KANSAS CITY LIFE INSURANCE CO
Form 10-Q
May 01, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x	QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [FEE REQUIRED] For the Quarterly Period ended March 31, 2009 or
o	TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED] For the Transition Period from_______to______

Commission File Number 2-40764

KANSAS CITY LIFE INSURANCE COMPANY

(Exact Name of Registrant as Specified in its Charter)

Missouri (State or Other Jurisdiction of Incorporation or Organization)	44-0308260 (I.R.S. Employer Identification Number)
3520 Broadway, Kansas City, Missouri	64111-2565
(Address of Principal Executive Offices)	(Zip Code)

Registrant’s Telephone Number, including Area Code: 816-753-7000

Not Applicable

(Former name or former address, if changed since last report)

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

Yes x No o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or 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. (Check one):

Large accelerated filer o Accelerated filer x

Non-accelerated filer o Smaller reporting company o

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

Yes o No x

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

Class	*Outstanding March 31, 2009*
Common Stock, $1.25 par	11,456,837 shares

KANSAS CITY LIFE INSURANCE COMPANY

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Part I Financial Information

Item 1. Financial Statements (Unaudited)

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

KANSAS CITY LIFE INSURANCE COMPANY
CONSOLIDATED BALANCE SHEETS

	March 31 2009 (Unaudited)	December 31 2008
ASSETS		
Investments:		
Fixed maturity securities available for sale, at fair value	$ 2,341,204	$ 2,342,873
Equity securities available for sale, at fair value	39,683	44,537
Mortgage loans	445,996	445,389
Real estate	101,262	99,576
Policy loans	87,146	88,304
Short-term investments	32,253	35,138
Total investments	3,047,544	3,055,817
Cash	7,954	9,720
Accrued investment income	38,192	33,689
Deferred acquisition costs	257,962	263,756
Value of business acquired	83,707	82,855
Reinsurance receivables	168,433	168,390
Property and equipment	25,249	25,922
Income taxes	41,121	39,628
Other assets	30,565	28,749
Separate account assets	229,869	258,565
Total assets	$ 3,930,596	$ 3,967,091
LIABILITIES		
Future policy benefits	$ 852,678	$ 853,456
Policyholder account balances	2,026,231	2,030,656
Policy and contract claims	31,973	34,913
Other policyholder funds	131,287	125,826
Other liabilities	138,435	136,568
Separate account liabilities	229,869	258,565
Total liabilities	3,410,473	3,439,984
STOCKHOLDERS' EQUITY		
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	37,548	36,281
Retained earnings	751,339	750,600
Accumulated other comprehensive loss	(136,956)	(130,799)
Treasury stock, at cost (2009 - 7,039,843 shares; 2008 - 7,066,380 shares)	(154,929)	(152,096)
Total stockholders' equity	520,123	527,107
Total liabilities and stockholders' equity	$ 3,930,596	$ 3,967,091

See accompanying Notes to Consolidated Financial Statements (Unaudited).

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KANSAS CITY LIFE INSURANCE COMPANY
CONSOLIDATED STATEMENTS OF INCOME

	Quarter Ended March 31	
	2009	2008
REVENUES	(Unaudited)	
Insurance revenues:		
Premiums	$46,540	$44,487
Contract charges	26,768	27,300
Reinsurance ceded	(12,539)	(12,660)
Total insurance revenues	60,769	59,127
Investment revenues:		
Net investment income	43,139	46,463
Realized investment gains, excluding impairment losses	1,414	120
Net impairment losses recognized in earnings:		
Total other-than-temporary impairment losses	(21,406)	—
Portion of loss recognized in comprehensive loss	15,288	—
Net impairment losses recognized in earnings	(6,118)	—
Total investment revenues	38,435	46,583
Other revenues	2,431	2,609
Total revenues	101,635	108,319
BENEFITS AND EXPENSES		
Policyholder benefits	48,687	45,486
Interest credited to policyholder account balances	21,174	21,703
Amortization of deferred acquisition costs and value of business acquired	12,479	11,112
Operating expenses	26,254	24,396
Total benefits and expenses	108,594	102,697
Income (loss) before income tax expense (benefit)	(6,959)	5,622
Income tax expense (benefit)	(2,411)	2,020
NET INCOME (LOSS)	$(4,548)	$3,602
Other comprehensive loss, net of taxes:		
Change in net unrealized gains and losses on securities available for sale	$442	$(14,741)
Other comprehensive loss	442	(14,741)
COMPREHENSIVE LOSS	$(4,106)	$(11,139)

Basic and diluted earnings per share:

Net income (loss)	$(0.40)	$0.31

See accompanying Notes to Consolidated Financial Statements (Unaudited).

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KANSAS CITY LIFE INSURANCE COMPANY
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	March 2009 (Unaudited)	December 2008
COMMON STOCK, beginning and end of period	$ 23,121	$ 23,121
ADDITIONAL PAID IN CAPITAL		
Beginning of period	36,281	30,244
Excess of proceeds over cost of treasury stock sold	1,267	6,037
End of period	37,548	36,281
RETAINED EARNINGS		
Beginning of period	750,600	780,133
Cumulative effect of change in accounting estimate (See Note 6)	8,399	—
Net loss	(4,548)	(17,050)
Stockholder dividends of $0.27 per share (2008 - $1.08)	(3,112)	(12,483)
End of period	751,339	750,600
ACCUMULATED OTHER COMPREHENSIVE LOSS		
Beginning of period	(130,799)	(19,811)
Cumulative effect of change in accounting estimate (See Note 6)	(6,599)	—
Other comprehensive income (loss)	442	(110,988)
End of period	(136,956)	(130,799)
TREASURY STOCK, at cost		
Beginning of period	(152,096)	(129,286)
Cost of 159,009 shares acquired (2008 - 557,424 shares)	(5,468)	(25,972)
Cost of 185,546 shares sold (2008 - 222,687 shares)	2,635	3,162
End of period	(154,929)	(152,096)
TOTAL STOCKHOLDERS' EQUITY	$ 520,123	$ 527,107

See accompanying Notes to Consolidated Financial Statements (Unaudited).

KANSAS CITY LIFE INSURANCE COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Quarter Ended March 31	
	2009	2008
	(Unaudited)	
OPERATING ACTIVITIES		
Net cash provided (used)	$ 12,557	$ (11,329)
INVESTING ACTIVITIES		
Purchases of investments:		
Fixed maturity securities	(68,657)	(135,732)
Equity securities	(592)	(8,204)
Mortgage loans	(12,260)	(1,650)
Real estate	(4,060)	(7,013)
Sales of investments:		
Fixed maturity securities	9,039	13,451
Equity securities	1,406	1,434
Real estate	2,736	8,361
Other investment assets	4,043	29,123
Maturities and principal paydowns of investments:		
Fixed maturity securities	48,130	84,563
Mortgage loans	11,654	10,869
Net dispositions of property and equipment	291	343
Net cash used	(8,270)	(4,455)
FINANCING ACTIVITIES		
Proceeds from borrowings	—	96,500
Repayment of borrowings	(2,900)	(65,014)
Deposits on policyholder account balances	53,947	48,662
Withdrawals from policyholder account balances	(59,435)	(67,127)
Net transfers from separate accounts	3,920	3,441
Change in other deposits	3,093	3,130
Cash dividends to stockholders	(3,112)	(3,163)
Net acquisition of treasury stock	(1,566)	(5,974)
Net cash provided (used)	(6,053)	10,455
Decrease in cash	(1,766)	(5,329)
Cash at beginning of year	9,720	12,158
Cash at end of period	$ 7,954	$ 6,829

See accompanying Notes to Consolidated Financial Statements (Unaudited).

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, the accompanying notes to these unaudited interim consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations of Kansas City Life Insurance Company include the accounts of the Company and its subsidiaries, principally Sunset Life Insurance Company of America (Sunset Life) and Old American Insurance Company (Old American).

The unaudited interim consolidated financial statements have been prepared in accordance with United States of America generally accepted accounting principles (GAAP) for interim financial reporting and with the instructions to Form 10-Q and Regulation S-X. 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 2008 Form 10-K. 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 March 31, 2009 and the results of operations for all periods presented have been made. The results of operations for any interim period are not necessarily indicative of the Company's operating results for a full year.

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

The preparation of the unaudited interim consolidated financial statements requires management of the Company to make estimates and assumptions relating to the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities 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.

Significant Accounting Policies

Presented below is a summary of significant accounting policies used by the Company. This is not intended to be an exhaustive list of all accounting policies used by the Company. For a full discussion, please refer to the Company's 2008 Form 10-K as filed with the Securities and Exchange Commission.

Investments

Investment income is recognized when earned. Realized gains and losses on the sale of investments are determined on the basis of specific security identification recorded on the trade date. Securities available for sale are stated at fair value. Unrealized gains and losses, net of adjustments to deferred acquisition costs (DAC), value of business acquired (VOBA), policyholder account balances and deferred income taxes, are reported as a separate component of accumulated other comprehensive loss in stockholders' equity. Unrealized losses represent the difference between amortized cost and fair value on the valuation date. The adjustments to DAC and VOBA represent changes in the amortization of DAC and VOBA that would have been required as a charge or credit to income had such unrealized amounts been realized. The adjustment to policyholder account balances represents the increase from using a discount rate that would have been required if such unrealized gains had been realized and the proceeds reinvested at current market interest rates, which were lower than the then-current effective portfolio rate.

The Company’s fair value of fixed maturity and equity securities are determined by management, primarily by relying on external pricing services or brokers. When external sources are not able to provide prices for certain securities or when the external prices are deemed to be unreliable, the Company utilizes internally generated matrices and calculations to determine fair value.

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

Investment income on mortgage-backed securities is initially based upon yield, cash flow, and prepayment assumptions at the date of purchase. Subsequent revisions in those assumptions are recorded using the retrospective method, except for adjustable rate mortgage-backed securities where the prospective method is used. Under the retrospective method, the amortized cost of the security is adjusted to the amount that would have existed had the revised assumptions been in place at the time of purchase. Under the prospective method, future cash flows are estimated and interest income is recognized going forward using the new internal rate of return. The adjustments to amortized cost under both methods are recorded as a charge or credit to net investment income.

Kansas City Life Insurance Company

Notes to Consolidated Financial Statements (Unaudited)-Continued

Mortgage loans are stated at cost, adjusted for amortization of premium and accrual of discount, less a valuation reserve for probable losses. A loan is considered impaired if it is probable that contractual amounts due will not be collected. The valuation reserve is determined based upon historical impairment experience and insurance industry studies. Such estimates are based upon the value of the expected cash flows and the underlying collateral on a net realizable basis. Loans in foreclosure and loans considered to be impaired are placed on a non-accrual status.

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

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

Valuation of Investments

The Company's principal investments are in fixed maturity securities, mortgage loans and real estate; all of which are exposed to three primary sources of investment risk: credit, interest rate and liquidity. The fixed maturity securities, which are all classified as available for sale, are carried at their fair value in the Company's balance sheet, with unrealized gains or losses recorded in accumulated other comprehensive loss. The unrealized gains or losses are recorded net of the adjustment to policyholder account balances to reflect what would have been earned had those gains or losses been realized and the proceeds reinvested. The Company's fair value of fixed maturity and equity securities are derived from external pricing sources, brokers, and internal matrices and calculations. At March 31, 2009, approximately 90% of the carrying value of these investments were from external pricing services while 10% were derived from brokers, internal matrices and calculations. The investment portfolio is monitored regularly to ensure that investments which may be other-than-temporarily impaired are identified in a timely fashion and properly valued, and that impairments due to credit are charged against earnings as realized investment losses. The valuation of the investment portfolio involves a variety of assumptions and estimates.

The Company monitors the various markets in which its investments are traded. The Company utilizes an independent third-party pricing service to determine the majority of its fair values. For values received by the Company from an independent pricing source, the Company reviews these values for validity. In addition, the Company tests a limited number of securities each reporting period to validate reliance on the fair values provided. When fair values are not available from external service providers, where possible, the Company utilizes quotes from brokers. When the Company cannot obtain reliable broker pricing a fair value is determined based upon an assessment of several factors about a specific issue, including but not limited to: the issuer's industry; liquidity; cash flows; marketability, ratings and the ability of the issuer to satisfy the obligation; government intervention or regulations; fair value of comparable securities in actively traded or quoted markets; or other factors. The Company creates a matrix of factors from which to calculate an estimable value. However, all factors may not be known or publicly available from which to determine a value and, as such, the fair value used by the Company may not be truly indicative of the actual value available in an active market or an actual exit price if the Company were to place the security for sale in the current market.

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

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. Further, detailed analysis is performed for each issue or issues having experienced a formal restructuring or where the security has experienced material deterioration in fair value or where the fair value is less than 80% of amortized cost.

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

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

Kansas City Life Insurance Company

Notes to Consolidated Financial Statements (Unaudited)-Continued

- The credit rating of the security;
- The extent and the length of time the fair value has been below cost;
- The financial position of the issuer, including the current and future impact of any specific events, material declines in the issuer’s revenues, margins, cash positions, liquidity issues, asset quality, debt levels and income results;
- Significant management or organizational changes;
- Significant uncertainty regarding the issuer’s industry;
- Violation of financial covenants;
- Consideration of information or evidence that supports timely recovery;
- The Company’s ability to hold a security to maturity or until it recovers in value;
- The Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases; and
- Other business factors related to the issuer’s industry.

To the extent the Company determines that a security is deemed to be other-than-temporarily impaired, the portion of the difference between amortized cost and fair value due to credit is charged to income as a realized investment loss, resulting in a reduction to the cost basis of the underlying investment.

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

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

Any of these situations could result in a charge to income in a future period. If the Company determines that a security is other-than-temporarily impaired, the difference between amortized cost and fair value is charged to income as a realized investment loss, resulting in a reduction to the cost basis of the underlying investment.

Deferred Acquisition Costs and Value of Business Acquired

Deferred acquisition costs (DAC), principally agent commissions and other selling, selection and issue costs, which vary with and are directly related to the production of new business, are capitalized as incurred. These deferred costs are then amortized in proportion to future premium revenues or the expected future profits of the business, depending upon the type of product.

When a new block of business is acquired or when an insurance company is purchased, a portion of the purchase price is allocated to a separately identifiable intangible asset, called the value of business acquired (VOBA). VOBA is established as the actuarially determined present value of future gross profits of the business acquired and is amortized in proportion to future premium revenues or the expected future profits, depending on the type of business acquired.

The Company considers the following assumptions to be of significance when evaluating the amortization of DAC and VOBA: expected mortality, interest spreads, surrender rates and expense margins. Mortality relates to the occurrence of death. Interest spreads are the difference between the investment returns earned and the crediting rates of interest applied to policyholder account balances. Surrender rates relate to the relative volume of policy terminations. Expense margins involve the expenses incurred for maintaining and servicing in-force policies.

Kansas City Life Insurance Company

Notes to Consolidated Financial Statements (Unaudited)-Continued

At least annually, a review is performed of the models and the assumptions used to develop expected future profits, based upon management's current view of future events. DAC is reviewed on an ongoing basis to determine that the unamortized portion does not exceed the expected recoverable amounts. Management's view primarily reflects Company experience but can also reflect emerging trends within the industry. Short-term deviations in experience affect the amortization of DAC and VOBA in the period, but do not necessarily indicate that a change to the long-term assumptions of future experience is warranted. If it is determined that it is appropriate to change the long-term assumptions of future experience, then an unlocking adjustment is recognized for the block of business being evaluated. Certain assumptions, such as interest spreads and surrender rates, may be interrelated. As such, unlocking adjustments often reflect revisions to multiple assumptions. The balances of DAC and VOBA are immediately impacted by any assumption changes, with the change reflected through the income statement as an unlocking adjustment in the amount of DAC or VOBA amortized. These adjustments can be positive or negative. The impact of unlocking adjustments from the changes in estimates for the periods reported are included in the *Consolidated Results of Operations* and *Operating Results by Segment* sections of the Management's Discussion and Analysis of Financial Condition and Results of Operations contained within this document.

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

Critical Accounting Estimate	Determination Methodology	Potential Effect on DAC, VOBA and Related Items
Mortality Experience	Based on Company mortality experience. Industry experience and trends are also considered.	A 2.5% increase in expected mortality experience for all future years would result in a reduction in DAC and VOBA, and a 2% increase in current period amortization.
Surrender Rates	Based on Company surrender experience. Industry experience and trends are also considered.	A 10% increase in expected surrender rates for all future years would result in a reduction in DAC and VOBA, and a 1% increase in current period amortization expense.
Interest Spreads	Based on expected future investment returns and expected future crediting rates applied to policyholder account balances; future crediting rates include constraints imposed by policy guarantees.	A 10 basis point reduction in future interest rate spreads would result in a reduction in DAC and VOBA, and a 1% increase in current period amortization expense.
Maintenance Expenses	Based on Company experience using an internal expense allocation methodology.	A 10% increase in future maintenance expenses would result in a reduction in DAC and VOBA, and a 1% increase in current period amortization expense.

Separate Accounts

Separate account assets and liabilities arise from the sale of variable life insurance and 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. Policyholder account deposits and withdrawals, investment income and realized investment gains and losses are excluded from the amounts reported in the Consolidated Statements of Income. Revenues to the Company from separate accounts consist principally of contract charges, which include maintenance charges, administrative fees and mortality and risk charges.

The total separate account assets were $229.9 million as of March 31, 2009. Variable life and variable annuity assets comprised 29% and 71% of this amount, respectively. Guarantees are offered under variable life and variable annuity contracts: a guaranteed minimum death benefit rider is available on certain variable universal life contracts and guaranteed minimum death benefits are provided on variable annuities. The guaranteed minimum death benefit rider for variable universal life contracts guarantees the death benefit for specified periods of time, regardless of investment performance, provided cumulative premium requirements are met. The Company

Kansas City Life Insurance Company

Notes to Consolidated Financial Statements (Unaudited)-Continued

introduced a guaranteed minimum withdrawal benefit (GMWB) rider in 2007 that can be added to new or existing variable annuity contracts. The rider provides a minimum guarantee that the owner can make annual withdrawals equal to 5% of the initial annuity deposit for twenty years, or for life if withdrawals were started at age 65 or later, regardless of market returns. The current value of variable annuity separate accounts with the GMWB rider was $32.6 million and the liability for the GMWB rider was $0.4 million at March 31, 2009. The value of the GMWB rider is recorded at fair value. The change in this liability is included in policyholder benefits in the Consolidated Statements of Income.

Future Policy Benefits

The Company establishes liabilities for amounts payable under insurance policies, including traditional life insurance, annuities and accident and health insurance. Generally, amounts are payable over an extended period of time. Liabilities for future policy benefits of traditional life insurance have been computed by a net level premium method based upon estimates at the time of issue for investment yields, mortality and withdrawals. These estimates include provisions for experience less favorable than initially expected.

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

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

Policyholder Account Balances

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

Recognition of Revenues

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

Deposits related to universal life, fixed deferred annuity contracts and investment-type products are credited to policyholder account balances. Revenues from such contracts consist of amounts assessed against policyholder account balances for mortality, policy administration and surrender charges, and are recognized in the period in which the benefits and services are provided. The cash flows from deposits are credited to policyholder account balances. Deposits are not recorded as revenue under FASB Statement No. 97, "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments." Deposits are shown as a Financing Activity in the Consolidated Statements of Cash Flows.

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

Reinsurance

Reinsurance is one of the tools that the Company uses to accomplish its business objectives. A variety of reinsurance vehicles are currently in use, including individual and bulk arrangements on both coinsurance and mortality/morbidity only basis. Reinsurance supports a multitude of corporate objectives, including managing statutory capital, reducing volatility and surplus strain. At the customer level, reinsurance increases the Company's capacity, provides access to additional underwriting expertise, and generally makes it possible for the Company to offer products at competitive levels that could not otherwise be made available. Reinsurance is an actively managed tool that has increased in importance over recent years and will continue to play a role in

Kansas City Life Insurance Company

Notes to Consolidated Financial Statements (Unaudited)-Continued

the Company's future. Reinsurance receivables include amounts related to paid benefits and estimated amounts related to unpaid policy and contract claims, future policy benefits and policyholder account balances.

2. NEW ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 provides a single definition of fair value, together with a framework for measuring it, and requires additional disclosure about the use of fair value to measure assets and liabilities. SFAS 157 also emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and established a fair value hierarchy with the highest priority being the quoted price in active markets. SFAS 157 amended SFAS 107, "Disclosure about Fair Value of Financial Instruments." This statement became effective for years beginning after November 15, 2007. The Company adopted SFAS 157 on January 1, 2008 with no material impact to the consolidated financial statements. Please see Note 3 – Fair Values for disclosures pertaining to SFAS 157.

In October 2008, the FASB issued FASB Staff Position (FSP) No. 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active" (FSP FAS 157-3). FSP FAS 157-3 clarifies the application of FASB Statement No. 157, "Fair Value Measurements", in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The Company adopted FSP FAS 157-3 on issuance, with no material impact to the consolidated financial statements. The Company adopted FSP FAS 157-3 on issuance, applicable to the third quarter 2008 financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of SFAS No. 115" (SFAS 159). SFAS 159 permits an entity to measure certain financial assets and liabilities at fair value. Under SFAS 159, entities that elect the fair value option will report unrealized gains and losses in earnings at each subsequent reporting date. The fair value option may be elected on an instrument-by-instrument basis, with a few exceptions, as long as it is applied to the instrument in its entirety. Once adopted, the fair value option election is irrevocable, unless a new election date occurs. This statement became effective for years beginning after November 15, 2007. Upon the adoption of SFAS 159, the Company was also required to adopt SFAS No. 157 concurrently. The Company elected to not measure financial assets and liabilities at fair value other than those already prescribed, such as securities available for sale, securities identified in trading portfolios and certain derivatives and hedging activity that the Company participates in. The Company adopted SFAS 159 on January 1, 2008 with no material impact to the consolidated financial statements. Please see Note 3 – Fair Values for additional information pertaining to SFAS 159.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities" (SFAS 161). This statement amends and expands the disclosure requirements of Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities". SFAS 161 requires companies with derivative instruments to disclose information about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under Statement 133, and how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. This statement shall be effective for financial statements issued for fiscal years beginning after November 15, 2008. The Company adopted SFAS 161 on January 1, 2009 with no material impact on the consolidated financial statements. Please see Note 3 – Fair Values for additional information pertaining to SFAS 161.

In May 2008, the FASB issued SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles” (SFAS 162). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements. This statement shall be effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board (PCAOB) amendments to AU Section 411, “The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles”. The Company adopted SFAS 162 on issuance, with no material impact on the consolidated financial statements.

In May 2008, the FASB issued SFAS No. 163, “Accounting for Financial Guarantee Insurance Contracts” (SFAS 163). SFAS 163 clarifies how FASB Statement No. 60, “Accounting and Reporting by Insurance Enterprises”, applies to financial guarantee insurance contracts, including the recognition and measurement of premium revenue and claim liabilities. This statement also requires expanded disclosures about financial guarantee insurance contracts. This statement became effective for financial statements issued for fiscal years beginning after December 15, 2008. The Company adopted SFAS 163 on January 1, 2009 with no material impact to the consolidated financial statements as it does not sell financial guarantee insurance contracts.

Kansas City Life Insurance Company

Notes to Consolidated Financial Statements (Unaudited)-Continued

In April 2009, the FASB issued Staff Position No. FAS 157-4, “Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly” (FSP FAS 157-4). FSP FAS 157-4 clarifies fair valuation in inactive markets and includes all assets and liabilities subject to fair valuation measurements. This staff position requires enhanced disclosures related to fair valued assets and liabilities. This staff position shall be effective for financial statements issued for interim and annual periods ending after June 15, 2009. The Company elected early adoption of FSP FAS 157-4 effective for the period ended March 31, 2009 with no material impact on the unaudited interim consolidated financial statements. Please see Note 3 – Fair Values for additional information pertaining to FSP FAS 157-4.

In April 2009, the FASB issued Staff Position No. FAS 115-2 and FAS 124-2, “Recognition and Presentation of Other-Than-Temporary Impairments” (FSP FAS 115-2 and FAS 124-2). FSP FAS 115-2 and FAS 124-2 provide additional guidance regarding other-than-temporary impairment of debt securities and changes in the recognition and presentation of debt securities determined to be other-than-temporarily impaired. The FSP requires an enterprise to bifurcate any other-than-temporary impairment between credit and non-credit impairments and then establishes accounting treatment for each aspect, in current and subsequent periods. This staff position also requires retroactive application to other-than-temporary impairments recorded in prior periods by making a cumulative-effect adjustment to the opening balance of retained earnings and accumulated other comprehensive income (loss) in the period of adoption. This staff position shall be effective for financial statements issued for interim and annual periods ending after June 15, 2009. The Company elected to early adopt FSP FAS 115-2 and FAS 124-2 effective for the period ended March 31, 2009 with selected retroactive application effective January 1, 2009. For additional information pertaining to FSP FAS 115-2 and FAS 124-2, please see Note 3 – Fair Values and Note 6 – Accumulated Effect of Change in Accounting Estimate.

In April 2009, the FASB issued Staff Position No. FAS 107-1 and APB 28-1, “Interim Disclosures about Fair Value of Financial Instruments” (FSP FAS 107-1 and APB 28-1). FSP FAS 107-1 and APB 28-1 expands the fair value disclosures required for all financial instruments within the scope of FAS 107 to interim periods. The staff position also requires entities to disclose the methods and significant assumptions used to estimate the fair value of financial instruments in financial statements on an interim and annual basis and to highlight any changes from prior periods. This staff position shall be effective for financial statements issued for interim and annual periods ending after June 15, 2009. The Company elected to early adopt FSP FAS 107-1 and APB 28-1 effective for the period ended March 31, 2009 with no material impact on the unaudited interim consolidated financial statements. Please see Note 3 – Fair Values for additional information pertaining to FSP FAS 107-1 and APB 28-1.

All other Standards and Interpretations of those Standards issued during the three months ended March 31, 2009 did not relate to accounting policies and procedures pertinent to the Company at this time.

3. FAIR VALUES

Fair Values Hierarchy

In accordance with SFAS 157, the Company groups its financial assets and liabilities measured at fair value in three levels, based on the inputs and assumptions used to determine the fair value. These levels are as follows:

Level 1 – Valuations are based upon quoted prices for identical instruments traded in active markets. Level 1 assets include U.S. Treasury Notes and Bonds, other U.S. Government securities and certain common and preferred stocks that are traded by dealers or brokers 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 2 assets include debt securities, preferred stocks and asset-backed securities that are model priced by vendors using observable inputs.

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 option pricing models, discounted cash flow models, spread-based models, and similar techniques, using the best information available in the circumstances. Level 3 assets include corporate securities and private placements.

Kansas City Life Insurance Company

Notes to Consolidated Financial Statements (Unaudited)-Continued

Determination of Fair Value

Under SFAS 157, the Company bases fair values on the price that would be received to sell an asset (exit price) or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is the Company's policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements, in accordance with the fair value hierarchy in SFAS 157. Accordingly, the Company uses an independent third party pricing service to price a significant portion of its fixed maturity securities and equity securities.

The Company performs an analysis on 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. The Company corroborates and validates the primary pricing sources through a variety of procedures that include but are not limited to comparison to additional independent third-party pricing services or brokers, where possible, a review of third party pricing service methodologies, back testing and comparison of prices to actual trades for specific securities where observable data exists. In addition, in accordance with SFAS No. 157, the Company analyzed the third-party pricing services' methodologies and related inputs and has also evaluated the various types of securities in its investment portfolio to determine an appropriate SFAS No. 157 fair value hierarchy.

Fair value measurements for assets and liabilities where there exists limited or no observable market data, are calculated using the Company's own estimates, 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, the results cannot be determined with precision and may not be realized in an actual sale or immediate settlement of the asset or liability. Additionally, there may be inherent weaknesses in any calculation technique. Further, changes in the underlying assumptions used, including discount rates and estimates of future cash flows, could significantly affect the results of current or future values.

The Company's own estimates of fair value are derived in a number of ways including, but not limited to: 1) pricing provided by brokers, where the price indicates reliability as to value; 2) fair values of comparable securities incorporating a spread adjustment for maturity differences, collateralization, credit quality, liquidity, marketability and other items, if applicable; 3) discounted cash flow models and margin spreads; 4) bond yield curves; 5) Trace trade quotes; 6) observable market prices and exchange quotes not provided by external pricing services; 7) statement values provided to the Company by fund managers; and 8) option pricing models.

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 in accordance with SFAS No.107.

Assets

Securities Available for Sale

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

Short-Term Financial Assets

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

Loans

The Company does not record loans at fair value. As such, valuation techniques discussed herein for loans are primarily for estimating fair value for SFAS No. 107 disclosure purposes.

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 and repricing characteristics.

The Company also has loans made to policyholders. These loans cannot exceed the cash surrender value of the policy. Fair value is calculated by discounting contractual cash flows, using discount rates based on the Company's estimate of appropriate risk-adjusted discount rates for these loans.

Kansas City Life Insurance Company

Notes to Consolidated Financial Statements (Unaudited)-Continued

Liabilities

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

Fair values for liabilities under investment-type insurance contracts are based upon account value. The fair values of investment-type insurance contracts included with policyholder account balances for fixed deferred annuities and other policyholder funds for supplementary contracts without life contingencies are estimated to be their cash surrender values. In accordance with SFAS No. 107, the fair values of deposits with no stated maturity are equal to the amount payable on demand at the measurement date.

Guaranteed Minimum Withdrawal Benefits (GMWB)

The Company introduced a GMWB rider in 2007 that can be added to new or existing variable annuity contracts. The rider provides a minimum guarantee that the owner can make annual withdrawals equal to 5% of the initial annuity deposit for twenty years, or for life if withdrawals were started at age 65 or later, regardless of market returns. The value of variable annuity separate accounts with the GMWB rider was $32.6 million and the liability was $0.4 million at March 31, 2009. The value of the GMWB rider is recorded at fair value. Fair value for GMWB rider contracts results in a Level 3 valuation as it is based on models developed for this purpose 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 risk and issuer non-performance. The change in this liability is included in policyholder benefits in the Consolidated Statements of Income.

Notes Payable

There were no borrowings at March 31, 2009. All of the amounts included within Notes Payable were in short-term borrowings at December 31, 2008. The carrying amount of these borrowings was a reasonable estimate of fair value because of the relatively short time between the origination of the borrowings and their expected repayment and maturities. See Note 7 - Notes Payable for an explanation of the terms of the debt outstanding.

Categories Reported at Fair Value

The following table presents categories reported at fair value on a recurring basis.

	March 31, 2009			
Assets:	**Total**	**Level 1**	**Level 2**	**Level 3**
Fixed maturities and equity securities available for sale	$ 2,380,887	$ 23,929	$ 2,275,670	$ 81,288
Total	$ 2,380,887	$ 23,929	$ 2,275,670	$ 81,288

Liabilities:				
Other policyholder funds				
Guaranteed minimum withdrawal benefits	$ 396	$ —	$ —	$ 396
Total	$ 396	$ —	$ —	$ 396

	December 31, 2008			
Assets:	**Total**	**Level 1**	**Level 2**	**Level 3**
Fixed maturities and equity securities available for sale	$ 2,387,410	$ 28,380	$ 2,264,390	$ 94,640
Total	$ 2,387,410	$ 28,380	$ 2,264,390	$ 94,640
Liabilities:				
Other policyholder funds				
Guaranteed minimum withdrawal benefits	$ 755	$ —	$ —	$ 755
Total	$ 755	$ —	$ —	$ 755

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Kansas City Life Insurance Company

Notes to Consolidated Financial Statements (Unaudited)-Continued

The following table presents the fair value of fixed maturities and equity securities available for sale by pricing source and SFAS 157 hierarchy level as of March 31, 2009.

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Priced from external pricing sources	$23,929	$2,112,346	$—	$2,136,275
Priced from independent broker quotations	—	118,274	—	118,274
Priced from internal matrices and calculations	—	45,050	81,288	126,338
Total	$23,929	$2,275,670	$81,288	$2,380,887
% of Total	1 %	96 %	3 %	100 %

The changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the first quarter ended March 31, 2009 are summarized below:

	Beginning balance as of December 31, 2008	Total realized and unrealized gains and losses: Included in earnings	Included in other comprehensive income	Purchases, sales, issuances and settlements	Net Transfers in (out)	Ending balance as of March 31, 2009	Net gains and losses included in net loss relating to assets held at March 31, 2009
Assets:							
Fixed maturity and equity securities available for sale	$ 94,640	$ —	$ 1,914	$ (60)	$(15,206)	$81,288	$ 1,914
Liabilities:							
Other policyholder funds-guaranteed minimum withdrawal benefits	755	(534)	—	175	—	396	(534)

The roll forward of Level 3 assets begins with the prior period balance and adjusts the balance for the gains or losses (realized and unrealized) that occurred during the current period. Any new purchases that are identified as Level 3 securities are then added and any sales of securities which were previously identified as Level 3 are subtracted. Next, any securities which were previously identified as Level 1 or Level 2 securities and which are currently identified as Level 3 are added. Finally, securities which were previously identified as Level 3 and which are now designated as Level 1 or as Level 2 are subtracted. The ending balance represents the current fair value of securities which are designated as Level 3.

The roll forward of Level 3 liabilities begins with the prior period balance and adjusts for the realized gains or losses that occurred during the current period. These realized gains or losses are reflected as policyholder benefits in the Consolidated Statements of Income. Issuances, or new sales, are then added and settlements are subtracted. The ending balance represents the current fair value of liabilities which are designated as Level 3.

Kansas City Life Insurance Company

Notes to Consolidated Financial Statements (Unaudited)-Continued

The table below is a summary of fair value estimates as of March 31, 2009 and December 31, 2008 for financial instruments, as defined by SFAS No.107. In accordance with SFAS No. 107, the Company has not included assets and liabilities that are not financial instruments in this disclosure. The total of the fair value calculations presented do not represent, and should not be construed to represent, the underlying value of the Company.

	March 31, 2009		**December 31, 2008**	
	Carrying Value	**Fair Value**	**Carrying Value**	**Fair Value**
Investments:				
Fixed maturity and equity securities available for sale				