Reported at Fair Value

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

|                                                                           | June 30, 2014 |              |           | Total        |
|---------------------------------------------------------------------------|---------------|--------------|-----------|--------------|
|                                                                           | Level 1       | Level 2      | Level 3   |              |
| <b>Assets:</b>                                                            |               |              |           |              |
| U.S. Treasury securities and obligations of U.S. Government               | \$ 12,366     | \$ 164,393   | \$—       | \$ 176,759   |
| Federal agencies <sup>1</sup>                                             | —             | 22,433       | —         | 22,433       |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | —             | 54,673       | —         | 54,673       |
| Subtotal                                                                  | 12,366        | 241,499      | —         | 253,865      |
| <b>Corporate obligations:</b>                                             |               |              |           |              |
| Industrial                                                                | —             | 564,839      | —         | 564,839      |
| Energy                                                                    | —             | 244,671      | —         | 244,671      |
| Communications and technology                                             | —             | 238,663      | —         | 238,663      |
| Financial                                                                 | —             | 295,394      | —         | 295,394      |
| Consumer                                                                  | —             | 531,228      | —         | 531,228      |
| Public utilities                                                          | —             | 260,161      | —         | 260,161      |
| Subtotal                                                                  | —             | 2,134,956    | —         | 2,134,956    |
| Corporate private-labeled residential mortgage-backed securities          | —             | 106,184      | —         | 106,184      |
| Municipal securities                                                      | —             | 154,220      | —         | 154,220      |
| Other                                                                     | —             | 94,529       | 1,277     | 95,806       |
| Redeemable preferred stocks                                               | —             | 17,000       | —         | 17,000       |
| Fixed maturity securities                                                 | 12,366        | 2,748,388    | 1,277     | 2,762,031    |
| Equity securities and other invested assets                               | 5,302         | 26,157       | —         | 31,459       |
| Total                                                                     | \$ 17,668     | \$ 2,774,545 | \$ 1,277  | \$ 2,793,490 |
| Percent of total                                                          | 1             | % 99         | % —       | % 100        |
| <b>Liabilities:</b>                                                       |               |              |           |              |
| Other policyholder funds                                                  |               |              |           |              |
| Guaranteed minimum withdrawal benefits                                    | \$—           | \$—          | \$(3,564) | \$(3,564)    |
| Total                                                                     | \$—           | \$—          | \$(3,564) | \$(3,564)    |

<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) (Unaudited)

|                                                                           | December 31, 2013 |              |           | Total        |
|---------------------------------------------------------------------------|-------------------|--------------|-----------|--------------|
|                                                                           | Level 1           | Level 2      | Level 3   |              |
| Assets:                                                                   |                   |              |           |              |
| U.S. Treasury securities and obligations of U.S. Government               | \$ 12,458         | \$ 126,562   | \$—       | \$ 139,020   |
| Federal agencies <sup>1</sup>                                             | —                 | 22,068       | —         | 22,068       |
| Federal agency issued residential mortgage-backed securities <sup>1</sup> | —                 | 62,128       | —         | 62,128       |
| Subtotal                                                                  | 12,458            | 210,758      | —         | 223,216      |
| Corporate obligations:                                                    |                   |              |           |              |
| Industrial                                                                | —                 | 534,779      | —         | 534,779      |
| Energy                                                                    | —                 | 222,745      | —         | 222,745      |
| Communications and technology                                             | —                 | 233,543      | —         | 233,543      |
| Financial                                                                 | —                 | 283,477      | —         | 283,477      |
| Consumer                                                                  | —                 | 493,756      | —         | 493,756      |
| Public utilities                                                          | —                 | 252,364      | 13        | 252,377      |
| Subtotal                                                                  | —                 | 2,020,664    | 13        | 2,020,677    |
| Corporate private-labeled residential mortgage-backed securities          | —                 | 116,482      | —         | 116,482      |
| Municipal securities                                                      | —                 | 147,619      | —         | 147,619      |
| Other                                                                     | —                 | 96,454       | 1,420     | 97,874       |
| Redeemable preferred stocks                                               | —                 | 12,752       | —         | 12,752       |
| Fixed maturity securities                                                 | 12,458            | 2,604,729    | 1,433     | 2,618,620    |
| Equity securities and other invested assets                               | 4,812             | 29,574       | —         | 34,386       |
| Total                                                                     | \$ 17,270         | \$ 2,634,303 | \$ 1,433  | \$ 2,653,006 |
| Percent of total                                                          | 1                 | % 99         | % —       | % 100        |
| Liabilities:                                                              |                   |              |           |              |
| Other policyholder funds                                                  |                   |              |           |              |
| Guaranteed minimum withdrawal benefits                                    | \$—               | \$—          | \$(4,703) | \$(4,703)    |
| Total                                                                     | \$—               | \$—          | \$(4,703) | \$(4,703)    |

<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 changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the second quarter and six months ended June 30, 2014 and year ended December 31, 2013 are summarized below:

|                                                        | Quarter Ended June 30, 2014                                  |                                            |         | Liabilities |
|--------------------------------------------------------|--------------------------------------------------------------|--------------------------------------------|---------|-------------|
|                                                        | Assets<br>Fixed maturity<br>securities available<br>for sale | Equity securities<br>available<br>for sale | Total   | GMWB        |
| Beginning balance                                      | \$1,357                                                      | \$—                                        | \$1,357 | \$(3,870 )  |
| Included in earnings                                   | 56                                                           | —                                          | 56      | 138         |
| Included in other comprehensive<br>income (loss)       | (34 )                                                        | —                                          | (34 )   | —           |
| Purchases, issuances, sales and other<br>dispositions: |                                                              |                                            |         |             |
| Purchases                                              | —                                                            | —                                          | —       | —           |
| Issuances                                              | —                                                            | —                                          | —       | 186         |
| Sales                                                  | —                                                            | —                                          | —       | —           |
| Other dispositions                                     | (102 )                                                       | —                                          | (102 )  | (18 )       |
| Transfers into Level 3                                 | —                                                            | —                                          | —       | —           |
| Transfers out of Level 3                               | —                                                            | —                                          | —       | —           |
| Ending balance                                         | \$1,277                                                      | \$—                                        | \$1,277 | \$(3,564 )  |
|                                                        | Six Months Ended June 30, 2014                               |                                            |         | Liabilities |
|                                                        | Assets<br>Fixed maturity<br>securities available<br>for sale | Equity securities<br>available<br>for sale | Total   | GMWB        |
| Beginning balance                                      | \$1,433                                                      | \$—                                        | \$1,433 | \$(4,703 )  |
| Included in earnings                                   | 56                                                           | —                                          | 56      | 875         |
| Included in other comprehensive<br>income (loss)       | (110 )                                                       | —                                          | (110 )  | —           |
| Purchases, issuances, sales and other<br>dispositions: |                                                              |                                            |         |             |
| Purchases                                              | —                                                            | —                                          | —       | —           |
| Issuances                                              | —                                                            | —                                          | —       | 244         |
| Sales                                                  | —                                                            | —                                          | —       | —           |
| Other dispositions                                     | (102 )                                                       | —                                          | (102 )  | 20          |
| Transfers into Level 3                                 | —                                                            | —                                          | —       | —           |
| Transfers out of Level 3                               | —                                                            | —                                          | —       | —           |
| Ending balance                                         | \$1,277                                                      | \$—                                        | \$1,277 | \$(3,564 )  |

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Kansas City Life Insurance Company

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

|                                                     | Year Ended December 31, 2013                 |                                      |           | Liabilities<br>GMWB |
|-----------------------------------------------------|----------------------------------------------|--------------------------------------|-----------|---------------------|
|                                                     | Assets                                       |                                      | Total     |                     |
|                                                     | Fixed maturity securities available for sale | Equity securities available for sale |           |                     |
| Beginning balance                                   | \$46,133                                     | \$1,255                              | \$47,388  | \$(1,080 )          |
| Included in earnings                                | (59 )                                        | 641                                  | 582       | (4,208 )            |
| Included in other comprehensive income (loss)       | 287                                          | (627 )                               | (340 )    | —                   |
| Purchases, issuances, sales and other dispositions: |                                              |                                      |           |                     |
| Purchases                                           | —                                            | —                                    | —         | —                   |
| Issuances                                           | —                                            | —                                    | —         | 737                 |
| Sales                                               | —                                            | —                                    | —         | —                   |
| Other dispositions                                  | (839 )                                       | (1,269 )                             | (2,108 )  | (152 )              |
| Transfers into Level 3                              | 116                                          | —                                    | 116       | —                   |
| Transfers out of Level 3                            | (44,205 )                                    | —                                    | (44,205 ) | —                   |
| Ending balance                                      | \$1,433                                      | \$—                                  | \$1,433   | \$(4,703 )          |

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 second quarters or six months ended June 30, 2014 and 2013.

The Company's primary category of assets using Level 3 fair values is fixed maturity securities, totaling \$1.3 million at June 30, 2014. 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 fair value of the GMWB embedded derivative is calculated using a discounted cash flow valuation model that projects future cash flows under multiple risk neutral stochastic equity scenarios. The risk neutral scenarios are generated using the current swap curve and projected equity volatilities and correlations. The equity correlations are based on historical price observations. For policyholder behavior assumptions, expected lapse and utilization assumptions are used and updated for actual experience. The mortality assumption uses the 2000 US Annuity Basic Table Mortality Table. The present value of cash flows is determined using the discount rate curve, based upon London InterBank Offered Rate (LIBOR) plus a credit spread.

The following table presents the valuation method for material financial instruments included in Level 3, as well as the unobservable inputs used in the valuation of those financial instruments at June 30, 2014.

|                            | Fair Value | Valuation Technique       | Unobservable Inputs | Range                                                           |
|----------------------------|------------|---------------------------|---------------------|-----------------------------------------------------------------|
| Embedded Derivative - GMWB | \$(3,564 ) | Actuarial cash flow model | Mortality           | 80% of US Annuity Basic Table (2000)                            |
|                            |            |                           | Lapse               | 0%-16% depending on product/duration/funded status of guarantee |
|                            |            |                           | Benefit Utilization | 0%-80% depending on age/duration/funded status of guarantee     |
|                            |            |                           |                     | 0.54%-1.39%                                                     |

Nonperformance  
Risk

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Kansas City Life Insurance Company

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The GMWB liability is sensitive to changes in observable and unobservable inputs. Observable inputs include risk-free rates, index returns, volatilities, and correlations. Increases in risk-free rates and equity returns reduce the liability, while increases in volatilities increase the liability. The Company's mortality, lapse, benefit utilization and nonperformance risk adjustment are unobservable. Increases in mortality, lapses and credit spreads used for nonperformance risk reduce the liability, while increases in benefit utilization increase the liability.

The Company estimates that the impact of unobservable inputs at June 30, 2014 is as follows: a 10% increase in the mortality assumption would reduce the liability less than \$0.1 million; a 10% decrease in the lapse assumption would increase the liability \$0.1 million; a 10% increase in the benefit utilization would increase the liability \$0.5 million; and a 10 basis point increase in the credit spreads used for non-performance would decrease the liability \$0.3 million.

The table below is a summary of fair value estimates at June 30, 2014 and December 31, 2013 for financial instruments. The total of the fair value calculations presented below may not be indicative of the value that can be obtained.

|                                                                  | June 30, 2014  |             | December 31, 2013 |             |
|------------------------------------------------------------------|----------------|-------------|-------------------|-------------|
|                                                                  | Carrying Value | Fair Value  | Carrying Value    | Fair Value  |
| Assets:                                                          |                |             |                   |             |
| Investments:                                                     |                |             |                   |             |
| Fixed maturity securities available for sale                     | \$2,762,031    | \$2,762,031 | \$2,618,620       | \$2,618,620 |
| Equity securities and other invested assets                      | 31,459         | 31,459      | 34,386            | 34,386      |
| Mortgage loans                                                   | 572,831        | 604,859     | 629,256           | 658,142     |
| Policy loans                                                     | 83,223         | 83,223      | 83,518            | 83,518      |
| Cash and short-term financial assets                             | 44,226         | 44,226      | 48,909            | 48,909      |
| Separate account assets                                          | 410,700        | 410,700     | 393,416           | 393,416     |
| Liabilities:                                                     |                |             |                   |             |
| Individual and group annuities                                   | \$1,096,649    | \$1,075,690 | \$1,100,495       | \$1,078,618 |
| Supplementary contracts and annuities without life contingencies | 54,567         | 53,315      | \$51,624          | \$50,097    |
| Separate account liabilities                                     | 410,700        | 410,700     | 393,416           | 393,416     |
| Other policyholder funds - GMWB                                  | (3,564 )       | (3,564 )    | (4,703 )          | (4,703 )    |



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Kansas City Life Insurance Company

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

## 5. Financing Receivables

The Company has financing receivables that have both a specific maturity date, either on demand or on a fixed or determinable date, and are recognized as assets in the Consolidated Balance Sheets.

The table below identifies the Company's financing receivables by classification amount at June 30, 2014 and December 31, 2013.

|                                                            | June 30<br>2014 | December 31<br>2013 |
|------------------------------------------------------------|-----------------|---------------------|
| Receivables:                                               |                 |                     |
| Agent receivables, net (allowance \$1,872; 2013 - \$2,245) | \$1,787         | \$1,660             |
| Investment-related financing receivables:                  |                 |                     |
| Mortgage loans, net (allowance \$2,955; 2013 - \$3,251)    | 572,831         | 629,256             |
| Total financing receivables                                | \$574,618       | \$630,916           |

The following table details the activity of the allowance for uncollectible accounts on agent receivables at June 30, 2014 and December 31, 2013.

|                   | June 30<br>2014 | December 31<br>2013 |
|-------------------|-----------------|---------------------|
| Beginning of year | \$2,245         | \$2,261             |
| Additions         | 162             | 69                  |
| Deductions        | (535)           | (85)                |
| End of period     | \$1,872         | \$2,245             |

The following table details the mortgage loan portfolio as collectively or individually evaluated for impairment at June 30, 2014 and December 31, 2013.

|                                                      | June 30<br>2014 | December 31<br>2013 |
|------------------------------------------------------|-----------------|---------------------|
| Mortgage loans collectively evaluated for impairment | \$531,807       | \$582,679           |
| Mortgage loans individually evaluated for impairment | 43,979          | 49,828              |
| Allowance for potential future losses                | (2,955)         | (3,251)             |
| Carrying value                                       | \$572,831       | \$629,256           |

The following table details the activity of the allowance for potential future losses on mortgage loans at June 30, 2014 and December 31, 2013.

|                   | June 30<br>2014 | December 31<br>2013 |
|-------------------|-----------------|---------------------|
| Beginning of year | \$3,251         | \$3,346             |
| Provision         | —               | —                   |
| Deductions        | (296)           | (95)                |
| End of period     | \$2,955         | \$3,251             |

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

## Agent Receivables

The Company has agent receivables that are classified as financing receivables and 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 \$3.7 million at June 30, 2014 with an allowance for doubtful accounts totaling \$1.9 million. Gross agent receivables totaled \$3.9 million with an allowance for doubtful accounts of \$2.2 million at December 31, 2013. 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 June 30, 2014 and December 31, 2013, these loans totaled \$1.1 million with an allowance for doubtful accounts of \$0.3 million.

Various agent commission advances and other commission receivables. Gross agent receivables in this category totaled \$2.6 million, and the allowance for doubtful accounts was \$1.6 million as of June 30, 2014. Gross agent receivables totaled \$2.8 million, and the allowance for doubtful accounts was \$1.9 million at December 31, 2013.

## 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 an allowance for potential future losses. Loans in foreclosure, loans considered impaired, or loans past due 90 days or more are placed on non-accrual status. Payments received on loans in a non-accrual status for these reasons are applied first to interest income not collected while on non-accrual status, followed by fees, accrued and past-due interest, and principal.

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. 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 3 - Investments, as are geographic distributions by both region and state. 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 June 30, 2014 and December 31, 2013, by property type.

|                   | Book Value | Amount of Payments Past Due |            |           | Total |
|-------------------|------------|-----------------------------|------------|-----------|-------|
|                   |            | 30-59 Days                  | 60-89 Days | > 90 Days |       |
| June 30, 2014     |            |                             |            |           |       |
| Industrial        | \$—        | \$—                         | \$—        | \$—       | \$—   |
| Office            | 7,880      | 15                          | —          | 916       | 931   |
| Medical           | —          | —                           | —          | —         | —     |
| Other             | —          | —                           | —          | —         | —     |
| Total             | \$7,880    | \$15                        | \$—        | \$916     | \$931 |
| December 31, 2013 |            |                             |            |           |       |
| Industrial        | \$—        | \$—                         | \$—        | \$—       | \$—   |
| Office            | 8,497      | 24                          | —          | 829       | 853   |
| Medical           | 3,921      | 32                          | —          | —         | 32    |
| Other             | —          | —                           | —          | —         | —     |
| Total             | \$12,418   | \$56                        | \$—        | \$829     | \$885 |

As of June 30, 2014, there were three mortgage loans that were 30 days or more past due, including two that were over 90 days past due. The two loans that were over 90 days past due were in the process of foreclosure. In July 2014, the book value of one of the loans in the foreclosure process was transferred to real estate without a loss.

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

As of December 31, 2013, there were five mortgage loans that were 30 days or more past due, including two over 90 days past due. The two loans that were over 90 days past due were in the process of foreclosure at December 31, 2013.

The Company had no troubled loans that were restructured or modified in 2014 or 2013.

Management's periodic evaluation and assessment of the adequacy of the allowance for potential future losses 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 \$3.0 million at June 30, 2014 and \$3.3 million at December 31, 2013. For information regarding management's periodic evaluation and assessment of mortgage loans and the allowance for potential future losses, please refer to Note 6 - Financing Receivables in the Company's 2013 Form 10-K.

**6. Variable Interest Entities**

The Company invests in certain affordable housing and real estate joint ventures which are considered to be variable interest entities (VIEs) and are included in Real Estate in the Consolidated Balance Sheets. The assets held in affordable housing real estate joint venture VIEs are primarily residential real estate properties that are restricted to provide affordable housing under federal or state programs for varying periods of time. The restrictions primarily apply to the rents that may be paid by tenants residing in the properties during the term of an agreement to remain in the affordable housing program. Investments in real estate joint ventures are equity interests in partnerships or limited liability 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. For additional information, please refer to Note 7 - Variable Interest Entities in the Company's 2013 Form 10-K.

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 June 30, 2014 and December 31, 2013. The table includes investments in five real estate joint ventures and 23 affordable housing real estate joint ventures at June 30, 2014 and investments in six real estate joint ventures and 25 affordable housing real estate joint ventures at December 31, 2013.

|                                               | June 30<br>2014    | Maximum<br>Exposure<br>to Loss | December 31<br>2013 | Maximum<br>Exposure<br>to Loss |
|-----------------------------------------------|--------------------|--------------------------------|---------------------|--------------------------------|
|                                               | Carrying<br>Amount |                                | Carrying<br>Amount  |                                |
| Real estate joint ventures                    | \$21,996           | \$21,996                       | \$22,104            | \$22,104                       |
| Affordable housing real estate joint ventures | 17,724             | 57,700                         | 19,422              | 61,624                         |
| Total                                         | \$39,720           | \$79,696                       | \$41,526            | \$83,728                       |

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 June 30, 2014, the Company had no unfunded commitments, compared to \$0.2 million at December 31, 2013.

There were no mortgage loan commitments outstanding to the real estate joint venture VIEs at either June 30, 2014 or December 31, 2013. At June 30, 2014, the Company had no unfunded equity commitments for the development of properties owned, compared to \$0.2 million at December 31, 2013. The loan commitments are included in Note 15 -

Commitments. 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.

In addition, the maximum exposure to loss on affordable housing joint ventures at June 30, 2014 and December 31, 2013 included \$22.3 million and \$22.5 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

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or third parties to whom the tax credit interests were transferred. A recapture event can occur at any time during a 15-year required compliance period. The principal causes of recapture include financial default and non-compliance with affordable housing program requirements by the properties controlled by the VIE. The potential exposure due to recapture may be mitigated by guarantees from the managing member or managing partner in the VIE, insurance contracts, or changes in the residual value accruing to the Company's interests in the VIEs.

## 7. 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 NAV of the underlying investment holdings as derived from closing prices on a national exchange or as provided by the issuer. 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 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 the separate accounts with the GMWB rider is recorded at fair value of \$133.6 million at June 30, 2014 (December 31, 2013 - \$123.9 million). The guarantee liability was \$(3.6) million at June 30, 2014 (December 31, 2013 - \$(4.7) million). 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.

In April 2013, the Company acquired a closed block of variable universal life insurance policies and variable annuity contracts from American Family. Please refer to the Reinsurance Transaction section of Note 1 - Nature of Operations and Significant Accounting Policies. The Company receives fees based upon both specific transactions and the fund value of the block of policies, as provided under modified coinsurance transactions. Also, as required under modified coinsurance transaction accounting, the separate account fund balances totaling \$324.0 million at June 30, 2014 were not recorded in the Company's financial statements. The coinsurance portion of the transaction represented approximately \$23.6 million in fund value and \$0.6 million in future policy benefits at acquisition. The fund value and future policy benefits approximated \$25.9 million and \$0.6 million at June 30, 2014, respectively. The Company recorded these general account obligations as a component of Policyholder account balances.

## 8. Notes Payable

The Company had no notes payable at June 30, 2014 or December 31, 2013.

As a member of the Federal Home Loan Bank of Des Moines (FHLB) with a capital investment of \$4.9 million, the Company has the ability to borrow on a collateralized basis from the FHLB. The Company received an insignificant amount of dividends on the capital investment in both the second quarters and six months of 2014 and 2013.

The Company had unsecured revolving lines of credit of \$60.0 million with two major commercial banks with no balances outstanding at June 30, 2014 or December 31, 2013. The lines of credit are at variable interest rates based upon short-term indices, and will mature in June of 2015. The Company anticipates renewing these lines of credit as they come due.

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## 9. Income Taxes

The following table provides a reconciliation of the federal income tax rate to the Company's effective income tax rate for the second quarters and six months ended June 30, 2014 and 2013.

|                                       | Quarter Ended |       | Six Months Ended |       |    |
|---------------------------------------|---------------|-------|------------------|-------|----|
|                                       | June 30       |       | June 30          |       |    |
|                                       | 2014          | 2013  | 2014             | 2013  |    |
| Federal income tax rate               | 35            | % 35  | % 35             | % 35  | %  |
| Tax credits, net of equity adjustment | (2            | )% (2 | )% (2            | )% (2 | )% |
| Permanent differences                 | (1            | )% (1 | )% (1            | )% (1 | )% |
| Effective income tax rate             | 32            | % 32  | % 32             | % 32  | %  |

The Company did not have any uncertain tax positions at June 30, 2014.

At June 30, 2014, the Company had a current tax asset of \$1.6 million and an \$84.9 million net deferred tax liability, compared to a \$0.7 million current tax asset and a \$68.0 million net deferred tax liability at December 31, 2013.

## 10. Pensions and Other Postemployment Benefits (OPEB)

The following table provides the components of net periodic benefit cost for the second quarters and six months ended June 30, 2014 and 2013.

|                                    | Pension Benefits |          | OPEB             |        |   |
|------------------------------------|------------------|----------|------------------|--------|---|
|                                    | Quarter Ended    |          | Quarter Ended    |        |   |
|                                    | June 30          |          | June 30          |        |   |
|                                    | 2014             | 2013     | 2014             | 2013   |   |
| Service cost                       | \$—              | \$—      | \$153            | \$224  |   |
| Interest cost                      | 1,550            | 1,335    | 374              | 349    |   |
| Expected return on plan assets     | (2,580           | ) (2,307 | ) —              | —      |   |
| Amortization of:                   |                  |          |                  |        |   |
| Unrecognized actuarial net loss    | 430              | 598      | 21               | 45     |   |
| Unrecognized prior service credit  | —                | —        | (286             | ) (111 | ) |
| Curtailment                        | —                | —        | —                | (116   | ) |
| Net periodic benefit cost (credit) | \$(600           | ) \$(374 | ) \$262          | \$391  |   |
|                                    | Pension Benefits |          | OPEB             |        |   |
|                                    | Six Months Ended |          | Six Months Ended |        |   |
|                                    | June 30          |          | June 30          |        |   |
|                                    | 2014             | 2013     | 2014             | 2013   |   |
| Service cost                       | \$—              | \$—      | \$306            | \$473  |   |
| Interest cost                      | 3,101            | 2,670    | 749              | 711    |   |
| Expected return on plan assets     | (5,161           | ) (4,614 | ) —              | —      |   |
| Amortization of:                   |                  |          |                  |        |   |
| Unrecognized actuarial net loss    | 859              | 1,196    | 43               | 103    |   |
| Unrecognized prior service credit  | —                | —        | (573             | ) (174 | ) |
| Curtailment                        | —                | —        | —                | (116   | ) |
| Net periodic benefit cost (credit) | \$(1,201         | ) \$(748 | ) \$525          | \$997  |   |

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Kansas City Life Insurance Company

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

Included in the Company's OPEB was a medical insurance plan for retired agents. During the second quarter of 2013, the Company notified the participants that this benefit was being terminated effective December 31, 2013. This benefit termination required a re-valuation of the plan, which was performed effective June 10, 2013 and resulted in a plan curtailment. The curtailment resulted in the immediate recognition of reduced operating expenses of \$0.1 million and a reduced liability of \$4.4 million.

11. 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.

During the first quarters of 2014 and 2013, the plan made payments of \$3.8 million and \$2.4 million for the three-year intervals ended December 31, 2013 and 2012, respectively. No payments were made to plan participants during the second quarters of 2014 or 2013.

At each reporting period, an estimate of the share-based compensation expense is accrued, utilizing the share price at the period end. The change in accrual for share-based compensation that reduced operating expense in the second quarter of 2014 was \$0.4 million, net of tax. The cost of share-based compensation accrued as an operating expense in the second quarter of 2013 was \$0.2 million, net of tax. The cost of share-based compensation accrued as an operating expense for the six months ended June 30, 2014 and 2013 was \$0.1 million and \$0.5 million, respectively.



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Kansas City Life Insurance Company

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

## 12. Comprehensive Income (Loss)

Comprehensive income (loss) is comprised of net income and other comprehensive income (loss). Other comprehensive income (loss) includes the unrealized investment gains or losses on securities available for sale (net of reclassifications for realized investment gains or losses) net of adjustments to deferred acquisition costs (DAC) and value of business acquired (VOBA), future policy benefits, and policyholder account balances (including deferred revenue liability). In addition, other comprehensive income (loss) includes the change in the liability for benefit plan obligations. Other comprehensive income (loss) reflects these items net of tax.

The table below provides information about comprehensive income (loss) for the second quarters and six months ended June 30, 2014 and 2013.

|                                                                                        | Quarter Ended June 30, 2014 |                             |                      |
|----------------------------------------------------------------------------------------|-----------------------------|-----------------------------|----------------------|
|                                                                                        | Pre-Tax<br>Amount           | Tax Expense<br>or (Benefit) | Net-of-Tax<br>Amount |
| Net unrealized gains (losses) arising during the year:                                 |                             |                             |                      |
| Fixed maturity securities                                                              | \$31,332                    | \$10,967                    | \$20,365             |
| Equity securities                                                                      | 660                         | 231                         | 429                  |
| Less reclassification adjustments:                                                     |                             |                             |                      |
| Net realized investment gains, excluding impairment losses                             | 662                         | 232                         | 430                  |
| Other-than-temporary impairment losses recognized in earnings                          | (243                        | ) (84                       | ) (159               |
| Other-than-temporary impairment losses recognized in other comprehensive income (loss) | 136                         | 47                          | 89                   |
| Net unrealized losses excluding impairment losses                                      | 31,437                      | 11,003                      | 20,434               |
| Effect on DAC and VOBA                                                                 | (2,348                      | ) (822                      | ) (1,526             |
| Future policy benefits                                                                 | (4,507                      | ) (1,578                    | ) (2,929             |
| Policyholder account balances                                                          | (174                        | ) (61                       | ) (113               |
| Other comprehensive income                                                             | \$24,408                    | \$8,542                     | 15,866               |
| Net income                                                                             |                             |                             | 8,457                |
| Comprehensive income                                                                   |                             |                             | \$24,323             |



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Kansas City Life Insurance Company

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

|                                                                                        | Six Months Ended June 30, 2013 |                             |                      |
|----------------------------------------------------------------------------------------|--------------------------------|-----------------------------|----------------------|
|                                                                                        | Pre-Tax<br>Amount              | Tax Expense<br>or (Benefit) | Net-of-Tax<br>Amount |
| Net unrealized losses arising during the year:                                         |                                |                             |                      |
| Fixed maturity securities                                                              | \$(104,010 )                   | \$(36,403 )                 | \$(67,607 )          |
| Equity securities                                                                      | (230 )                         | (81 )                       | (149 )               |
| Less reclassification adjustments:                                                     |                                |                             |                      |
| Net realized investment gains, excluding impairment losses                             | 2,275                          | 796                         | 1,479                |
| Other-than-temporary impairment losses recognized in earnings                          | (459 )                         | (161 )                      | (298 )               |
| Other-than-temporary impairment losses recognized in other comprehensive income (loss) | 99                             | 35                          | 64                   |
| Net unrealized losses excluding impairment losses                                      | (106,155 )                     | (37,154 )                   | (69,001 )            |
| Change in benefit plan obligations                                                     | 7,708                          | 2,698                       | 5,010                |
| Effect on DAC and VOBA <sup>1</sup>                                                    | 38,656                         | 13,530                      | 25,126               |
| Future policy benefits                                                                 | 10,652                         | 3,728                       | 6,924                |
| Policyholder account balances                                                          | 495                            | 173                         | 322                  |
| Other comprehensive loss                                                               | \$(48,644 )                    | \$(17,025 )                 | \$(31,619 )          |
| Net income                                                                             |                                |                             | 16,039               |
| Comprehensive loss                                                                     |                                |                             | \$(15,580 )          |

<sup>1</sup> The pre-tax amount includes \$16.0 million for a one-time refinement in estimate and \$5.6 million for the effect on the deferred revenue liability.

The following table provides accumulated balances related to each component of accumulated other comprehensive income at June 30, 2014, net of tax.

|                                                                  | Unrealized<br>Gain (Loss) on<br>Non-Impaired<br>Securities | Unrealized<br>Gain (Loss) on<br>Impaired<br>Securities | Benefit<br>Plan<br>Obligations | DAC/<br>VOBA<br>Impact | Future<br>Policy<br>Benefits | Policyholder<br>Account<br>Balances | Total     |
|------------------------------------------------------------------|------------------------------------------------------------|--------------------------------------------------------|--------------------------------|------------------------|------------------------------|-------------------------------------|-----------|
| Beginning of year                                                | \$ 78,496                                                  | \$ 2,381                                               | \$(38,363 )                    | \$(17,536 )            | \$(10,478 )                  | \$(330 )                            | \$ 14,170 |
| Other comprehensive income (loss) before reclassification        | 40,020                                                     | 2,033                                                  | —                              | (4,545 )               | (6,562 )                     | (244 )                              | 30,702    |
| Amounts reclassified from accumulated other comprehensive income | 978                                                        | (175 )                                                 | —                              | (38 )                  | —                            | —                                   | 765       |
| Net current-period other comprehensive income (loss)             | 40,998                                                     | 1,858                                                  | —                              | (4,583 )               | (6,562 )                     | (244 )                              | 31,467    |
| End of period                                                    | \$ 119,494                                                 | \$ 4,239                                               | \$(38,363 )                    | \$(22,119 )            | \$(17,040 )                  | \$(574 )                            | \$ 45,637 |



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Kansas City Life Insurance Company

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

The following table presents the pre-tax and the related income tax expense (benefit) components of the amounts reclassified from the Company's accumulated other comprehensive income to the Company's Consolidated Statements of Comprehensive Income for the second quarters and six months ended June 30, 2014 and 2013.

|                                                                                                      | Quarter Ended |          | Six Months Ended |          |
|------------------------------------------------------------------------------------------------------|---------------|----------|------------------|----------|
|                                                                                                      | June 30       |          | June 30          |          |
|                                                                                                      | 2014          | 2013     | 2014             | 2013     |
| Reclassification adjustments related to unrealized gains (losses) on investment securities:          |               |          |                  |          |
| Having impairments recognized in the Consolidated Statements of Comprehensive Income <sup>1</sup>    | \$ 662        | \$ 1,663 | \$ 1,505         | \$ 2,275 |
| Income tax expense <sup>2</sup>                                                                      | (232 )        | (582 )   | (527 )           | (796 )   |
| Net of taxes                                                                                         | 430           | 1,081    | 978              | 1,479    |
| Having no impairments recognized in the Consolidated Statements of Comprehensive Income <sup>1</sup> | (107 )        | (231 )   | (269 )           | (360 )   |
| Income tax benefit <sup>2</sup>                                                                      | 37            | 81       | 94               | 126      |
| Net of taxes                                                                                         | (70 )         | (150 )   | (175 )           | (234 )   |
| Reclassification adjustment related to DAC and VOBA <sup>1</sup>                                     | (17 )         | (5 )     | (58 )            | (28 )    |
| Income tax benefit (expense) <sup>2</sup>                                                            | 6             | 2        | 20               | 10       |
| Net of taxes                                                                                         | (11 )         | (3 )     | (38 )            | (18 )    |
| Total pre-tax reclassifications                                                                      | 538           | 1,427    | 1,178            | 1,887    |
| Total income tax expense                                                                             | (189 )        | (499 )   | (413 )           | (660 )   |
| Total reclassification, net taxes                                                                    | \$ 349        | \$ 928   | \$ 765           | \$ 1,227 |

<sup>1</sup> (Increases) decreases net realized investment gains (losses) on the Consolidated Statements of Comprehensive Income.

<sup>2</sup> (Increases) decreases income tax expense on the Consolidated Statements of Comprehensive Income.

## 13. 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 periods reported. The average number of shares outstanding for the quarters ended June 30, 2014 and 2013 was 10,967,910 and 11,022,809, respectively. The average number of shares outstanding for the six months ended June 30, 2014 and 2013 was 10,968,182 and 11,024,306, respectively. The number of shares outstanding at June 30, 2014 and December 31, 2013 was 10,967,987 and 10,968,839, respectively.

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

## 14. Segment Information

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

|                              |      | Individual<br>Insurance | Group<br>Insurance  | Old<br>American | Intercompany<br>Eliminations <sup>1</sup> | Consolidated         |
|------------------------------|------|-------------------------|---------------------|-----------------|-------------------------------------------|----------------------|
| Insurance revenues:          |      |                         |                     |                 |                                           |                      |
| Second quarter:              | 2014 | \$39,100                | \$14,379            | \$18,791        | \$(102 )                                  | \$72,168             |
|                              | 2013 | 42,805                  | <sup>2</sup> 13,025 | 18,230          | (99 )                                     | 73,961 <sup>2</sup>  |
| Six months:                  | 2014 | 76,991                  | 28,627              | 37,338          | (203 )                                    | 142,753              |
|                              | 2013 | 91,052                  | <sup>2</sup> 25,551 | 36,319          | (197 )                                    | 152,725 <sup>2</sup> |
| Net investment income:       |      |                         |                     |                 |                                           |                      |
| Second quarter:              | 2014 | \$38,410                | \$135               | \$2,806         | \$—                                       | \$41,351             |
|                              | 2013 | 39,801                  | 118                 | 2,959           | —                                         | 42,878               |
| Six months:                  | 2014 | 76,056                  | 260                 | 5,726           | —                                         | 82,042               |
|                              | 2013 | 79,170                  | 249                 | 5,869           | —                                         | 85,288               |
| Total benefits and expenses: |      |                         |                     |                 |                                           |                      |
| Second quarter:              | 2014 | \$69,621                | \$14,415            | \$20,121        | \$(102 )                                  | \$104,055            |
|                              | 2013 | 72,742                  | <sup>2</sup> 12,629 | 19,586          | (99 )                                     | 104,858 <sup>2</sup> |
| Six months:                  | 2014 | 140,327                 | 29,025              | 42,054          | (203 )                                    | 211,203              |
|                              | 2013 | 155,758                 | <sup>2</sup> 25,024 | 40,453          | (197 )                                    | 221,038 <sup>2</sup> |
| Net income (loss):           |      |                         |                     |                 |                                           |                      |
| Second quarter:              | 2014 | \$7,394                 | \$97                | \$966           | \$—                                       | \$8,457              |
|                              | 2013 | 9,465                   | 358                 | 1,028           | —                                         | 10,851               |
| Six months:                  | 2014 | 13,153                  | (23 )               | 829             | —                                         | 13,959               |
|                              | 2013 | 14,394                  | 550                 | 1,095           | —                                         | 16,039               |

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.

During the third quarter of 2013, the Company identified an immaterial correction of an error in the presentation of net premiums and policyholder benefits that resulted from the incorrect recognition of premiums related to the conversion of fixed deferred annuity contracts to immediate annuities with life contingencies. The impact of the correction was an equal and offsetting increase to both premiums and policyholder benefits. The error resulted in no impact to net income, earnings per share, stockholders' equity, or cash flows. Related to the immaterial correction, the Company understated the presentation of net premiums and policyholder benefits by \$15.7 million in the first quarter and \$8.4 million in the second quarter of 2013. The numbers reported above have been corrected to reflect these adjustments.

## 15. Commitments

In the normal course of business, the Company has open purchase and sale commitments. At June 30, 2014, the Company had purchase commitments to fund mortgage loans and affordable housing projects of \$25.7 million. Subsequent to June 30, 2014 the Company entered into commitments to fund additional mortgage loans of \$4.2 million.



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

16. 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 - or independent audit firms engaged by such 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, any of which could have a material adverse effect on the Company's financial condition or results of operations.

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. Based on its analysis to date, the Company believes that it has sufficiently reviewed its existing business and has adequately reserved for contingencies from a 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.



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.

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Kansas City Life Insurance Company

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

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.

17. Guarantees and Indemnifications

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

18. Subsequent Events

On July 21, 2014, the Company issued a press release announcing the sale of certain assets of Sunset Financial Services, Inc., a wholly-owned subsidiary of the Company, to Securities America Financial Corporation. The sale is subject to approval by FINRA, but is expected to close during 2014 if approval is granted. As a result of the sale, the Company expects to record a gain on sale of assets, net of taxes and transaction expenses, of up to \$2.0 million or \$0.18 per share based on the number of shares outstanding as of June 30, 2014.

On July 28, 2014, the Kansas City Life Board of Directors declared a quarterly dividend of \$0.27 per share that will be paid on August 13, 2014 to stockholders of record on August 7, 2014.

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Item 2. 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 is intended to provide in narrative form the perspective of the management of Kansas City Life Insurance Company (the Company) on its financial condition, results of operations, liquidity, and certain other factors that may affect its future results. The following is a discussion and analysis of the results of operations for the second quarters and six months ended June 30, 2014 and 2013 and the financial condition of the Company at June 30, 2014. This discussion should be read in conjunction with the consolidated financial statements and accompanying notes included in this document, as well as the Company's 2013 Form 10-K.

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. For additional information, please refer to the Overview included in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's 2013 Form 10-K.

Immaterial Correction of Error

During the third quarter of 2013, the Company identified an immaterial correction of an error in the presentation of net premiums and policyholder benefits that resulted from the incorrect recognition of premiums related to the conversion of fixed deferred annuity contracts to immediate annuities with life contingencies. The impact of the correction was an equal and offsetting increase to both net premiums and policyholder benefits. The error resulted in no impact to net income, earnings per share, stockholders' equity, or cash flows. Related to the immaterial correction, the Company understated the presentation of net premiums and policyholder benefits by \$15.7 million in the first quarter and \$8.4 million in the second quarter of 2013. The numbers reported have been corrected to reflect these adjustments. The error was insignificant to any previous periods presented.

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.

Actual results may differ materially from those included in the forward-looking statements as a result of risks and uncertainties. Those risks and uncertainties include, but are not limited to, the risk factors listed in Item 1A. Risk Factors as filed in the Company's 2013 Form 10-K. For additional information, please refer to the Overview included in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's 2013 Form 10-K.

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## Consolidated Results of Operations

## Summary of Results

The Company earned net income of \$8.5 million in the second quarter of 2014 compared to \$10.9 million in the second quarter of 2013. Net income per share was \$0.77 in the second quarter of 2014 versus \$0.98 in the same period in the prior year. Net income for the first six months of 2014 was \$14.0 million compared to \$16.0 million in the prior year. Net income per share for the six months was \$1.27 versus \$1.45 one year earlier.

The following table presents variances between the results for the second quarters and six months ended June 30, 2014 and 2013.

|                                                                              | Quarter Ended<br>June 30<br>2014 Versus 2013 | Six Months Ended<br>June 30<br>2014 Versus 2013 |
|------------------------------------------------------------------------------|----------------------------------------------|-------------------------------------------------|
| Insurance and other revenues                                                 | \$(2,008                                     | ) \$(10,087                                     |
| Net investment income                                                        | (1,527                                       | ) (3,246                                        |
| Net realized investment gains (losses)                                       | (824                                         | ) 362                                           |
| Policyholder benefits and interest credited to policyholder account balances | (1,963                                       | ) 7,148                                         |
| Amortization of deferred acquisition costs                                   | (1,625                                       | ) (1,588                                        |
| Operating expenses                                                           | 4,391                                        | 4,275                                           |
| Income tax expense                                                           | 1,162                                        | 1,056                                           |
| Total variance                                                               | \$(2,394                                     | ) \$(2,080                                      |

Information on these items is presented below.

## Sales

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. Consumer preferences and customer choices are very hard to predict and significantly influence life and annuity insurance purchases. These changing preferences and choices can result in large fluctuations period to period. The Company attempts to provide a varied portfolio of products that support consumer needs and is constantly assessing new products and opportunities.

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 recognizes conversions of policies and contracts on interest sensitive products to traditional life and annuity products as new premiums at the time of conversion. Most notably, the Company has fixed deferred annuities that convert to immediate annuities. Deferred annuity contracts typically provide for such conversions as one of several settlement options, and the volume of such contracts can vary based upon the individual needs and decisions of contract owners. In addition, the timing of these conversions can often result in large fluctuations period to period. 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 Company evaluates the profitability of sales to groups and adjusts the ongoing pricing to support benefit and profit expectations.



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The following table presents gross premiums by new and renewal business, less reinsurance ceded, as included in insurance revenues, for the second quarters and six months ended June 30, 2014 and 2013. New premiums are also detailed by product.

|                                     | Quarter Ended June 30    |          |    |           |          |   |
|-------------------------------------|--------------------------|----------|----|-----------|----------|---|
|                                     | 2014                     | % Change |    | 2013      | % Change |   |
| New premiums:                       |                          |          |    |           |          |   |
| Individual life insurance           | \$4,393                  | (1       | )% | \$4,423   | —        | % |
| Immediate annuities                 | 7,352                    | (34      | )% | 11,212    | 224      | % |
| Group life insurance                | 880                      | 10       | %  | 800       | 8        | % |
| Group accident and health insurance | 3,770                    | 4        | %  | 3,618     | 13       | % |
| Total new premiums                  | 16,395                   | (18      | )% | 20,053    | 70       | % |
| Renewal premiums                    | 39,260                   | 3        | %  | 38,037    | 3        | % |
| Total premiums                      | 55,655                   | (4       | )% | 58,090    | 19       | % |
| Reinsurance ceded                   | (14,321 )                | (3       | )% | (14,740 ) | 1        | % |
| Net premiums                        | \$41,334                 | (5       | )% | \$43,350  | 27       | % |
|                                     | Six Months Ended June 30 |          |    |           |          |   |
|                                     | 2014                     | % Change |    | 2013      | % Change |   |
| New premiums:                       |                          |          |    |           |          |   |
| Individual life insurance           | \$8,693                  | (1       | )% | \$8,793   | —        | % |
| Immediate annuities                 | 14,484                   | (57      | )% | 33,408    | 546      | % |
| Group life insurance                | 1,755                    | 18       | %  | 1,485     | 21       | % |
| Group accident and health insurance | 7,877                    | 16       | %  | 6,764     | 18       | % |
| Total new premiums                  | 32,809                   | (35      | )% | 50,450    | 141      | % |
| Renewal premiums                    | 78,391                   | 4        | %  | 75,629    | 2        | % |
| Total premiums                      | 111,200                  | (12      | )% | 126,079   | 32       | % |
| Reinsurance ceded                   | (28,079 )                | (1       | )% | (28,313 ) | —        | % |
| Net premiums                        | \$83,121                 | (15      | )% | \$97,766  | 46       | % |

Consolidated total premiums decreased \$2.4 million in the second quarter of 2014 versus the prior year, as total new premiums decreased \$3.7 million and total renewal premiums increased \$1.2 million. The decrease in new premiums resulted from a \$3.9 million decrease 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. In addition, the conversions from fixed deferred annuities are based upon the individual needs and decisions of contract owners. Conversions from fixed deferred annuities totaled \$4.2 million during the second quarter of 2014, down from \$8.4 million in the second quarter of 2013. Conversions increased in 2013, reflecting an increase in eligible deferred annuities and changes in marketing and policyholder communications. Excluding the conversions from fixed deferred annuities, total new premiums increased \$0.5 million or 4% in the second quarter of 2014 compared to the prior year. The increase in renewal premiums was due to a \$0.8 million or 3% increase in renewal individual life insurance premiums, principally from the Old American segment.

Consolidated total premiums decreased \$14.9 million in the first six months of 2014 versus the prior year, as total new premiums decreased \$17.6 million and total renewal premiums increased \$2.8 million. The decrease in new premiums was due to an \$18.9 million decrease in new immediate annuity premiums. Conversions from fixed deferred annuities totaled \$8.9 million during the first half of 2014, down from \$24.1 million in the first half of 2013. As mentioned above, conversions increased in 2013, reflecting an increase in eligible deferred annuities and changes in marketing and policyholder communications. Excluding the conversions from fixed deferred annuities, total new premiums decreased \$2.5 million or 9% in the first six months of 2014 compared to the prior year. Partially offsetting the decline in immediate annuity premiums, new group accident and health insurance premiums increased \$1.1 million or 16%. The increase in group accident and health premiums was largely from the dental product line, which increased \$1.3 million or 36% compared with the prior year. This increase is consistent with the expanded marketing efforts initiated in 2013. The increase in renewal premiums was due to a \$1.5 million or 3% increase in renewal

individual life insurance premiums, principally from the Old American segment. In addition, group accident and health renewal premiums increased \$1.0 million or 5%, largely in the dental line.

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The following table reconciles deposits with the Consolidated Statements of Cash Flows and provides detail by new and renewal deposits for the second quarters and six months ended June 30, 2014 and 2013. New deposits are also detailed by product.

|                                   | Quarter Ended June 30    |          | 2013      | 2013   |          |
|-----------------------------------|--------------------------|----------|-----------|--------|----------|
|                                   | 2014                     | % Change |           |        | % Change |
| New deposits:                     |                          |          |           |        |          |
| Universal life insurance          | \$2,754                  | (40 )%   | \$4,613   | 61     | %        |
| Variable universal life insurance | 154                      | (73 )%   | 560       | 444    | %        |
| Fixed annuities                   | 14,409                   | 11 %     | 12,986    | 4      | %        |
| Variable annuities                | 10,711                   | 62 %     | 6,614     | 42     | %        |
| Total new deposits                | 28,028                   | 13 %     | 24,773    | 23     | %        |
| Renewal deposits                  | 42,786                   | 7 %      | 39,938    | 13     | %        |
| Total deposits                    | \$70,814                 | 9 %      | \$64,711  | 17     | %        |
|                                   | Six Months Ended June 30 |          | 2013      | 2013   |          |
|                                   | 2014                     | % Change |           |        | % Change |
| New deposits:                     |                          |          |           |        |          |
| Universal life insurance          | \$5,685                  | (43 )%   | \$10,027  | 63     | %        |
| Variable universal life insurance | 512                      | (55 )%   | 1,126     | 333    | %        |
| Fixed annuities                   | 25,554                   | 18 %     | 21,633    | (32 )% |          |
| Variable annuities                | 18,257                   | 90 %     | 9,614     | 12     | %        |
| Total new deposits                | 50,008                   | 18 %     | 42,400    | (9 )%  |          |
| Renewal deposits                  | 79,845                   | 8 %      | 74,085    | 6      | %        |
| Total deposits                    | \$129,853                | 11 %     | \$116,485 | —      | %        |

Total new deposits increased \$3.3 million or 13% in the second quarter of 2014 compared with the second quarter of 2013. The increase in 2014 resulted from a \$4.1 million increase in variable annuity deposits and a \$1.4 million increase in fixed annuity deposits. Partially offsetting these increases, new universal life deposits declined \$1.9 million. Total renewal deposits increased \$2.8 million or 7% in the second quarter of 2014 versus the prior year. The reinsurance transaction on variable products increased renewal deposits \$6.7 million in the second quarter of 2014 compared to \$7.3 million in the second quarter of 2013. Excluding this transaction, renewal deposits increased \$3.5 million or 11%, reflecting a \$3.9 million increase in fixed annuity renewal deposits. Universal life and fixed annuity deposits can have sizeable fluctuations based upon changes in financial conditions, alternative and competitive products, and consumer preferences.

Total new deposits increased \$7.6 million or 18% in the first six months of 2014 compared with the prior year. The increase in 2014 resulted from an \$8.6 million increase in variable annuity deposits and a \$3.9 million increase in fixed annuity deposits. Partially offsetting these increases, new universal life deposits declined \$4.3 million. Total renewal deposits increased \$5.8 million or 8% in the first six months of 2014 compared to the prior year. The reinsurance transaction on variable products increased renewal deposits \$13.0 million in the first six months of 2014 compared to \$7.3 million in the prior year, as the reinsurance transaction occurred in April of 2013. Excluding this transaction, renewal deposits were essentially flat, as a \$1.6 million or 10% increase in fixed annuity renewal deposits was offset by a \$1.0 million decline in variable annuity renewal deposits and a \$0.4 million decline in universal life renewal 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.

Contract charges consist of cost of insurance, expense loads, amortization of unearned revenues, and surrender charges on policyholder account balances. Certain contract charges are not recognized in income immediately but are deferred and are amortized into income in proportion to the expected future gross profits of the business, in a manner similar to deferred acquisition costs (DAC). Profit expectations are based upon assumptions of future interest spreads,



mortality margins, expense margins, and policy and premium persistency experience. At least annually, a review is performed of the assumptions related to profit

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expectations. If it is determined the assumptions should be revised, the impact is recorded as a change in the revenue reported in the current period as an unlocking adjustment.

Total contract charges increased \$0.2 million or 1% in the second quarter of 2014 compared to the second quarter of 2013. This increase was due to increased amortization of deferred revenue, largely resulting from unlocking. An unlocking adjustment increased deferred revenue \$1.8 million during the second quarter of 2014. In comparison, an unlocking adjustment increased deferred revenue \$1.1 million in the second quarter of 2013. The unlocking adjustments for both years were associated with mortality and interest margins.

Total contract charges increased \$4.7 million or 9% in the first six months of 2014, compared to the first six months of 2013. The reinsurance transaction contributed \$8.4 million to contract charges in the first half of 2014, compared to \$4.4 million in the first half of 2013, as the reinsurance transaction occurred in April of 2013. Excluding this transaction, total contract charges on all blocks of business increased \$0.8 million or 1% in the first half of 2014 compared to the first quarter of 2013. This increase was largely due to the unlocking mentioned above.

Contract charges are impacted by the sales of new products and the persistency of both existing and closed blocks of business. The closed blocks of business reflect products and entities that the Company has purchased but to which the Company is not actively pursuing marketing efforts to generate new sales. The Company services these policies to achieve long-term profit streams. Total contract charges on closed blocks equaled 41% and 42% of total consolidated contract charges in the second quarters of 2014 and 2013, and 42% and 39% in the first six months of 2014 and 2013, respectively. The increases in 2014 can be attributed to the reinsurance transaction with American Family, which is considered a closed block. Excluding this transaction, total contract charges on closed blocks equaled 31% and 32% of total consolidated contract charges in the second quarters of 2014 and 2013, and 32% and 34% in the first six months of 2014 and 2013, respectively. The declines in 2014 reflect the runoff of business. Total contract charges on open, or ongoing, blocks of business increased 3% in both the second quarter and first half of 2014 compared to the same periods in 2013. This reflects the unlocking mentioned above.

The Company uses reinsurance as a means to mitigate its risks and to reduce the earnings volatility from claims.

Reinsurance ceded premiums decreased 3% in the second quarter and 1% in the first six months of 2014 compared to the same periods one year earlier.

#### 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 declined \$1.7 million or 4% in the second quarter and \$3.3 million or 4% in the first six months of 2014 compared with the same periods in 2014. These declines primarily reflected lower overall yields earned and available on certain investments.

Fixed maturity securities provided a majority of the Company's investment income during the quarter and six months ended June 30, 2014. Income on these investments declined \$0.6 million or 2% in the second quarter and \$1.8 million or 3% in the first half of 2014 compared to the same periods in 2013, reflecting declines in yields earned.

Investment income from commercial mortgage loans decreased \$0.9 million or 9% in the second quarter and \$1.6 million or 8% in the first six months of 2014 compared to the prior year. The declines in 2014 were largely due to a lower mortgage loan portfolio balance compared to the prior year, primarily from maturities and principal paydowns that have exceeded new mortgage loan originations.

The Company realizes investment gains and losses from several sources, including write-downs of investment securities and mortgage loans, 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 on or at a particular date or within a particular time frame. Depending upon the terms of the call provision and price at which the security was purchased, a gain or loss may be realized.

The Company recorded a net realized investment gain of \$0.7 million in the second quarter of 2014, compared with a net realized investment gain of \$1.5 million in the second quarter of 2013. During the second quarter of 2014, the Company recorded \$0.4 million in gains from investment securities called and other. Net realized investment gains for the first six months totaled \$2.2 million in 2014 compared to \$1.8 million in 2013. Gains due to investment securities called and other were \$1.7 million in 2014 and \$2.5 million in 2013. Partially offsetting these gains, investment losses

of \$0.3 million and \$0.4 million were recorded due to write-downs of investment securities that were considered other-than-temporarily impaired in the first six months of 2014 and 2013, respectively.

The Company's analysis of securities for the second quarter ended June 30, 2014 resulted in the determination that two fixed maturity securities had other-than-temporary impairments and were written down by a combined \$0.2 million, including \$0.1

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million that was determined to be non-credit and was recognized in other comprehensive income (loss). The total fair value of the affected securities after the write-downs was \$10.3 million.

**Policyholder Benefits**

Policyholder benefits consist of death benefits, immediate annuity benefits, accident and health benefits, surrenders, interest, other benefits, and the associated increase or decrease in reserves for future policy benefits. The largest component of policyholder benefits was death benefits for the periods presented. Death benefits reflect mortality results, after consideration of the impact of reinsurance. Mortality fluctuates from period to period.

Policyholder benefits increased \$2.6 million or 5% in the second quarter of 2014 compared to the same period one year earlier. This change was the result of increases in death benefit payments and group benefit payments, largely from the group dental product. Partially offsetting this was a decrease in benefit and contract reserves. Several factors contributed to the change in reserves. The largest factor was a decrease in immediate annuity premiums, largely due to a lower volume of conversions of fixed deferred annuities. Policyholder reserves for immediate annuity premiums are established on an approximately equal and offsetting basis, and a decrease in premiums results in a decrease to reserves on a comparative basis. Partially offsetting this decline, changes in the fair value of the GMWB rider resulted in an increase in benefit and contract reserves. In addition, the Company refined its reserve calculation methodology for new traditional life insurance issues beginning in 2013. These refinements resulted in an increase in reserves for traditional life products in 2014 compared with the prior year, predominantly in the Old American segment. The impact of the reserve methodology change is partially offset by reduced amortization of DAC.

Policyholder benefits decreased \$5.8 million or 5% in the first six months of 2014 compared to the prior year. This result was largely due to a decrease in death benefit payments and a decrease in benefit and contract reserves. Partially offsetting these was an increase in group dental benefit payments. Several factors contributed to the change in reserves. The largest factor was a decrease in immediate annuity premiums, largely due to a lower volume of conversions of fixed deferred annuities. Partially offsetting this, changes in the fair value of the GMWB rider resulted in an increase in policyholder benefits. Also, the Company refined its reserve calculation methodology for new traditional life insurance issues beginning in 2013. These refinements resulted in an increase in reserves for traditional life products in 2014 compared with the prior year, predominantly in the Old American segment. The impact of the reserve methodology change is partially offset by reduced amortization of DAC.

The Company has a GMWB rider for variable annuity contracts that is considered to be a financial derivative and, as such, is accounted for at fair value. The Company determines the fair value of the GMWB rider using a risk-neutral valuation method. The value of the riders will fluctuate depending on market conditions. As of June 30, 2014, the fair value of the liability increased \$1.1 million compared to the fair value at December 31, 2013. This fluctuation can be primarily attributed to decreases in risk-free swap rates that were partially offset by favorable returns in the capital markets.

**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 stipulated in certain policies or contracts, as well as allowances for adjustments to be made to reflect current market conditions in certain policies or contracts. Accordingly, the Company reviews and adjusts crediting rates as necessary and appropriate. Amounts credited are a function of account balances and current period crediting rates. As account balances fluctuate, so will the amount of interest credited to policyholder account balances. Interest credited to policyholder account balances decreased \$0.6 million or 3% in the second quarter and \$1.3 million or 3% in the first six months of 2014 compared with the same period one year earlier. These declines were due to lower average crediting rates, including reduced interest bonuses, as well as a decrease in policyholder account balances compared to one year earlier.

**Amortization of DAC**

Total amortization of deferred acquisition costs increased \$1.6 million in both the second quarter and the first half of 2014 compared to the same periods in the prior year. These increases were largely due to an unlocking adjustment that increased DAC amortization \$1.7 million in the second quarter and six months of 2014, as compared to an unlocking adjustment that increased DAC amortization \$0.2 million in the second quarter and six months of 2013. DAC

amortization also increased due to the reinsurance transaction on variable products, which contributed \$0.8 million to DAC amortization in the second quarter and \$2.1 million in the first half of 2014, compared to \$1.4 million in both the second quarter and first half of 2013. Included in DAC amortization for the reinsurance transaction in the second quarter and first half of 2014 was a \$0.4 million reduction from an unlocking adjustment. Excluding the reinsurance transaction, the amortization of deferred acquisition costs increased \$2.3 million or 24% in the second quarter and \$0.9 million in the six months compared with the prior year. Another factor was the refinement in reserve calculation estimate for new traditional life insurance issues mentioned above. These refinements resulted in a decrease in amortization of DAC for traditional life products in 2014, primarily in the Old American segment.

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Operating Expenses

Operating expenses consist of incurred commission expense from the sale of insurance products, net of the deferral of certain commissions and certain expenses directly associated with the attainment of new business, expenses from the Company's operations, the amortization of VOBA, and other expenses. Operating expenses decreased \$4.4 million or 17% in the second quarter and \$4.3 million or 8% in the first six months of 2014 compared to the same periods one year earlier. The decreases in both periods were primarily due to decreases in agent and employee benefit expenses and the amortization of VOBA. The decrease in the agent benefits largely resulted from a decline in the market value of deferred compensation plans, the termination of a medical insurance plan for retired agents, and forfeitures of non-vested benefits from terminated agents. The decline in employee benefits was largely due to reduced retirement plan expense, the decline in market value of deferred compensation plans, and the change in the accrual for incentive compensation plans.

The amortization of VOBA will generally decline over time, as policies run off. In addition, VOBA is evaluated on an ongoing basis for unlocking adjustments. If necessary, adjustments are made in the current period VOBA amortization. The amortization of VOBA decreased \$2.7 million in both the second quarter and the first six months of 2014 compared to the same periods one year earlier. The decrease in both periods was largely due to an unlocking adjustment, which decreased VOBA amortization \$1.5 million in both the second quarter and first six months of 2014. This compares to an unlocking adjustment that increased VOBA amortization \$0.9 million in the same periods one year earlier. The unlocking in 2014 was associated with interest and expense margins, while the unlocking in 2013 was associated with interest margins and premium persistency.

Income Taxes

The second quarter income tax expense was \$4.0 million or 32% of income before tax for 2014, versus \$5.2 million or 32% of income before tax for the prior year period. The income tax expense for the six months ended June 30, 2014 was \$6.5 million or 32% of income before tax, versus \$7.5 million or 32% of income before tax for the prior year. The effective income tax rate was lower than the prevailing corporate federal income tax rate of 35% in the second quarters of 2014 and 2013, primarily due to permanent differences. These differences include the dividends-received deduction and tax benefits related to affordable housing investments. Permanent differences, including the dividends-received deduction, resulted in a benefit of approximately 1% of income before tax in the second quarters of 2014 and 2013.

The effective income tax rate was lower than the prevailing corporate federal income tax rate of 35% for the six months ended June 30, 2014 and 2013. Permanent differences, including the dividends-received deduction, resulted in a benefit of approximately 1% of income before tax for the six months ended June 30, 2014 and 2013. Investments in affordable housing resulted in a benefit of approximately 2% of income before tax for the six months ended June 30, 2014 and June 30, 2013.

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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. In addition, the reinsurance transaction with American Family, as previously discussed, is included with the Individual Insurance segment. 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 uses internal sales representatives to market through a nationwide sales force of general agents, agents, and independent brokers and also markets products through third party providers that market directly or through independent brokers. 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 14 - 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 second quarters and six months ended June 30, 2014 and 2013.

|                                                                                 | Quarter Ended |          | Six Months Ended |          |
|---------------------------------------------------------------------------------|---------------|----------|------------------|----------|
|                                                                                 | June 30       |          | June 30          |          |
|                                                                                 | 2014          | 2013     | 2014             | 2013     |
| Insurance revenues:                                                             |               |          |                  |          |
| Net premiums                                                                    | \$8,266       | \$12,194 | \$17,359         | \$36,093 |
| Contract charges                                                                | 30,834        | 30,611   | 59,632           | 54,959   |
| Total insurance revenues                                                        | 39,100        | 42,805   | 76,991           | 91,052   |
| Investment revenues:                                                            |               |          |                  |          |
| Net investment income                                                           | 38,410        | 39,801   | 76,056           | 79,170   |
| Net realized investment gains, excluding other-than-temporary impairment losses | 684           | 1,707    | 2,142            | 2,162    |
| Net impairment losses recognized in earnings:                                   |               |          |                  |          |
| Total other-than-temporary impairment losses                                    | (243)         | (272)    | (456)            | (458)    |
| Portion of impairment losses recognized in other comprehensive income (loss)    | 136           | 46       | 188              | 120      |
| Net other-than-temporary impairment losses recognized in earnings               | (107)         | (226)    | (268)            | (338)    |
| Total investment revenues                                                       | 38,987        | 41,282   | 77,930           | 80,994   |
| Other revenues                                                                  | 2,294         | 2,521    | 4,557            | 4,719    |
| Total revenues                                                                  | 80,381        | 86,608   | 159,478          | 176,765  |
| Policyholder benefits                                                           | 29,608        | 29,456   | 60,327           | 72,147   |
| Interest credited to policyholder account balances                              | 19,260        | 19,865   | 38,206           | 39,528   |
| Amortization of deferred acquisition costs                                      | 8,251         | 6,679    | 12,966           | 10,571   |
| Operating expenses                                                              | 12,502        | 16,742   | 28,828           | 33,512   |
| Total benefits and expenses                                                     | 69,621        | 72,742   | 140,327          | 155,758  |
| Income before income tax expense                                                | 10,760        | 13,866   | 19,151           | 21,007   |
| Income tax expense                                                              | 3,366         | 4,401    | 5,998            | 6,613    |
| Net income                                                                      | \$7,394       | \$9,465  | \$13,153         | \$14,394 |

The net income for this segment in the second quarter of 2014 was \$7.4 million compared to \$9.5 million in the second quarter of 2013. Factors contributing to this decline were decreases in net premiums and net investment income, lower net realized



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investment gains, and an increase in amortization of deferred acquisition costs. Partially offsetting these were decreases in interest credited to policyholder account balances and operating expenses.

Net income for this segment was \$13.2 million for the first six months of 2014 compared to \$14.4 million in the same period in 2013. This decline in the current year reflected lower net premiums and net investment income, along with an increase in amortization of deferred acquisition costs. Partially offsetting these changes were increased contract charges and decreased policyholder benefits, interest credited to policyholder account balances, and operating expenses.

Total insurance revenues decreased \$3.7 million in the second quarter of 2014, reflecting a \$3.9 million decrease in net premiums that was partially offset by a \$0.2 million increase in contract charges. Total insurance revenues decreased \$14.1 million in the first six months of 2014, as net premiums decreased \$18.7 million or 52% and contract charges increased \$4.7 million or 9%.

The following table presents gross premiums by new and renewal business, less reinsurance ceded for the second quarters and six months ended June 30, 2014 and 2013. New premiums are also detailed by product.

|                           | Quarter Ended June 30    |          | 2013      | 2013 |          |
|---------------------------|--------------------------|----------|-----------|------|----------|
|                           | 2014                     | % Change |           |      | % Change |
| New premiums:             |                          |          |           |      |          |
| Individual life insurance | \$1,228                  | 2 %      | \$1,209   | 3 %  |          |
| Immediate annuities       | 7,352                    | (34) %   | 11,212    | 224  | %        |
| Total new premiums        | 8,580                    | (31) %   | 12,421    | 168  | %        |
| Renewal premiums          | 10,599                   | 2 %      | 10,364    | (2)  | %        |
| Total premiums            | 19,179                   | (16) %   | 22,785    | 50   | %        |
| Reinsurance ceded         | (10,913 )                | 3 %      | (10,591 ) | (2)  | %        |
| Net premiums              | \$8,266                  | (32) %   | \$12,194  | 175  | %        |
|                           | Six Months Ended June 30 |          | 2013      | 2013 |          |
|                           | 2014                     | % Change |           |      | % Change |
| New premiums:             |                          |          |           |      |          |
| Individual life insurance | \$2,468                  | 5 %      | \$2,355   | 1    | %        |
| Immediate annuities       | 14,484                   | (57) %   | 33,408    | 546  | %        |
| Total new premiums        | 16,952                   | (53) %   | 35,763    | 377  | %        |
| Renewal premiums          | 21,198                   | 1 %      | 20,914    | (1)  | %        |
| Total premiums            | 38,150                   | (33) %   | 56,677    | 98   | %        |
| Reinsurance ceded         | (20,791 )                | 1 %      | (20,584 ) | (1)  | %        |
| Net premiums              | \$17,359                 | (52) %   | \$36,093  | 358  | %        |

Total new premiums for this segment decreased \$3.8 million or 31% and total renewal premiums increased \$0.2 million or 2% in the second quarter of 2014 compared to the same period one year earlier. The decrease in new premiums resulted from a \$3.9 million or 34% decline 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. In addition, the conversions from fixed deferred annuities are based upon the individual needs and decisions of contract owners. Conversions from fixed deferred annuities totaled \$4.2 million during the second quarter of 2014, down from \$8.4 million in the second quarter of 2013. Conversions increased in 2013, reflecting an increase in eligible deferred annuities and changes in marketing and policyholder communications. Total new premiums for this segment decreased \$18.8 million or 53% and total renewal premiums increased \$0.3 million or 1% in the first six months of 2014 compared to the same period one year earlier. The decrease in new premiums was due to a \$18.9 million or 57% decline in new immediate annuity premiums. Conversions from fixed deferred annuities totaled \$8.9 million during the first half of 2014, down from \$24.1 million in the first half of 2013. As mentioned above, conversions increased in 2013, reflecting an increase in eligible deferred annuities and changes in marketing and policyholder communications.



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The following table provides detail by new and renewal deposits for the second quarters and six months ended June 30, 2014 and 2013. New deposits are also detailed by product.

|                                   | Quarter Ended June 30    |          |    |           |          |    |
|-----------------------------------|--------------------------|----------|----|-----------|----------|----|
|                                   | 2014                     | % Change |    | 2013      | % Change |    |
| New deposits:                     |                          |          |    |           |          |    |
| Universal life insurance          | \$2,754                  | (40      | )% | \$4,613   | 61       | %  |
| Variable universal life insurance | 154                      | (73      | )% | 560       | 444      | %  |
| Fixed annuities                   | 14,409                   | 11       | %  | 12,986    | 4        | %  |
| Variable annuities                | 10,711                   | 62       | %  | 6,614     | 42       | %  |
| Total new deposits                | 28,028                   | 13       | %  | 24,773    | 23       | %  |
| Renewal deposits                  | 42,786                   | 7        | %  | 39,938    | 13       | %  |
| Total deposits                    | \$70,814                 | 9        | %  | \$64,711  | 17       | %  |
|                                   | Six Months Ended June 30 |          |    |           |          |    |
|                                   | 2014                     | % Change |    | 2013      | % Change |    |
| New deposits:                     |                          |          |    |           |          |    |
| Universal life insurance          | \$5,685                  | (43      | )% | \$10,027  | 63       | %  |
| Variable universal life insurance | 512                      | (55      | )% | 1,126     | 333      | %  |
| Fixed annuities                   | 25,554                   | 18       | %  | 21,633    | (32      | )% |
| Variable annuities                | 18,257                   | 90       | %  | 9,614     | 12       | %  |
| Total new deposits                | 50,008                   | 18       | %  | 42,400    | (9       | )% |
| Renewal deposits                  | 79,845                   | 8        | %  | 74,085    | 6        | %  |
| Total deposits                    | \$129,853                | 11       | %  | \$116,485 | —        | %  |

Total new deposits increased \$3.3 million or 13% in the second quarter of 2014 compared to last year, reflecting a \$4.1 million increase in new variable annuity deposits and a \$1.4 million increase in new fixed annuity deposits. Partially offsetting these increases, new universal life deposits declined \$1.9 million. Total renewal deposits increased \$2.8 million or 7% in the second quarter of 2014. The reinsurance transaction on variable products increased renewal deposits \$6.7 million in the second quarter of 2014 compared to \$7.3 million in the second quarter of 2013. Excluding this transaction, renewal deposits increased \$3.5 million or 11%, reflecting a \$3.9 million increase in fixed annuity renewal deposits. Universal life and fixed annuity deposits can have sizeable fluctuations based upon changes in financial conditions, alternative and competitive products, and consumer preferences.

Total new deposits increased \$7.6 million or 18% in the first six months of 2014 compared to last year, due to an \$8.6 million increase in new variable annuity deposits and a \$3.9 million increase in new fixed annuity deposits. Partially offsetting these increases, new universal life deposits declined \$4.3 million. Total renewal deposits increased \$5.8 million or 8% in the first six months of 2013. The reinsurance transaction on variable products increased renewal deposits \$13.0 million in the first six months of 2014 compared to \$7.3 million in the prior year, as the reinsurance transaction occurred in April of 2013. Excluding this transaction, renewal deposits were essentially flat, as a \$1.6 million or 10% increase in fixed annuity renewal deposits was offset by a \$1.0 million decline in variable annuity renewal deposits and a \$0.4 million decline in universal life renewal deposits.

Total contract charges on all blocks of business increased \$0.2 million or 1% in the second quarter and \$4.7 million or 9% in the first six months of 2014 compared to the same periods one year earlier. An unlocking adjustment increased deferred revenue \$1.8 million during the second quarter of 2014. In comparison, an unlocking adjustment increased deferred revenue \$1.1 million in the second quarter of 2013. The unlocking adjustments for both years were associated with mortality and interest margins. In addition, the reinsurance transaction contributed \$8.4 million to contract charges in the first half of 2014, compared to \$4.4 million in the first half of 2013, as the reinsurance transaction occurred in April of 2013.

Total contract charges on closed blocks decreased 2% in the second quarter and increased 16% in the first six months of 2014, largely attributable to the reinsurance transaction on variable products that is considered a closed block. Excluding this transaction, total contract charges on closed blocks declined 2% in the both the second quarter and first half of 2014 compared to the prior year, reflecting the runoff of business. Total contract charges on open blocks of

business, where there is ongoing marketing for new sales, increased 3% in the both the second quarter and first six months of 2014.

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Net investment income decreased \$1.4 million or 3% in the second quarter and \$3.1 million or 4% in the first half of 2014 compared to the same periods in the prior year. These declines primarily reflected lower overall yields earned and available on certain investments.

Policyholder benefits increased \$0.2 million in the second quarter of 2014 compared to the prior year, reflecting higher net death benefit payments. Partially offsetting this change was a decrease in benefit and contract reserves. Several factors contributed to the change in reserves. The largest factor was a decrease in immediate annuity premiums, largely due to a lower volume of conversions of fixed deferred annuities during the current year.

Policyholder reserves for immediate annuity premiums are established on an approximately equal and offsetting basis, and a decrease in premiums results in a corresponding decrease to reserves on a comparative basis. Partially offsetting this decline, changes in the fair value of the GMWB rider resulted in an increase in benefit and contract reserves. In addition, the Company refined its reserve calculation methodology for new traditional life insurance issues beginning in 2013. These refinements resulted in an increase in reserves for traditional life products in 2014 compared with the prior year. The impact of the reserve methodology change is partially offset by reduced amortization of DAC.

Policyholder benefits decreased \$11.8 million or 16% in the first six months of 2014 compared to the prior year. This decline reflected lower net death benefit payments and a decrease in benefit and contract reserves. Several factors contributed to the change in reserves. The largest factor was a decrease in immediate annuity premiums, largely due to a lower volume of conversions of fixed deferred annuities in 2014. Policyholder reserves for immediate annuity premiums are established on an approximately equal and offsetting basis, and a corresponding decrease in premiums results in a decrease to reserves on a comparative basis. Partially offsetting this decline, changes in the fair value of the GMWB rider resulted in an increase in benefit and contract reserves. In addition, the Company refined its reserve calculation methodology for new traditional life insurance issues beginning in 2013. These refinements resulted in an increase in reserves for traditional life products in 2014 compared with the prior year. The impact of the reserve methodology change is partially offset by reduced amortization of DAC.

Interest credited to policyholder account balances decreased \$0.6 million or 3% in the second quarter and \$1.3 million or 3% in the first six months of 2014 compared to one year earlier. These declines were due to lower average crediting rates, including reduced interest bonuses, as well as a decrease in total policyholder account balances.

The amortization of DAC increased \$1.6 million or 24% in the second quarter and \$2.4 million or 23% in the first six months of 2014 compared to the same periods in the prior year. These increases were largely due to an unlocking adjustment that increased DAC amortization \$1.7 million in the second quarter and six months of 2014, as compared to an unlocking adjustment that increased DAC amortization \$0.2 million in the second quarter and six months of 2013. In addition, DAC amortization increased due to the reinsurance transaction on variable products, which contributed \$0.8 million to DAC amortization in the second quarter and \$2.1 million in the first half of 2014, compared to \$1.4 million in both the second quarter and first half of 2014. Included in DAC amortization for the reinsurance transaction in the second quarter and first half of 2014 was a \$0.4 million reduction from an unlocking adjustment. Excluding the reinsurance transaction, the amortization of deferred acquisition costs increased \$2.2 million or 42% in the second quarter and \$1.7 million or 19% in the first half of 2014 compared with the prior year. This decrease can also be attributed to the refinement in reserve calculation estimate for new traditional life insurance issues that occurred in 2013. These refinements resulted in a decrease in amortization of DAC for traditional life products in 2014 of approximately \$0.3 million in the second quarter and \$0.7 million in the first half.

Operating expenses decreased \$4.2 million or 25% in the second quarter and \$4.7 million or 14% in the first six months of 2014 compared with one year earlier. The decreases in both periods were primarily due to decreases in agent and employee benefit expenses and the amortization of VOBA.

VOBA amortization decreased \$2.7 million in the second quarter and \$2.6 million the first six months of 2014 compared to the same periods one year earlier. The decrease in both periods was largely due to an unlocking adjustment which decreased VOBA amortization \$1.5 million in both the second quarter and first six months of 2014. This compares to an unlocking adjustment that increased VOBA amortization \$0.9 million in the same periods one year earlier. The unlocking in 2014 was associated with interest and expense margins, while the unlocking in 2013 was associated with interest margins and premium persistency.



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## Group Insurance

The following table presents financial data of the Group Insurance business segment for the second quarters and six months ended June 30, 2014 and 2013.

|                                            | Quarter Ended |           | Six Months Ended |           |
|--------------------------------------------|---------------|-----------|------------------|-----------|
|                                            | June 30       |           | June 30          |           |
|                                            | 2014          | 2013      | 2014             | 2013      |
| Insurance revenues:                        |               |           |                  |           |
| Net premiums                               | \$ 14,379     | \$ 13,025 | \$ 28,627        | \$ 25,551 |
| Total insurance revenues                   | 14,379        | 13,025    | 28,627           | 25,551    |
| Investment revenues:                       |               |           |                  |           |
| Net investment income                      | 135           | 118       | 260              | 249       |
| Other revenues                             | 49            | 36        | 102              | 70        |
| Total revenues                             | 14,563        | 13,179    | 28,989           | 25,870    |
| Policyholder benefits                      | 8,460         | 6,728     | 16,999           | 13,566    |
| Operating expenses                         | 5,955         | 5,901     | 12,026           | 11,458    |
| Total benefits and expenses                | 14,415        | 12,629    | 29,025           | 25,024    |
| Income before income tax expense (benefit) | 148           | 550       | (36 )            | 846       |
| Income tax expense (benefit)               | 51            | 192       | (13 )            | 296       |
| Net income (loss)                          | \$ 97         | \$ 358    | \$(23 )          | \$ 550    |

Sales from internal sales representatives through independent general agents and agents accounted for approximately 67% of this segment's total premiums during both the second quarter and first half of 2014, 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.

In addition, effective January 1, 2015, the Affordable Care Act requires that small employers that purchase health plans outside of a public exchange must provide Essential Health Benefits (EHB) within a Qualified Health Plan (QHP). Pediatric dental benefits are one of ten EHBs that health plans must contain. As a result, group dental carriers face added pressure and expense in order to have their group dental plans certified as a QHP. Certification entails a rigorous process and subjects these plans to certain federal and state oversight and mandates. The Company has undertaken efforts to continue to compete in this market and has submitted the group dental product to the state and federal regulators for approval. The Company anticipates receiving certification in the majority of its target markets by the end of October and in time to start marketing for business on January 1, 2015 and thereafter.

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The following table presents gross premiums by new and renewal business, less reinsurance ceded for the second quarters and six months ended June 30, 2014 and 2013. New premiums are also detailed by product.

|                            | Quarter Ended June 30    |          |     |          |          |    |    |   |
|----------------------------|--------------------------|----------|-----|----------|----------|----|----|---|
|                            | 2014                     | % Change |     | 2013     | % Change |    |    |   |
| New premiums:              |                          |          |     |          |          |    |    |   |
| Group life insurance       | \$880                    | 10       | %   | \$800    | 8        | %  |    |   |
| Group dental insurance     | 2,275                    | 22       | %   | 1,865    | 81       | %  |    |   |
| Group disability insurance | 1,483                    | (14      | )%  | 1,730    | (18      | )% |    |   |
| Other group insurance      | 12                       | (48      | )%  | 23       | (62      | )% |    |   |
| Total new premiums         | 4,650                    | 5        | %   | 4,418    | 12       | %  |    |   |
| Renewal premiums           | 12,741                   | 4        | %   | 12,298   | 6        | %  |    |   |
| Total premiums             | 17,391                   | 4        | %   | 16,716   | 8        | %  |    |   |
| Reinsurance ceded          | (3,012                   | )        | (18 | )%       | (3,691   | )  | 10 | % |
| Net premiums               | \$14,379                 | 10       | %   | \$13,025 | 7        | %  |    |   |
|                            | Six Months Ended June 30 |          |     |          |          |    |    |   |
|                            | 2014                     | % Change |     | 2013     | % Change |    |    |   |
| New premiums:              |                          |          |     |          |          |    |    |   |
| Group life insurance       | \$1,755                  | 18       | %   | \$1,485  | 21       | %  |    |   |
| Group dental insurance     | 4,833                    | 36       | %   | 3,541    | 80       | %  |    |   |
| Group disability insurance | 3,013                    | (5       | )%  | 3,178    | (14      | )% |    |   |
| Other group insurance      | 31                       | (31      | )%  | 45       | (50      | )% |    |   |
| Total new premiums         | 9,632                    | 17       | %   | 8,249    | 18       | %  |    |   |
| Renewal premiums           | 25,457                   | 6        | %   | 24,095   | 1        | %  |    |   |
| Total premiums             | 35,089                   | 8        | %   | 32,344   | 5        | %  |    |   |
| Reinsurance ceded          | (6,462                   | )        | (5  | )%       | (6,793   | )  | 5  | % |
| Net premiums               | \$28,627                 | 12       | %   | \$25,551 | 5        | %  |    |   |

New group direct premiums increased \$0.2 million or 5% in the second quarter of 2014 compared with the same period in 2013. New sales in the second quarter were led by the group dental line, which increased \$0.4 million or 22%. However, short-term disability sales declined \$0.3 million or 26% versus the second quarter of 2013. New group direct premiums increased \$1.4 million or 17% for the first six months of 2014, compared to the same period one year earlier. This increase was largely from the dental product, which had a \$1.3 million or 36% increase versus the prior year. The long-term disability product and the group life product also had increases in the first half of 2014 but were mostly offset by a decline in short-term disability premiums.

Renewal premiums increased \$0.4 million or 4% in the second quarter of 2014 versus the second quarter of 2013, reflecting a \$0.7 million or 13% increase in group dental premiums and a \$0.2 million or an 8% increase in group life premiums. However, these increases were partially offset by a \$0.5 million or 20% decrease in short-term disability product sales. The increases in group dental and group life premiums reflected improved retention on profitable business. Renewal premiums for the first half of 2014 for this segment increased \$1.4 million or 6% versus the same period one year earlier. Group dental renewal sales increased \$1.1 million or 10% and group life premiums also increased \$0.4 million or 8% for the first half, while the short-term disability product sales declined \$0.2 million or 5% during this period.

This segment uses targeted reinsurance in several of its product lines to help mitigate risk and allow for a higher level and volume of sales and profitability. While reinsurance is used in most of the Company's group products, it is not used in the group dental product. Reinsurance ceded premiums decreased \$0.7 million for the second quarter and \$0.3 million for the first six months of 2014 compared with the same respective periods in 2013.





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Total policyholder benefits for this segment consist of claim payments and increases or decreases in reserves for future policy benefits. Total benefits, net of reinsurance, for the group segment increased \$1.7 million or 26% in the second quarter of 2014, compared with the same period in 2013. Claim payments for the group dental product increased \$1.3 million or 27% in the second quarter of 2014 compared with the prior year, largely reflecting the expanded volume of business in 2014. In addition, group life benefits increased \$0.3 million or 22% during the second quarter compared with the prior year. Total benefits, net of reinsurance, increased \$3.4 million or 25% for the first six months of 2014 compared with the prior year. The increase was largely from the group dental and group life products, which increased \$2.1 million or 21% and \$0.7 million or 27%, respectively.

This segment identifies and tracks a policyholder benefit ratio, which is derived by dividing policyholder benefits, net of reinsurance, by total group insurance revenues. This ratio allows for a measure of the comparability of product and marketing changes over time. This ratio was 59% for the second quarter of 2014, an increase from 52% for the same period in 2013. This ratio was 59% for the first six months of 2014, an increase from 53% for the same period one year earlier. The increases in this ratio were most notable in the group dental, group life and long-term disability lines. The increases largely reflect increased benefit payments in these product lines in 2014.

Operating expenses consist of commissions, fees to third-party marketing and administrative organizations, and expenses from the Company's internal operations. Operating expenses for this segment increased \$0.1 million or 1% in the second quarter of 2014 and \$0.6 million or 5% for the six months of 2014 compared with the same periods in the prior year. These results primarily reflect increased commissions on new sales. In addition, third-party provider expenses increased, primarily related to increased group dental sales.

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## Old American

The following table presents financial data of the Old American business segment for the second quarters and six months ended June 30, 2014 and 2013.

|                                                                                 | Quarter Ended   |          | Six Months Ended |          |
|---------------------------------------------------------------------------------|-----------------|----------|------------------|----------|
|                                                                                 | June 30<br>2014 | 2013     | June 30<br>2014  | 2013     |
| Insurance revenues:                                                             |                 |          |                  |          |
| Net premiums                                                                    | \$18,791        | \$18,230 | \$37,338         | \$36,319 |
| Total insurance revenues                                                        | 18,791          | 18,230   | 37,338           | 36,319   |
| Investment revenues:                                                            |                 |          |                  |          |
| Net investment income                                                           | 2,806           | 2,959    | 5,726            | 5,869    |
| Net realized investment gains, excluding other-than-temporary impairment losses | 100             | 25       | 307              | 16       |
| Net impairment losses recognized in earnings:                                   |                 |          |                  |          |
| Total other-than-temporary impairment losses                                    | —               | —        | —                | (1 )     |
| Portion of impairment losses recognized in other comprehensive income (loss)    | —               | (5 )     | (1 )             | (21 )    |
| Net other-than-temporary impairment losses recognized in earnings               | —               | (5 )     | (1 )             | (22 )    |
| Total investment revenues                                                       | 2,906           | 2,979    | 6,032            | 5,863    |
| Other revenues                                                                  | —               | 1        | 17               | 2        |
| Total revenues                                                                  | 21,697          | 21,210   | 43,387           | 42,184   |
| Policyholder benefits                                                           | 12,085          | 11,401   | 25,581           | 23,020   |
| Amortization of deferred acquisition costs                                      | 4,278           | 4,225    | 8,391            | 9,198    |
| Operating expenses                                                              | 3,758           | 3,960    | 8,082            | 8,235    |
| Total benefits and expenses                                                     | 20,121          | 19,586   | 42,054           | 40,453   |
| Income before income tax expense                                                | 1,576           | 1,624    | 1,333            | 1,731    |
| Income tax expense                                                              | 610             | 596      | 504              | 636      |
| Net income                                                                      | \$966           | \$1,028  | \$829            | \$1,095  |

Net income for the Old American segment was \$1.0 million in the second quarter of 2014, which was down slightly from the same period one year earlier. Total insurance revenues increased \$0.6 million compared with the prior year but were offset by a \$0.7 million increase in policyholder benefits. Total investment income decreased \$0.1 million and amortization of deferred acquisition costs increased \$0.1 million, while operating expenses decreased \$0.2 million.

Net income for this segment for the first six months of 2014 was \$0.8 million, which was a decrease of \$0.3 million compared with the prior year. Policyholder benefits increased \$2.6 million for the first six months. Partially offsetting this increase, life insurance premiums increased \$1.0 million, total investment income increased \$0.2 million, and the amortization of deferred acquisition costs decreased \$0.8 million.

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The following table presents gross premiums by new and renewal business, less reinsurance ceded, as included in insurance revenues for the second quarters and six months ended June 30, 2014 and 2013.

|                              | Quarter Ended June 30    |          |          |          |
|------------------------------|--------------------------|----------|----------|----------|
|                              | 2014                     | % Change | 2013     | % Change |
| New individual life premiums | \$3,165                  | (2 )%    | \$3,214  | (1 )%    |
| Renewal premiums             | 16,022                   | 4 %      | 15,474   | 4 %      |
| Total premiums               | 19,187                   | 3 %      | 18,688   | 3 %      |
| Reinsurance ceded            | (396 )                   | (14 )%   | (458 )   | (12 )%   |
| Net premiums                 | \$18,791                 | 3 %      | \$18,230 | 3 %      |
|                              | Six Months Ended June 30 |          |          |          |
|                              | 2014                     | % Change | 2013     | % Change |
| New individual life premiums | \$6,225                  | (3 )%    | \$6,438  | — %      |
| Renewal premiums             | 31,939                   | 4 %      | 30,817   | 4 %      |
| Total premiums               | 38,164                   | 2 %      | 37,255   | 3 %      |
| Reinsurance ceded            | (826 )                   | (12 )%   | (936 )   | (10 )%   |
| Net premiums                 | \$37,338                 | 3 %      | \$36,319 | 4 %      |

Total new premiums were essentially flat, while total renewal premiums increased \$0.5 million or 4% in the second quarter of 2014 compared to the same period one year earlier. Total new premiums decreased \$0.2 million or 3% in the first half of 2014, while total renewal premiums increased \$1.1 million or 4%. New sales growth has slowed in 2014, due to lower agent productivity and transition of management in certain territories. The Company continues to experience increases in renewal premiums, which are largely the result of growth in new sales in prior periods and favorable retention of business.

This segment focuses on the recruitment and development of new agencies and agents, with the intent and direction being to generate improved production from existing agencies and agents, and expanding or opening territories believed to offer additional growth opportunities. Further, this segment also focuses on servicing its policyholders and creating and maintaining products that are created and priced to be competitive in the senior markets.

Net investment income declined \$0.2 million in the second quarter and \$0.1 million for the first six months of 2014 versus the same periods in the prior year. Average invested assets increased versus the same periods in the prior year. The increase in average invested assets was primarily in fixed maturity securities, while commercial mortgage loan balances decreased. Offsetting this increase were lower overall yields earned and available on certain investments. In addition, net realized investment gains totaled \$0.1 million in the second quarter and \$0.3 million for the first six months of 2014, up slightly versus the same periods in 2013.

Policyholder benefits increased \$0.7 million in the second quarter of 2014 versus one year earlier. This increase was largely due to an increase in reserves of \$1.5 million. Partially offsetting the increase in reserves was a \$0.7 million decrease in death benefits, net of reinsurance. The increase in reserves was the result of several factors, including favorable mortality, a larger in-force block of business, the low interest rate environment, and the 2013 change in reserve calculation methodology. The reserve method change was a transition from a mean reserve calculation to a more refined modal reserve calculation on new policies issued beginning in 2013. The impact of the reserve methodology change is partially offset by reduced amortization of DAC. The increase in reserves due to updated assumptions and a change in method was \$1.0 million in the second quarter of 2014 relative to the prior year. The impact of this change in amortization of DAC was a reduction of \$0.3 million for the same comparative periods. The resulting net impact of these changes was a reduction to income before tax of \$0.8 million in the second quarter of 2014.

Policyholder benefits increased \$2.6 million in the first six months of 2014 versus one year earlier. This increase was largely due to an increase in reserves of \$3.7 million. Partially offsetting the increase in reserves was a \$1.0 million decrease in death benefits, net of reinsurance. The increase in reserves was the result of several factors, including favorable mortality, a larger in-force block of business, the low interest rate environment and the 2013 change in reserve calculation methodology. The reserve method change was a transition from a mean reserve calculation to a

more refined modal reserve calculation on new policies issued beginning in 2013. The impact of the reserve methodology change is partially offset by reduced amortization of DAC. The increase in reserves due to updated assumptions and a change in method was \$2.5 million in the first six months of 2014 relative to the prior year. The

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impact of this change in amortization of DAC was a reduction of \$1.1 million for the same comparative periods. The resulting net impact of these changes was a reduction to income before tax of \$1.4 million in the first six months of 2014.

The amortization of DAC was mostly flat for the second quarter of 2014 versus the prior year. However, the amortization of DAC decreased \$0.8 million for the six months. This decrease was largely the result of the change in reserve methodology, as described above.

Operating expenses declined \$0.2 million in both the second quarter and first six months of 2014 compared with the same periods one year earlier. The decreases in both periods primarily reflected reduced benefits versus the prior year.

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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 in the Company's 2013 Form 10-K.

The fair value of fixed maturity and equity securities with unrealized losses was \$319.2 million at June 30, 2014, compared with \$635.8 million at December 31, 2013. The decline primarily reflected the decrease in interest rates during the first half of 2014. At June 30, 2014, 89% of security investments with an unrealized loss were investment grade and accounted for 84% of the total unrealized losses. At December 31, 2013, 91% of securities with an unrealized loss were investment grade and accounted for 90% of the total unrealized losses. At June 30, 2014, the Company had gross unrealized losses on fixed maturity and equity securities of \$10.6 million that were offset by \$201.0 million in gross unrealized gains. At December 31, 2013, the Company had \$33.9 million in gross unrealized losses on fixed maturity and equity securities, offset by \$158.3 million in gross unrealized gains. At June 30 2014, 89% of the fixed maturity and equity securities portfolio had unrealized gains, an increase from 76% at December 31, 2013. The increase in unrealized gains at June 30, 2014 largely reflects an overall decrease in interest rates during the first half of 2014. Gross unrealized losses on fixed maturity and equity securities for less than 12 months accounted for \$0.4 million or 4% of total unrealized losses and 17% of the value of the securities in a gross loss position at June 30, 2014. Gross unrealized losses on fixed maturity and equity security investments of 12 months or longer increased from \$7.6 million at December 31, 2013 to \$10.2 million at June 30, 2014.

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The following table summarizes the Company's investments in fixed maturity and equity securities available for sale with unrealized losses at June 30, 2014 and should be considered in conjunction with information in Note 3 - Investments.

|                                                       | Amortized<br>Cost | Fair<br>Value | Gross<br>Unrealized<br>Losses |
|-------------------------------------------------------|-------------------|---------------|-------------------------------|
| Securities owned without realized impairment:         |                   |               |                               |
| Unrealized losses of 10% or less                      | \$305,302         | \$296,034     | \$9,268                       |
| Unrealized losses of 20% or less and greater than 10% | 6,946             | 6,109         | 837                           |
| Subtotal                                              | 312,248           | 302,143       | 10,105                        |
| Unrealized losses greater than 20%:                   |                   |               |                               |
| Investment grade:                                     |                   |               |                               |
| Less than twelve months                               | —                 | —             | —                             |
| Twelve months or greater                              | 908               | 692           | 216                           |
| Total investment grade                                | 908               | 692           | 216                           |
| Below investment grade:                               |                   |               |                               |
| Less than twelve months                               | 195               | 118           | 77                            |
| Twelve months or greater                              | —                 | —             | —                             |
| Total below investment grade                          | 195               | 118           | 77                            |
| Unrealized losses greater than 20%                    | 1,103             | 810           | 293                           |
| Subtotal                                              | 313,351           | 302,953       | 10,398                        |
| Securities owned with realized impairment:            |                   |               |                               |
| Unrealized losses of 10% or less                      | 16,507            | 16,286        | 221                           |
| Unrealized losses of 20% or less and greater than 10% | —                 | —             | —                             |
| Unrealized losses greater than 20%                    | —                 | —             | —                             |
| Subtotal                                              | 16,507            | 16,286        | 221                           |
| Total                                                 | \$329,858         | \$319,239     | \$10,619                      |



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The following table summarizes the Company's investments in securities available for sale with unrealized losses at December 31, 2013 and should be considered in conjunction with information in Note 3 - Investments.

|                                                       | Amortized<br>Cost | Fair<br>Value | Gross<br>Unrealized<br>Losses |
|-------------------------------------------------------|-------------------|---------------|-------------------------------|
| Securities owned without realized impairment:         |                   |               |                               |
| Unrealized losses of 10% or less                      | \$578,006         | \$553,790     | \$24,216                      |
| Unrealized losses of 20% or less and greater than 10% | 40,186            | 34,087        | 6,099                         |
| Subtotal                                              | 618,192           | 587,877       | 30,315                        |
| Unrealized losses greater than 20%:                   |                   |               |                               |
| Investment grade:                                     |                   |               |                               |
| Less than twelve months                               | 9,047             | 6,993         | 2,054                         |
| Twelve months or greater                              | 908               | 680           | 228                           |
| Total investment grade                                | 9,955             | 7,673         | 2,282                         |
| Below investment grade:                               |                   |               |                               |
| Less than twelve months                               | —                 | —             | —                             |
| Twelve months or greater                              | 173               | 131           | 42                            |
| Total below investment grade                          | 173               | 131           | 42                            |
| Unrealized losses greater than 20%                    | 10,128            | 7,804         | 2,324                         |
| Subtotal                                              | 628,320           | 595,681       | 32,639                        |
| Securities owned with realized impairment:            |                   |               |                               |
| Unrealized losses of 10% or less                      | 41,367            | 40,125        | 1,242                         |
| Unrealized losses of 20% or less and greater than 10% | —                 | —             | —                             |
| Unrealized losses greater than 20%                    | —                 | —             | —                             |
| Subtotal                                              | 41,367            | 40,125        | 1,242                         |
| Total                                                 | \$669,687         | \$635,806     | \$33,881                      |

The three classes of investments with the largest amount of unrealized losses at June 30, 2014 were from the industrial sector, the consumer sector, and the energy sector. The Company continues to monitor these investments as described in Note 3 - Investments. Please refer to that note for further information.

The following table provides information on fixed maturity securities with gross unrealized losses by actual or equivalent Standard & Poor's rating at June 30, 2014.

|                              | Fair<br>Value | %<br>of Total | Gross<br>Unrealized<br>Losses | %<br>of Total |   |
|------------------------------|---------------|---------------|-------------------------------|---------------|---|
| AAA                          | \$12,772      | 4             | % \$228                       | 2             | % |
| AA                           | 64,762        | 21            | % 2,233                       | 23            | % |
| A                            | 84,604        | 27            | % 2,434                       | 25            | % |
| BBB                          | 112,860       | 37            | % 3,307                       | 34            | % |
| Total investment grade       | 274,998       | 89            | % 8,202                       | 84            | % |
| BB                           | 16,489        | 6             | % 1,348                       | 14            | % |
| B and below                  | 16,286        | 5             | % 221                         | 2             | % |
| Total below investment grade | 32,775        | 11            | % 1,569                       | 16            | % |
|                              | \$307,773     | 100           | % \$9,771                     | 100           | % |

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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, 2013.

|                              | Fair<br>Value | %<br>of Total | Gross<br>Unrealized<br>Losses | %<br>of Total |   |
|------------------------------|---------------|---------------|-------------------------------|---------------|---|
| AAA                          | \$21,794      | 4             | % \$1,206                     | 4             | % |
| AA                           | 112,762       | 18            | % 5,668                       | 18            | % |
| A                            | 214,381       | 34            | % 9,179                       | 29            | % |
| BBB                          | 220,890       | 35            | % 12,294                      | 39            | % |
| Total investment grade       | 569,827       | 91            | % 28,347                      | 90            | % |
| BB                           | 13,350        | 2             | % 1,650                       | 5             | % |
| B and below                  | 42,767        | 7             | % 1,438                       | 5             | % |
| Total below investment grade | 56,117        | 9             | % 3,088                       | 10            | % |
|                              | \$625,944     | 100           | % \$31,435                    | 100           | % |

The Company's residential mortgage-backed securities, commercial mortgage-backed securities, and asset-backed securities that were rated below investment grade at June 30, 2014 were 38% of the below investment grade total, compared to 40% at December 31, 2013.

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 23 and 24 non-U.S. agency mortgage-backed securities that were determined to have such indications at June 30, 2014 and December 31, 2013, 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. 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. 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.

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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 June 30, 2014 and December 31, 2013. The Company believes that the assumptions below are reasonable and they are based largely upon the actual historical results of the underlying security collateral.

| June 30, 2014 |                      |        |                       |      |        |        |                  |      |  |  |
|---------------|----------------------|--------|-----------------------|------|--------|--------|------------------|------|--|--|
| Vintage       | Initial Default Rate |        | Initial Severity Rate |      |        |        | Prepayment Speed |      |  |  |
|               | Low                  | High   | Low                   | High | Low    | High   | Low              | High |  |  |
| 2003          | 1.0                  | % 1.0  | % 30                  | % 35 | % 14.0 | % 30.0 |                  |      |  |  |
| 2004          | 0.9                  | % 7.0  | % 35                  | % 55 | % 8.0  | % 20.0 |                  |      |  |  |
| 2005          | 4.9                  | % 12.4 | % 35                  | % 57 | % 6.0  | % 18.0 |                  |      |  |  |
| 2006          | 6.0                  | % 6.4  | % 35                  | % 85 | % 8.0  | % 16.0 |                  |      |  |  |
| 2007          | 11.3                 | % 11.3 | % 47                  | % 47 | % 8.0  | % 8.0  |                  |      |  |  |

| December 31, 2013 |                      |        |                       |      |        |        |                  |      |  |  |
|-------------------|----------------------|--------|-----------------------|------|--------|--------|------------------|------|--|--|
| Vintage           | Initial Default Rate |        | Initial Severity Rate |      |        |        | Prepayment Speed |      |  |  |
|                   | Low                  | High   | Low                   | High | Low    | High   | Low              | High |  |  |
| 2003              | 0.8                  | % 5.5  | % 35                  | % 41 | % 16.0 | % 30.0 |                  |      |  |  |
| 2004              | 1.0                  | % 6.9  | % 35                  | % 51 | % 8.0  | % 20.0 |                  |      |  |  |
| 2005              | 3.9                  | % 13.2 | % 40                  | % 64 | % 6.0  | % 18.0 |                  |      |  |  |
| 2006              | 5.7                  | % 7.5  | % 35                  | % 85 | % 8.0  | % 16.0 |                  |      |  |  |
| 2007              | 11.4                 | % 11.4 | % 52                  | % 52 | % 8.0  | % 8.0  |                  |      |  |  |

The determination of any amount of impairment that is due to credit for loan-backed and similar asset-backed securities in an unrealized loss position 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. Less than 1% of the Company's total investments were in these types of investments at June 30, 2014 and December 31, 2013.

The Company has investments in 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.



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The following tables divide these investment types among vintage and credit ratings at June 30, 2014.

|                                            | Fair<br>Value | Amortized<br>Cost | Unrealized<br>Gains (Losses) |
|--------------------------------------------|---------------|-------------------|------------------------------|
| Residential & Non-agency MBS: <sup>1</sup> |               |                   |                              |
| Investment Grade:                          |               |                   |                              |
| Vintage 2003 and earlier                   | \$9,305       | \$8,926           | \$379                        |
| 2004                                       | 8,405         | 8,050             | 355                          |
| Total investment grade                     | 17,710        | 16,976            | 734                          |
| Below Investment Grade:                    |               |                   |                              |
| 2004                                       | 32,386        | 30,714            | 1,672                        |
| 2005                                       | 60,681        | 59,091            | 1,590                        |
| 2006                                       | 4,946         | 3,717             | 1,229                        |
| 2007                                       | 3,666         | 3,400             | 266                          |
| Total below investment grade               | 101,679       | 96,922            | 4,757                        |
| Other Structured Securities:               |               |                   |                              |
| Investment grade                           | 51,311        | 51,306            | 5                            |
| Below investment grade                     | 15,644        | 16,476            | (832)                        |
| Total other                                | 66,955        | 67,782            | (827)                        |
| Total structured securities                | \$186,344     | \$181,680         | \$4,664                      |

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

The following tables divide these investment types among vintage and credit ratings at December 31, 2013.

|                                            | Fair<br>Value | Amortized<br>Cost | Unrealized<br>Gains (Losses) |
|--------------------------------------------|---------------|-------------------|------------------------------|
| Residential & Non-agency MBS: <sup>1</sup> |               |                   |                              |
| Investment grade:                          |               |                   |                              |
| Vintage 2003 and earlier                   | \$12,641      | \$12,178          | \$463                        |
| 2004                                       | 8,939         | 8,808             | 131                          |
| Total investment grade                     | 21,580        | 20,986            | 594                          |
| Below investment grade:                    |               |                   |                              |
| 2004                                       | 36,094        | 34,718            | 1,376                        |
| 2005                                       | 63,398        | 63,873            | (475)                        |
| 2006                                       | 5,884         | 4,906             | 978                          |
| 2007                                       | 3,787         | 3,609             | 178                          |
| Total below investment grade               | 109,163       | 107,106           | 2,057                        |
| Other structured securities:               |               |                   |                              |
| Investment grade                           | 52,560        | 53,410            | (850)                        |
| Below investment grade                     | 15,323        | 16,509            | (1,186)                      |
| Total other                                | 67,883        | 69,919            | (2,036)                      |
| Total structured securities                | \$198,626     | \$198,011         | \$615                        |

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

Total net unrealized gains on investments in non-U.S. Agency structured securities totaled \$4.7 million at June 30, 2014, compared to a net unrealized gain of \$0.6 million at December 31, 2013. Total net unrealized gains on these securities as a percent of total amortized cost totaled 3% at June 30, 2014.

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The Company has written down certain investments in previous periods. Fixed maturity securities written down and continuing to be owned at June 30, 2014 had a fair value of \$113.4 million with net unrealized gains of \$6.3 million, which compares to the December 31, 2013 fair value of \$118.1 million and net unrealized gains of \$3.5 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 its contractual cash flows from securities previously written down, the accretion of income is adjusted. The Company did not change its evaluation of any investments under this process during the second quarters of 2014 or 2013.

The Company maintains a diversified investment portfolio, including 4% of its investment portfolio in municipal bond securities and 7% in bond securities from foreign issuers at June 30, 2014. Approximately 67% of the Company's foreign securities were from issuers in Canada, Australia, and Great Britain at June 30, 2014. The Company has no holdings in European sovereign debt and all of these investments are denominated in U.S. dollars. The fair value of the Company's securities from foreign issuers at June 30, 2014 was \$258.6 million with a net unrealized gain of \$11.5 million. This compares to a fair value of \$233.2 million with a net unrealized gain of \$4.8 million at December 31, 2013.

The Company did not have any material direct exposure to financial guarantors at June 30, 2014 or December 31, 2013. The Company's indirect exposure to financial guarantors totaled \$28.4 million, which was 1% of the Company's investment assets at June 30, 2014. The unrealized gain on these investments totaled \$3.1 million at June 30, 2014. The Company's indirect exposure to financial guarantors at December 31, 2013 totaled \$28.0 million, which was 1% of the Company's total investments. Total net unrealized gains on these investments totaled \$2.3 million at December 31, 2013.

The Company's investment portfolio also includes mortgage loans, real estate, policy loans, and short-term investments. Mortgage loans comprised 16% and 18% of total investments at June 30, 2014 and December 31, 2013, respectively. Real estate investments were 4% of total investments at both June 30, 2014 and December 31, 2013. Policy loans and short-term investments comprised 3% of total invested assets at both June 30, 2014 and December 31, 2013.

Investments in mortgage loans totaled \$572.8 million at June 30, 2014 and \$629.3 million at December 31, 2013. The Company's mortgage loans are mostly secured by commercial real estate and are stated at the outstanding principal balance, 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 \$3.0 million at June 30, 2014 and \$3.3 million at December 31, 2013. For additional information on the Company's mortgage loan portfolio, please see Note 3 - Investments.

#### Liquidity and Capital Resources

##### Liquidity

Statements made in the Company's 2013 Form 10-K remain pertinent, as the Company's liquidity position is materially unchanged from year-end 2013.

Net cash provided by operating activities was \$15.9 million for the six months ended June 30, 2014. The primary sources of cash from operating activities in the first six months of 2014 were premium receipts and net investment income. The primary uses of cash from operating activities in the first six months of 2014 were for the payment of policyholder benefits and operating expenses. Net cash used by investing activities was \$15.7 million, driven largely by purchases of investments totaling \$214.4 million, partially offset by sales, maturities, calls, and principal paydowns of investments totaling \$194.3 million and net sales of short-term investments of \$5.1 million. Net cash provided by financing activities was \$0.2 million, primarily due to net transfers from separate accounts of \$3.8 million and the change in other deposits of \$3.8 million. These were partially offset by \$1.4 million of withdrawals, net of deposits, from interest sensitive policyholder account balances and the payment of stockholder dividends of \$5.9 million.

##### Debt and Short-Term Borrowing

The Company and certain subsidiaries have access to borrowing capacity through their membership affiliation with the FHLB. At June 30, 2014 and December 31, 2013, 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. These lines of credit will mature in June of 2015. 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. In addition, the Company's statutory equity exceeds the minimum capital deemed necessary to support its insurance business, as determined by the risk-based capital calculations and guidelines established by the National Association of Insurance Commissioners. The Company believes these statutory limitations impose no practical restrictions on its dividend payment plans.

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The following table shows the capital adequacy for the Company.

|                                                                      | June 30<br>2014 | December 31<br>2013 |
|----------------------------------------------------------------------|-----------------|---------------------|
| Total assets, excluding separate accounts                            | \$4,186,586     | \$4,121,250         |
| Total stockholders' equity                                           | 764,864         | 725,404             |
| Ratio of stockholders' equity to assets, excluding separate accounts | 18%             | 18%                 |

The ratio of equity to assets less separate accounts was 18% at both June 30, 2014 and December 31, 2013.

Stockholders' equity increased \$39.5 million from year-end 2013. The increase was largely due to other comprehensive income, resulting from an increase in net unrealized gains compared to 2013.

The stock repurchase program was extended by the Board of Directors through January 2015 to permit the purchase of up to one million of the Company's shares on the open market. During the first six months of 2014, the Company did not purchase any shares under the stock repurchase program. The Company made purchases of \$0.4 million under this plan in the first six months of 2013.

During the six months ended June 30, 2014, the Company purchased 288 shares and sold 1,140 shares of treasury stock from the Company's employee stock ownership plan for a net increase in treasury stock of \$0.1 million. The employee stock ownership plan held 23,675 shares of the Company's stock at June 30, 2014.

On July 28, 2014, the Board of Directors declared a quarterly dividend of \$0.27 per share, unchanged from the prior year. The dividend will be paid August 13, 2014 to stockholders of record as of August 7, 2014. Total stockholder dividends paid were \$5.9 million and \$6.0 million for the six months ended June 30, 2014 and 2013, respectively.

In June 2014, the A.M. Best Company, an independent rating agency, reviewed the financial strength rating and outlook of Kansas City Life, Sunset Life, and Old American. A. M. Best reaffirmed the "Stable" outlooks and financial strength ratings of A (Excellent) and A- (Excellent) for Kansas City Life and Sunset Life, respectively. Old American was upgraded to a financial strength rating of A- (Excellent) from B++ (Good) and was also assigned a "Stable" outlook rating.

#### Item 3: Quantitative and Qualitative Disclosures About Market Risk

Periods of volatility and market uncertainty represent a heightened risk for all financial institutions. Such events could negatively affect the Company and policyholder activity, such as a reduction in sales, increased policy surrenders, increased policy loans, and reduced earnings. The Company has factored these risks into its risk management processes and its disclosures of financial condition.

Please refer to the Company's 2013 Form 10-K for a more complete discussion of quantitative and qualitative disclosures about market risk.

#### Item 4. Controls and Procedures

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



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Part II: Other Information

Item 1. Legal Proceedings

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

Similarly, the Company's retail broker-dealer subsidiary is in an industry that also involves substantial risks of liability. In recent years, litigation and arbitration proceedings involving actions against registered representatives and securities products (including mutual funds, variable annuities, and alternative investments, such as real estate investment products 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 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 in the Company's Risk Factors included in Part I, Item 1A of the Company's 2013 Form 10-K.

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## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

## Issuer Purchases of Equity Securities

| Period           | Total Number of<br>Shares Purchased<br>Open<br>Market/Benefit<br>Plans | Average<br>Purchase Price<br>Paid per Share | Total Number of<br>Shares Purchased<br>as a Part of<br>Publicly Announced<br>Plans or Programs | Maximum Number<br>of Shares that May<br>Yet be Purchased<br>Under the<br>Plans or Programs |
|------------------|------------------------------------------------------------------------|---------------------------------------------|------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------|
| 1/1/14 - 1/31/14 | —<br>507                                                               | 1 \$—<br>2 47.74                            | —                                                                                              | —                                                                                          |
| 2/1/14 - 2/28/14 | —<br>—                                                                 | 1 —<br>2 —                                  | —                                                                                              | 1,000,000                                                                                  |
| 3/1/14 - 3/31/14 | —<br>633                                                               | 1 —<br>2 48.20                              | —                                                                                              | 1,000,000                                                                                  |
| 4/1/14 - 4/30/14 | —<br>—                                                                 | 1 —<br>2 —                                  | —                                                                                              | 1,000,000                                                                                  |
| 5/1/14 - 5/31/14 | —<br>—                                                                 | 1 —<br>2 —                                  | —                                                                                              | 1,000,000                                                                                  |
| 6/1/14 - 6/30/14 | —<br>—                                                                 | 1 —<br>2 —                                  | —                                                                                              | 1,000,000                                                                                  |
| Total            | 1,140                                                                  |                                             | —                                                                                              |                                                                                            |

<sup>1</sup> On January 27, 2014, the Company's Board of Directors authorized the repurchase of up to 1,000,000 shares of its common stock through January 26, 2015.

<sup>2</sup> Included in this column are the total shares purchased from the employee stock ownership (ESOP) plan sponsored by the Company during the consecutive months of January through June 2014.

## Item 3. Defaults Upon Senior Securities

Not applicable.

## Item 4. Mine Safety Disclosures

Not applicable.

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## Item 5. Other Information

3520 Broadway, Kansas City, MO 64111

Contact:

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

For Immediate Release: July 30, 2014, press release reporting financial results for the second quarter of 2014.

## Kansas City Life Announces Second Quarter 2014 Results

Kansas City Life Insurance Company recorded net income of \$8.5 million or \$0.77 per share in the second quarter of 2014, a decrease of \$2.4 million or \$0.21 per share relative to the same quarter in the prior year. This change reflected a decrease in total investment revenues, including the impact of lower yields earned and a decline in net realized investment gains. In addition, policyholder benefits increased in the second quarter, primarily due to increased death benefits and group dental payments. Partially offsetting these items was a decrease in operating expenses, largely resulting from reduced agent and employee benefit expenses.

The Company recorded net income of \$14.0 million or \$1.27 per share for the first half of 2014, a decrease of \$2.1 million or \$0.18 per share compared to the prior year. The most significant factors contributing to the decrease were reduced investment revenues from lower yields earned and increased group dental benefit payments. These were partially offset by increased contract charges, lower death benefit payments, and reduced operating expenses.

On July 28, 2014, the Kansas City Life Board of Directors declared a quarterly dividend of \$0.27 per share that will be paid on August 13, 2014 to stockholders of record on August 7, 2014.

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 \$483.6 million in 2013, and assets and life insurance in force were \$4.5 billion and \$32.0 billion, respectively, as of December 31, 2013. The Company operates in 49 states and the District of Columbia. For more information, please see the Company's Year End Form 10-K as filed with the Securities and Exchange Commission or please visit [www.kclife.com](http://www.kclife.com).

Kansas City Life Insurance Company  
Condensed Consolidated Income Statement  
(amounts in thousands, except share data)

|                                         | Quarter Ended |            | Six Months Ended |            |
|-----------------------------------------|---------------|------------|------------------|------------|
|                                         | June 30       |            | June 30          |            |
|                                         | 2014          | 2013       | 2014             | 2013       |
| Revenues                                | \$116,539     | \$120,898  | \$231,651        | \$244,622  |
| Net income                              | \$8,457       | \$10,851   | \$13,959         | \$16,039   |
| Net income per share, basic and diluted | \$0.77        | \$0.98     | \$1.27           | \$1.45     |
| Dividends paid                          | \$0.27        | \$0.27     | \$0.54           | \$0.54     |
| Average number of shares outstanding    | 10,967,910    | 11,022,809 | 10,968,182       | 11,024,306 |

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Item 6. Exhibits

(a) Exhibits

Exhibit

Number:

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

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Signatures

Pursuant to the requirements of 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  
(Registrant)

/s/ R. Philip Bixby  
R. Philip Bixby  
President, Chief Executive Officer  
and Chairman of the Board

/s/ Tracy W. Knapp  
Tracy W. Knapp  
Senior Vice President, Finance

Date: July 30, 2014