

KANSAS CITY LIFE INSURANCE CO
Form 10-Q
November 05, 2004

United States
Securities and Exchange Commission
Washington, D.C. 20549

Form 10-Q

Quarterly Report Under Section 13 or 15 (d) of the
Securities Exchange Act of 1934

For the Quarter ended September 30, 2004

Commission File No. 2-40764

Kansas City Life Insurance Company
3520 Broadway
Kansas City, Missouri 64111-2565

Phone: (816) 753-7000

IRS Number: 44-0308260

Incorporated in the State of Missouri

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, and (2) has been subject to such filing requirements for the past 90 days.

Yes

No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the most recent date available.

Incorporated in the State of Missouri

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

Class Outstanding October 21, 2004
 Common Stock, \$1.25 par value 11,939,223 shares

**KANSAS CITY LIFE INSURANCE COMPANY
 TABLE OF CONTENTS**

Part I. Financial Information.....

Item 1. Financial Statements.....

 Consolidated Balance Sheets.....

 Consolidated Statements of Income.....

 Consolidated Statements of Cash Flows.....

 Notes to Consolidated Financial Statements.....

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

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

Item 4. Controls and Procedures.....

Part II. Other Information.....

Item 1. Legal Proceedings.....

Item 5. Other Information.....

Item 6. Exhibits.....

Signatures.....

Part I Financial Information
Item 1. Financial Statements

**KANSAS CITY LIFE INSURANCE COMPANY
 CONSOLIDATED BALANCE SHEETS**
 (amounts in thousands, except share data)

	September 30 2004 <u>(Unaudited)</u>	December 31 2003 <u> </u>
ASSETS		
Investments:		
Fixed maturities available for sale, at fair value	\$ 2,985,176	\$ 2,814,485
Equity securities available for sale, at fair value	64,939	63,808
Mortgage loans	418,237	456,656
Real estate	104,856	112,691
Policy loans	109,710	114,420
Short-term investments	12,433	71,823
Other investments	<u>1,817</u>	<u>903</u>
Total investments	3,697,168	3,634,786
Cash	371	20,029
Accrued investment income	42,542	39,132

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

Deferred acquisition costs	234,449	241,057
Value of business acquired	100,494	106,334
Reinsurance recoverable	153,839	151,577
Other assets	52,800	54,306
Separate account assets	318,696	304,691
Total assets	<u>\$ 4,600,359</u>	<u>\$ 4,551,912</u>

LIABILITIES

Future policy benefits	\$ 873,070	\$ 872,114
Policyholder account balances	2,282,197	2,239,223
Policy and contract claims	32,425	33,012
Other policyholder funds	98,339	101,084
Notes payable	110,865	133,670
Income taxes	43,272	36,918
Other liabilities	176,336	186,762
Separate account liabilities	318,696	304,691
Total liabilities	<u>3,935,200</u>	<u>3,907,474</u>

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	23,990	23,310
Retained earnings	703,685	688,800
Accumulated other comprehensive income	28,720	23,418
Less treasury stock, at cost (2004 - 6,560,208 shares;		
2003 - 6,572,087 shares)	<u>(114,357)</u>	<u>(114,211)</u>
Total stockholders' equity	<u>665,159</u>	<u>644,438</u>
Total liabilities and stockholders' equity	<u>\$ 4,600,359</u>	<u>\$ 4,551,912</u>

See accompanying Notes to Consolidated Financial Statements.

KANSAS CITY LIFE INSURANCE COMPANY
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)
(amounts in thousands, except share data)

	Quarter ended		Nine
	September 30		Se
	2004	2003	2004
REVENUES			
Insurance revenues:			
Premiums	\$ 49,209	\$ 57,960	\$ 143,57
Contract charges	28,797	29,578	87,32
Reinsurance ceded	<u>(13,802)</u>	<u>(14,784)</u>	<u>(40,66</u>
Total insurance revenues	64,204	72,754	190,24
Investment revenues:			
Net investment income	48,874	51,273	147,99
Realized investment gains (losses)	2,809	(5,129)	4,33
Other revenues	<u>1,927</u>	<u>2,452</u>	<u>6,19</u>
Total revenues	<u>117,814</u>	<u>121,350</u>	<u>348,76</u>
BENEFITS AND EXPENSES			
Policyholder benefits	44,052	57,349	140,27
Interest credited to policyholder account balances	25,856	24,629	73,20
Amortization of deferred acquisition costs			
and value of business acquired	10,100	9,880	30,29
Operating expenses	<u>22,818</u>	<u>25,327</u>	<u>72,42</u>
Total benefits and expenses	<u>102,826</u>	<u>117,185</u>	<u>316,20</u>

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

Income (loss) before income tax expense (benefit)	14,988	4,165	32,566
Income tax expense (benefit)	<u>3,455</u>	<u>(3,563)</u>	<u>7,911</u>
NET INCOME	<u>\$ 11,533</u>	<u>\$ 7,728</u>	<u>\$ 24,657</u>
Basic and diluted earnings per share:			
Net income	<u>\$ 0.97</u>	<u>\$ 0.65</u>	<u>\$ 2.00</u>

See accompanying Notes to Consolidated Financial Statements.

KANSAS CITY LIFE INSURANCE COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(amounts in thousands)

	Nine Months ended	
	<u>September 30</u>	
	<u>2004</u>	<u>2003</u>
OPERATING ACTIVITIES		
Net cash provided	<u>\$ 27,169</u>	<u>\$ 54,822</u>
INVESTING ACTIVITIES		
Purchases of investment securities:		
Fixed maturities	(627,035)	(872,111)
Equity securities	(4,657)	(3,376)
Sales of investment securities:		
Fixed maturities	120,880	131,734
Equity securities	3,051	11,952
Maturities and principal paydowns of investment securities:		
Fixed maturities	338,844	553,068
Equity securities	265	5,780
Purchases of other investments	(50,516)	(121,960)
Sales, maturities and principal paydowns of other investments	103,120	128,745
Net sales of short-term investments	59,390	35,904
Net additions to property and equipment	(1,345)	(690)
Insurance business acquired	<u>-</u>	<u>(52,264)</u>
Net cash used	<u>(58,003)</u>	<u>(183,218)</u>
FINANCING ACTIVITIES		
Proceeds from borrowings	3,960	16,267
Repayment of borrowings	(26,765)	(587)
Deposits on policyholder contracts	205,720	256,304
Withdrawals from policyholder account balances	(152,096)	(126,651)
Net transfers to separate accounts	(8,449)	(5,289)
Change in other deposits	(1,963)	5,363
Cash dividends to stockholders	(9,765)	(9,682)
Net disposition (acquisition) of treasury stock	<u>534</u>	<u>(2,787)</u>
Net cash provided	<u>11,176</u>	<u>132,938</u>
Increase (decrease) in cash	(19,658)	4,542
Cash at beginning of year	<u>20,029</u>	<u>14,645</u>
Cash at end of period	<u>\$ 371</u>	<u>\$ 19,187</u>

See accompanying Notes to Consolidated Financial Statements.

Kansas City Life Insurance Company
Notes to Consolidated Financial Statements

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

(amounts in thousands, except share data)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The unaudited consolidated financial statements, the accompanying notes to these financial statements and the accompanying Management's Discussion and Analysis 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). These items have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial reporting and with the instructions to Form 10-Q of Regulation S-X. Accordingly, they do not include all of the disclosures required by GAAP for complete financial statements and as such, these unaudited interim financial statements should be read in conjunction with the Company's 2003 Form 10-K and the 2003 Annual Report to Stockholders. 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 September 30, 2004 and the results of its 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 reclassifications have been made to the prior year results to conform with the current year's presentation.

Insurance Company Acquisition

On June 30, 2003, the Company acquired all of the issued and outstanding stock of GuideOne Life Insurance Company (GuideOne) from GuideOne Financial Group, Inc. and GuideOne Mutual Company. The purchase price of the acquisition was \$59.4 million and added \$393.1 million in assets on the acquisition date, including an identifiable intangible asset called the value of business acquired (VOBA) of \$38.0 million. The financial position and results of operations of GuideOne have been included in these financial statements on a GAAP basis using the purchase method of accounting since July 1, 2003. As of October 1, 2003, GuideOne was merged into Kansas City Life Insurance Company. For segment reporting purposes, GuideOne is included in the Kansas City Life - Individual segment.

Significant Accounting Policies

These significant accounting policies should be read in conjunction with statements and disclosures made in the Company's 2003 Form 10-K as filed with the United States Securities and Exchange Commission.

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

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 and the profitability of the products is dependent on the assumptions used in the pricing of the products. Principal assumptions used in pricing policies and in the establishment of liabilities for future policy benefits are mortality, morbidity, expenses, persistency, investment returns and inflation. Differences between actual experience and assumptions used in the pricing of these policies and in the establishment of liabilities may result in variability of net income.

Policyholder account balances include universal life insurance, fixed deferred annuity contracts and investment-type contracts. The account balances for universal life contracts are equal to cumulative premiums, less contract charges, plus interest credited. The account balances for fixed deferred annuities and investment contracts are equal to the cumulative deposits less any applicable contract charges plus interest credited. The profitability of these products is also dependent on principal assumptions similar to traditional insurance products, and differences between actual experience and pricing assumptions may result in variability of net income.

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. Profit expectations are based upon assumptions of future interest spreads, mortality margins, expense margins and policy and premium persistency experience. These assumptions involve judgment and are compared to actual experience on an ongoing basis. If it is determined that the assumptions related to the profit expectations for interest sensitive and variable insurance products should be revised, the impact of the change is reported in the current period's income as an unlocking adjustment.

When new business is acquired, 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. Similar to DAC, the assumptions regarding future experience can affect the carrying value of VOBA, including interest spreads, mortality, expense

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

margins and policy and premium persistency experience. Significant changes in these assumptions can impact the carrying balance of VOBA and produce changes that must be reflected in the current period's income as an unlocking adjustment.

The Company maintains a diversified securities portfolio. The Company's securities available for sale are carried at fair value in the Company's balance sheet. The Company receives fair values for its securities portfolio from a variety of external sources. Various measures have been taken to manage the portfolio's credit and interest rate risks, as discussed in the Company's 2003 Form 10-K and the 2003 Annual Report to Stockholders. The Company performs a review of its securities' fair values on an ongoing basis to determine changes in the value of the portfolio. Several factors are analyzed in evaluating these securities, including an analysis of the issuing company, its industry, valuation levels and subsequent developments. Based upon these inputs, the Company establishes its securities values in accordance with GAAP.

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 relates to unexpired terms of coverage.

Deposits related to universal life, fixed deferred annuity contracts and investment-type products are credited to policyholder account balances. Revenues from such contracts consist of amounts assessed against policyholder account balances for mortality, policy administration and surrender charges, and are recognized in the period in which the services are provided.

In the normal course of business, the Company cedes risks to other insurers primarily to protect the Company against adverse fluctuations in mortality experience. The Company also assumes risks ceded by other companies. Reinsurance is effected on individual risks and through various pooling arrangements. Business is reinsured primarily through yearly renewable term and coinsurance agreements. Under yearly renewable term insurance, the Company pays annual premiums and the reinsurer reimburses claims paid related to this coverage. Under coinsurance, the reinsurer receives a proportionate share of the premiums less applicable commissions and is liable for a corresponding share of policy benefits. The Company remains contingently liable if the reinsurer should be unable to meet obligations assumed under the reinsurance contract.

Reinsurance recoverable includes amounts related to paid benefits and estimated amounts related to unpaid policy and contract claims, future policy benefits and policyholder account balances. The cost of reinsurance is accounted for over the terms of the underlying reinsured policies using assumptions consistent with those used to account for the policies.

New Accounting Pronouncements

Financial Accounting Standards Board (FASB) Interpretation (FIN) 46, Consolidation of Variable Interest Entities, was issued in January 2003. This is an interpretation of Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements. This interpretation requires the consolidation of entities in which an enterprise absorbs a majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both, as a result of ownership, contractual terms or other financial interests in the entity. This interpretation was adopted July 1, 2003 and had no material impact. Subsequently, in December 2003, the FASB issued a revision known as FIN 46R, which replaces FIN 46. The Company is required to apply FIN 46R to variable interest entities created after December 31, 2003. This revised interpretation was adopted on January 1, 2004, with no material impact.

Statement of Position (SOP) 03-01, Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts, was issued in July 2003 by the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants. The SOP addresses: 1) separate account presentation; 2) accounting for an insurance company's proportionate interest in separate accounts; 3) transfers of assets from the general account to a separate account; 4) valuation of certain insurance liabilities and policy features such as guaranteed minimum death benefits and annuitization benefits; and 5) accounting for sales inducements. This SOP was adopted on January 1, 2004, with no material impact.

In March 2004, the Emerging Issues Task Force reached a consensus on Issue No. 03-1 The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (EITF 03-1). EITF 03-1 provides guidance for determining the meaning of other-than-temporarily impaired and its application to certain debt and equity securities within the scope of Statement of Financial Accounting Standards No. 115

Accounting for Certain Investments in Debt and Equity Securities (SFAS 115) and investments accounted for under the cost method. The guidance requires that investments which have declined in value due to credit concerns or solely due to changes in interest rates must be recorded as other-than-temporarily impaired unless the Corporation can assert and demonstrate its intention to hold the security for a period of time sufficient to allow for a recovery of fair value up to or beyond the cost of the investment, which might mean maturity. This issue also requires disclosures assessing the ability and intent to hold investments in instances in which an investor determines that an investment with a fair value less than cost is not other-than-temporarily impaired. The guidance for evaluating whether an investment is other-than-temporarily impaired is to be applied to reporting periods beginning after June 15, 2004.

On September 8, 2004, the FASB agreed to a FASB Staff Proposal to delay the effective date for the application guidance contained in EITF Issue 03-01. The proposal will be open for comment for 15 days and essentially removed the September 30, 2004 effective date. The effective date of paragraph 16 of this issue, which deals with debt securities that are impaired solely because of interest rate and/or sector spread

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

increases, has been delayed until a FASB staff position addressing this paragraph has been issued.

All other Standards and Interpretations of those Standards issued during 2004 did not relate to accounting policies and procedures pertinent to the Company at this time.

Comprehensive Income

Comprehensive income is comprised of net income and other comprehensive income, which includes unrealized investment gains or losses on securities available for sale and the change in the additional minimum pension liability. For the third quarter, comprehensive income was \$47.5 million in 2004, and comprehensive loss was \$8.0 million in 2003. Excluding the third quarter 2004 net income of \$11.5 million, other comprehensive income was \$35.9 million. This other comprehensive income amount consisted of unrealized investment gains on securities, which was net of reclassification adjustments of investment losses realized in net income, and net of applicable deferred acquisition costs and income taxes.

For the nine months, comprehensive income was \$30.0 million in 2004, and comprehensive income was \$52.7 million for 2003. Excluding the nine months ended 2004 net income of \$24.7 million, other comprehensive income was \$5.3 million. This other comprehensive income amount consisted of unrealized investment gains on securities, which was net of reclassification adjustments of investment losses realized in net income, and net of applicable deferred acquisition costs and income taxes.

Income Per Share

Due to the Company's capital structure and the absence of other potentially dilutive securities, there is no difference between basic and diluted earnings per common share for any of the periods reported. The weighted average number of shares outstanding were 11,928,520 and 11,949,992 for the nine months of 2004 and 2003, respectively.

Income Taxes

The third quarter income tax was an expense of \$3.5 million or 23.1% of income before tax for 2004, versus a benefit \$3.6 million or 85.5% of income before tax for the prior year period. The income tax for the first nine months was an expense of \$7.9 million or 24.3% of income before tax and a benefit of \$10.7 million or 120.4% of loss before tax in 2004 and 2003, respectively.

The income tax rate in both years was reduced by tax credits generated from the Company's investments in affordable housing. The effect of the affordable housing credits on the effective tax rate was a benefit of \$1.5 million or 9.8% of income before tax and a benefit of \$1.1 million or 27.5% for third quarters of 2004 and 2003, respectively. The effect of the affordable housing credits for the first nine months was a benefit of \$3.4 million or 10.5% of income before tax and a benefit of \$2.7 million or 30.1% of loss before tax for 2004 and 2003, respectively.

As necessary, the Company will establish a contingent tax liability to provide for potential challenges by taxing jurisdictions of the Company's tax filings. In 2003, the Company's effective tax rate was reduced by the reversal of a contingent tax liability relating to 1999, a tax year that closed in 2003. The reversal of previously accrued taxes was a benefit of \$3.1 million or 73.8% of income before tax for the third quarter of 2003 and a benefit of \$4.1 million or 45.8% of loss before tax for the first nine months of 2003.

2. SEGMENT INFORMATION

Company operations have been classified and summarized into four reportable segments. The segments, while generally classified along Company lines, are based upon distribution method, product portfolio and target market. The Parent Company is divided into two segments. The Kansas City Life - Individual segment consists of sales of variable life and annuities, interest sensitive products and traditional life insurance products through a nationwide sales force of independent general agents. GuideOne is included in the Kansas City Life - Individual Segment. The Kansas City Life - Group segment consists of sales of group life, disability, stop loss, dental products and administrative services only. Group segment products and services are marketed by a nationwide sales force of independent general agents and group brokers, along with third party marketing arrangements. The Sunset Life segment consists of sales of interest sensitive and traditional products through a nationwide sales force of independent general agents. The Old American segment sells final expense insurance products nationwide through its general agency system with exclusive territories, using direct response marketing to supply agents with leads.

Separate investment portfolios are maintained for each of the companies. However, investments are allocated to the group segment based upon its cash flows. Its investment income is modeled using the year of investment method. Home office functions are fully integrated for the three companies in order to maximize economies of scale. Therefore, operating expenses are allocated to the segments based upon internal cost studies, which are consistent with industry cost methodologies.

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

The following schedule provides, in thousands, the financial performance of each of the four reportable operating segments of the Company.

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

			<u>Kansas City Life</u>	<u>Group</u>	<u>Sunset</u>	<u>Life</u>	<u>Old</u>	<u>American</u>	<u>Total</u>		
Insurance revenues:											
Third quarter:	2004	\$	32,930	\$	10,659	\$	3,744	\$	16,871	\$	64,871
	2003		37,582		13,277		4,552		17,343		72,151
Nine months:	2004	\$	96,108	\$	32,280	\$	10,973	\$	50,883	\$	190,164
	2003		103,672		36,363		12,259		52,045		204,280
Net investment income:											
Third quarter:	2004	\$	38,882	\$	81	\$	6,673	\$	3,238	\$	48,874
	2003		40,788		66		7,078		3,341		51,273
Nine months:	2004	\$	117,120	\$	230	\$	20,859	\$	9,783	\$	147,422
	2003		111,739		220		22,171		10,502		144,530
Net income (loss):											
Third quarter:	2004	\$	8,713	\$	(624)	\$	1,380	\$	2,064	\$	11,533
	2003		4,456		(993)		2,426		1,839		7,628
Nine months:	2004	\$	17,031	\$	(1,974)	\$	5,292	\$	4,301	\$	24,650
	2003		(636)		(2,644)		3,550		1,535		1,279

3. CONTINGENT LIABILITIES

The life insurance industry, including the Company, has been subject to an increase in litigation in recent years. Such litigation has been pursued on behalf of purported classes of policyholders and other claims and legal actions in jurisdictions where juries often award punitive damages, which are grossly disproportionate to actual 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 claims and actions, would have no material effect on the Company's business, results of operations or financial position.

4. 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 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. While we are unable to estimate with certainty the ultimate legal and financial liability with respect to these indemnifications, we believe 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 our business, financial position or results of operations.

5. COMMITMENTS

In the normal course of business the Company has open purchase and sale commitments. At September 30, 2004, the Company had open purchase commitments of \$20.2 million and open sales commitments of \$2.8 million. Subsequent to September 30, 2004, the Company entered into purchase commitments of \$8.4 million. Typically, these purchase and sales commitments are for securities, mortgage loans, real estate, affordable housing and other investments. The ultimate financial impact of these commitments is not presently determinable.

The Company entered into a definitive agreement to sell its bank subsidiary, Generations Bank, for \$10.1 million to Generations Bancorp, with an expected gain on the sale of approximately \$1.9 million. This transaction is subject to regulatory approval by the Office of Thrift Supervision and is expected to close in early 2005.

6. DISCONTINUED OPERATIONS

On October 25, 2004, the Company entered into a definitive agreement to sell its bank subsidiary, Generations Bank, for \$10.1 million to Generations Bancorp, with an expected gain on the sale of approximately \$1.9 million. This transaction is subject to regulatory approval by the Office of Thrift Supervision and is expected to close in early 2005. The bank subsidiary and the results of its operations are not significant to the financial statements of the Company and are not disclosed separately.

7. PENSIONS AND OTHER POSTRETIREMENT BENEFITS

Components of net periodic benefit cost:

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

	<u>Pension Benefits</u>		<u>Other Benefits</u>	
	Quarter ended		Quarter ended	
	September 30		September 30	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Service cost	\$ 554	\$ 584	\$ 193	\$ 189
Interest cost	1,821	1,804	376	352
Expected return on plan assets	(1,856)	(1,610)	(17)	(19)
Amortization of:				
Unrecognized net loss	718	830	23	7
Unrecognized prior service cost	(162)	(162)	-	-
Net periodic benefit cost	<u>\$ 1,075</u>	<u>\$ 1,446</u>	<u>\$ 575</u>	<u>\$ 529</u>

	<u>Pension Benefits</u>		<u>Other Benefits</u>	
	Nine Months ended		Nine Months ended	
	September 30		September 30	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Service cost	\$ 1,661	\$ 1,751	\$ 579	\$ 566
Interest cost	5,462	5,411	1,127	1,055
Expected return on plan assets	(5,568)	(4,831)	(50)	(57)
Amortization of:				
Unrecognized net loss	2,153	2,491	69	20
Unrecognized prior service cost	(485)	(485)	-	-
Net periodic benefit cost	<u>\$ 3,223</u>	<u>\$ 4,337</u>	<u>\$ 1,725</u>	<u>\$ 1,584</u>

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) was signed into law. This Act introduces a prescription drug benefit under Medicare (Medicare Part D), as well as a federal subsidy to sponsors of retiree health benefits. On May 19, 2004, the FASB issued Staff Position No. 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug Modernization Act of 2003* (FSP 106-2). FSP 106-2 provides guidance on the accounting for the effects of the Act. In accordance with the deferral provision of FSP 106-2, our benefit obligations and net periodic postretirement benefit costs do not reflect any amount associated with the subsidy as we have not determined that the benefits provided by the plan are actuarially equivalent to Medicare. The adoption of FSP No. 106-2 is not expected to have a material effect on the Company's consolidated financial statements.

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

Cautionary Statement on Forward-Looking Information

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

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

- Changes in general economic conditions, including the performance of financial markets and interest rates;
- Increasing competition, which may affect the Company's ability to sell its products;
- Customer and agent response to new products, distribution channels and marketing initiatives;
- Fluctuations in experience regarding current mortality, morbidity, persistency and interest rates relative to expected amounts used in pricing the Company's products;
- Changes in assumptions related to deferred acquisition costs and the value of business acquired;
- Regulatory, accounting or tax changes that may affect the cost of, or the demand for, the Company's products or services;

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

- Unanticipated changes in industry trends and ratings assigned by nationally recognized rating organizations.

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

Consolidated Results of Operations

In the third quarter of 2004, the Company's net income increased \$3.8 million versus the prior year, to a total of \$11.5 million. Net income per share increased to \$0.97 per share versus \$0.65 per share in last year's third quarter. For the first nine months of 2004, net income increased \$22.8 million to equal \$24.7 million, and net income per share increased to \$2.07 per share compared to \$0.15 per share in the prior year. The largest factor in the increase was the improvement in realized investment gains and losses. In the third quarter of 2004, the Company recorded realized investment gains of \$2.8 million, a \$7.9 million increase over the prior year's third quarter loss. For the nine months of 2004, net realized investment gains totaled \$4.3 million, versus a net realized investment loss of \$36.1 million in the prior year. This improvement was primarily the result of a general improvement in the overall economy and credit markets compared with the prior year. Additionally, increased invested assets, which resulted from the acquisition of GuideOne and the sizable sales of annuity products in the prior year, contributed to the improved net investment income for the nine months. This increase in the volume of assets more than offset the negative effect of lower interest rates. Also, contributing to the improved results was improved mortality, as seen through decreased death benefits. Partially offsetting these improvements was a decrease in premiums, an increase in amortization of deferred acquisition costs, and an increase in income taxes (primarily due to prior year reversal of an accrued contingent tax liability).

Sales

The Company measures sales in terms of new premiums and deposits. Premiums are included in insurance revenues in the Consolidated Statements of Income, while deposits are shown in the Consolidated Statements of Cash Flows. The first set of tables below reconciles premiums included in insurance revenues and provides detail by new and renewal business. New premiums are also detailed by product. The second set of tables reconciles deposits with the Consolidated Statements of Cash Flows and provides detail by new and renewal deposits. New deposits are also detailed by product.

There was a decline in premiums and deposits from 2003, which was largely the result of decreases in sales of deferred and immediate annuities. These declines were due to a change in consumer preferences for fixed-rate products in the low interest rate environment and changes made by the Company to its deferred and immediate annuity products and distribution efforts. In August of 2003, the Company introduced a new deferred annuity with lower interest guarantees that replaced previous products. In addition, the Company has refocused its distribution efforts on agencies that write a balanced mix of life and annuity products, which has resulted in a lower volume of annuity sales.

For the third quarter, new premiums declined 41%, primarily due to a 51% decrease in immediate annuity sales. New premiums for the nine months decreased 36% versus last year, primarily due to a 63% decrease in the sale of immediate annuities. These sales have been generally slowing since the second half of 2003, due in part to the Company's emphasis on life insurance sales and changes in the marketplace.

Individual life insurance sales increased 8% for the third quarter and 14% for the nine months versus 2003. For the third quarter, group life sales decreased 67% and group accident and health premiums declined 29%. For the nine months, group life sales decreased 23%, and group accident and health sales increased 15%. Third party marketing arrangements continue to generate sales in both the long-term disability and stop loss lines. Renewal premiums declined 1% for the third quarter but grew 2% in the nine months.

	<u>Quarter ended September 30</u>			
	<u>2004</u>	<u>% chg</u>	<u>2003</u>	<u>% chg</u>
New premiums:				
Individual life insurance	\$ 3,312	8	\$ 3,054	3
Immediate annuities	5,553	(51)	11,239	333
Group life insurance	306	(67)	922	251
Group accident and health insurance	2,550	(29)	3,575	5
Individual accident and health insurance	<u>98</u>	<u>(93)</u>	<u>1,362</u>	<u>-</u>
Total new premiums	11,819	(41)	20,152	118
Renewal premiums	<u>37,390</u>	<u>(1)</u>	<u>37,808</u>	<u>3</u>
Total premiums	<u>\$ 49,209</u>	<u>(15)</u>	<u>\$ 57,960</u>	<u>26</u>

	<u>Nine Months ended September 30</u>			
	<u>2004</u>	<u>% chg</u>	<u>2003</u>	<u>% chg</u>
New premiums:				
Individual life insurance	\$ 9,508	14	\$ 8,377	(7)

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

Immediate annuities	11,860	(63)	31,675	507
Group life insurance	1,117	(23)	1,447	70
Group accident and health insurance	9,721	15	8,463	(6)
Individual accident and health insurance	<u>406</u>	(70)	<u>1,362</u>	-
Total new premiums	32,612	(36)	51,324	113
Renewal premiums	<u>110,967</u>	2	<u>108,266</u>	(3)
Total premiums	<u>\$143,579</u>	(10)	<u>\$159,590</u>	17

Total new deposits declined 59% for the third quarter and 41% for the nine months, largely due to fixed deferred annuity sales which decreased 66% in the third quarter and 53% for the nine months. As mentioned earlier, sales declined for both immediate and fixed deferred annuities due to the large sales volume in 2003. New deposits on universal life products increased 10% in the third quarter and 23% for the nine months. For the third quarter, new variable annuities decreased 37% and new variable universal life sales decreased 6%. For the nine months, variable annuity deposits declined 9% and variable universal life deposits increased 7%. Sales of variable products has remained slow during both the quarter and the nine months, reflecting the current year negative performance of the equity markets. Renewal deposits increased 7% for the third quarter and 12% for the nine months.

	<u>Quarter ended September 30</u>			
	<u>2004</u>	<u>% chg</u>	<u>2003</u>	<u>% chg</u>
New deposits:				
Universal life insurance	\$ 2,536	10	\$ 2,300	101
Variable universal life insurance	651	(6)	689	(46)
Fixed deferred annuities	18,592	(66)	55,158	136
Variable annuities	<u>6,931</u>	(37)	<u>11,079</u>	131
Total new deposits	28,710	(59)	69,226	126
Renewal deposits	<u>37,920</u>	7	<u>35,358</u>	12
Total deposits	<u>\$ 66,630</u>	(36)	<u>\$ 104,584</u>	69

	<u>Nine Months ended September 30</u>			
	<u>2004</u>	<u>% chg</u>	<u>2003</u>	<u>% chg</u>
New deposits:				
Universal life insurance	\$ 8,083	23	\$ 6,589	32
Variable universal life insurance	2,632	7	2,462	(60)
Fixed deferred annuities	56,197	(53)	118,319	109
Variable annuities	<u>23,133</u>	(9)	<u>25,489</u>	46
Total new deposits	90,045	(41)	152,859	80
Renewal deposits	<u>115,675</u>	12	<u>103,445</u>	3
Total deposits	<u>\$ 205,720</u>	(20)	<u>\$ 256,304</u>	38

Insurance Revenues

Insurance revenues consist of premiums and contract charges, less reinsurance ceded. Insurance revenues decreased 12% in the third quarter and 7% in the first nine months, largely due to the decrease in immediate annuity premiums. Life insurance premiums grew 5% in the third quarter and 8% for the nine months. Individual life premiums include premiums from the GuideOne acquisition for the nine months in 2004 but only one quarter's results for 2003, consistent with the purchase at June 30, 2003. Sales of traditional life products reflected positive growth for the quarter and nine months. Annuity sales declined 51% in the third quarter and 63% for the nine months. Annuity sales were exceptionally strong in the first half of 2003. Subsequently, the Company has placed more emphasis on life insurance. Accident and health premiums decreased 28% for the third quarter and 7% for the nine months. This decline was the result of two factors. First, the purchase of GuideOne brought with it a student accident and health insurance product that the Company elected to discontinue. Secondly, the Company terminated a group dental third party marketing arrangement effective with year end 2003. In addition, in late 2003, the Company signed an agreement with another third party marketing provider, principally to sell disability products to broaden and strengthen these lines. Total premiums decreased 15% in the third quarter and 10% for the nine months.

Contract charges decreased 3% for the third quarter but increased 8% for the nine months. The increase for the nine months resulted from the addition of GuideOne's portfolio of universal life and annuity products. Reinsurance ceded decreased 7% in the third quarter but rose 12% in the nine months.

Insurance revenues may be affected by the persistency of policyholders, which may be influenced by economic conditions, as well as competitive forces and fluctuations in mortality experience. The Company's persistency and mortality experience have been and continue to be

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

consistent with expectations assumed in pricing over time. However, the continued volatility of the financial markets influences consumers preferences. Consumers continue to desire a broad portfolio of products with safety and competitive return objectives, which the Company strives to provide. The Company's full range of products, including its variable insurance products, allows policyholders to participate in both the equity and fixed income markets; and, interest sensitive and traditional insurance products combine safety of principal with competitive interest returns.

Investment Revenues

Net investment income decreased 5% in the third quarter but increased 2% for the nine months. While the Company's overall yield declined due to lower available market yields, the Company's investable assets were greater than a year ago due to both the acquisition of GuideOne and the significant volume of sales of annuity products in the prior year.

As discussed above, the Company recorded realized investment gains for the third quarter of \$2.8 million. This was a \$7.9 million improvement over realized investment losses of \$5.1 million in the prior year. The Company recorded realized investment gains for the nine months of \$4.3 million, a \$40.5 million improvement over a loss of \$36.1 million one year earlier. The Company continues to enhance its portfolio quality while seeking to maximize its overall returns. The overall improvement in the economy and credit markets have been the primary reason for the decline in realized losses. The following table provides detail concerning realized investment gains and losses for the third quarter and nine-month periods of 2004 and 2003.

	Quarter ended		Nine Months ended	
	September 30		September 30	
	2004	2003	2004	2003
Realized Investment Gains and Losses				
Gross gains resulting from:				
Sales of investment securities	\$ 2,306	\$ 504	\$ 6,965	\$ 5,211
Investment securities called	337	870	686	1,811
Sales of real estate	2,555	81	4,145	1,211
Total gross gains	<u>5,198</u>	<u>1,455</u>	<u>11,796</u>	<u>8,233</u>
Gross losses resulting from:				
Sales of investment securities	(2,268)	(6,851)	(6,049)	(16,021)
Write-downs of investment securities	-	(330)	(555)	(28,571)
Investment securities called	(114)	(59)	(1,123)	(501)
Total gross losses	<u>(2,382)</u>	<u>(7,240)</u>	<u>(7,727)</u>	<u>(45,101)</u>
Amortization of deferred acquisition costs	(7)	656	267	73
Realized investment gains (losses)	<u>\$ 2,809</u>	<u>\$ (5,129)</u>	<u>\$ 4,336</u>	<u>\$ (36,131)</u>

The Company regularly evaluates the quality of its investment portfolio. Occasionally, in a diversified portfolio, certain investments may suffer market price deterioration due to a wide variety of factors. Distressed securities are placed onto watch lists that are then further analyzed to identify any specific securities that the Company believes may have experienced other than temporary declines in fair value. To the extent that the Company believes these fluctuations represent an other than temporary decline in value, the value of the investment is adjusted by charging off the loss against income. The Company's analysis identified no securities with other than temporary impairment in the third quarter and only \$0.6 million in other than temporary declines in value in the nine months. For the nine month period of 2003, the Company recorded \$28.6 million in other than temporary declines in value, which were largely due to investments in the airline industry.

The interest rate environment experienced volatility during the quarter and ended with rates trending down, which resulted in a general increase in market values at September 30, 2004. At the end of third quarter 2004 and at year-end 2003, the Company had investments of \$1.0 billion in fair value that had unrealized losses. The unrealized losses were \$21.2 million and \$28.9 million as of these dates, respectively.

Policyholder Benefits and Interest Credited to Policyholder Account Balances

Total policyholder benefits and interest credited to policyholder account balances decreased 15% or \$12.1 million in the third quarter and 6% or \$12.4 million in the nine months. Policyholder benefits decreased in the nine months largely due to lower immediate annuity sales, which resulted in lower required reserves. This decline was partially offset by an increase in individual death benefit payments, primarily due to the GuideOne acquisition and other benefits.

Interest credited to policyholder account balances increased 5% in the third quarter and 10% in the nine months. The increase for the nine-month period is largely the result of interest credited on policyholder account balances received in the GuideOne acquisition.

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

For the third quarter of 2004, the amortization of DAC was \$8.3 million compared with \$8.0 million for 2003. The amortization of DAC for the nine months totaled \$24.9 million in 2004 versus \$23.3 million in 2003. The nine months increase is largely due to the unlocking of DAC

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

assumptions in 2003, which reduced the amortization of DAC by \$1.8 million. The Company evaluates the assumptions used in the amortization of deferred acquisition costs on a regular basis. As warranted by a combination of historical results and expected future trends, the Company unlocks these assumptions and accordingly increases or decreases the deferred acquisition costs. For the first nine months of 2004, the unlocking of DAC assumptions was not material to the financial statements and for the third quarter, 2004, the Company did not unlock any DAC assumptions.

The amortization of VOBA was \$1.8 million in the third quarter of 2004 and \$1.9 million for the same period in 2003. VOBA amortization was \$5.4 million for the first nine months of 2004 compared to \$5.1 million in 2003. Additional VOBA of \$38.0 million was established on June 30, 2003 due to the acquisition of GuideOne.

Operating Expenses

Operating expenses decreased 3% in the third quarter of 2004 but were flat for the nine months due to the partial year impact of GuideOne in 2003. The Company's consolidation of the GuideOne operations into the home office is on schedule and is targeted to be completed in the fourth quarter. Certain cost savings have been achieved thus far through staffing consolidations and reductions.

Income Taxes

The third quarter income tax was an expense of \$3.5 million or 23.1% of income before tax for 2004, versus a benefit of \$3.6 million or 85.5% of income before tax for the prior year period. The income tax for the first nine months was an expense of \$7.9 million or 24.3% of income before tax and a benefit of \$10.7 million or 120.4% of loss before tax in 2004 and 2003, respectively.

The income tax rate in both years was reduced by tax credits generated from the Company's investments in affordable housing. The effect of the affordable housing credits on the effective tax rate was a benefit of \$1.5 million or 9.8% of income before tax and a benefit of \$1.1 million or 27.5% for the third quarters of 2004 and 2003, respectively. The effect of the affordable housing credits for the first nine months was a benefit of \$3.4 million or 10.5% of income before tax and a benefit of \$2.7 million or 30.1% of loss before tax for 2004 and 2003, respectively.

As necessary, the Company will establish a contingent tax liability to provide for potential challenges by taxing jurisdictions of the Company's. In 2003, the Company's effective tax rate was reduced by the reversal of a contingent tax liability relating to 1999, a tax year that closed in 2003. The reversal of previously accrued taxes was a benefit of \$3.1 million or 73.8% of income before tax for the third quarter of 2003 and a benefit of \$4.1 million or 45.8% of loss before tax for the first nine months of 2003.

Operating Results by Segment

The following schedules provide key supplemental financial information for each of the Company's four reportable operating segments for the first quarters and first nine months of 2004 and 2003 and are reconciled to the financial statements contained herein (in thousands):

	Kansas City Life		Sunset	Old
	<u>Individual</u>	<u>Group</u>	<u>Life</u>	<u>Americ</u>
2004 (third quarter):				
Premiums:				
New premiums	\$ 6,968	\$ 2,856	\$ 87	\$ 1,9
Renewal premiums	<u>8,751</u>	<u>10,713</u>	<u>1,458</u>	<u>16,4</u>
Total premiums	15,719	13,569	1,545	18,3
Contract charges	23,112	-	5,685	
Reinsurance ceded	<u>(5,901)</u>	<u>(2,910)</u>	<u>(3,486)</u>	<u>(1,5</u>
Total insurance revenues	<u>\$ 32,930</u>	<u>\$ 10,659</u>	<u>\$ 3,744</u>	<u>\$ 16,8</u>
Net investment income	38,882	81	6,673	3,2
Realized investment gains (losses)	3,115	-	(192)	(1
Other revenues	1,137	556	294	(
Policyholder benefits and interest credited to policyholder account balances	46,308	7,440	5,630	10,5
Expenses and taxes	<u>21,043</u>	<u>4,480</u>	<u>3,509</u>	<u>7,3</u>
Net income (loss)	<u>\$ 8,713</u>	<u>\$ (624)</u>	<u>\$ 1,380</u>	<u>\$ 2,0</u>
Deposits:				
New deposits	\$ 27,487	\$ -	\$ 1,223	\$
Renewal deposits	<u>30,796</u>	<u>-</u>	<u>7,124</u>	<u>-</u>
Total deposits	<u>\$ 58,283</u>	<u>\$ -</u>	<u>\$ 8,347</u>	<u>\$</u>

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

	Kansas City Life		Sunset	Old
	<u>Individual</u>	<u>Group</u>	<u>Life</u>	<u>Americ</u>
2003 (third quarter):				
Premiums:				
New premiums	\$ 13,010	\$ 4,491	\$ 712	\$ 1,9
Renewal premiums	8,637	10,789	1,338	17,0
Total premiums	21,647	15,280	2,050	18,9
Contract charges	23,745	-	5,833	
Reinsurance ceded	(7,810)	(2,003)	(3,331)	(1,6
Total insurance revenues	\$ 37,582	\$ 13,277	\$ 4,552	\$ 17,3
Net investment income	40,788	66	7,078	3,3
Realized investment gains (losses)	(3,295)	-	(1,193)	(6
Other revenues	1,746	657	47	
Policyholder benefits and interest credited to policyholder account balances	54,670	9,908	6,100	11,3
Expenses and taxes	17,695	5,085	1,958	6,9
Net income (loss)	\$ 4,456	\$ (993)	\$ 2,426	\$ 1,8

Deposits:				
New deposits	\$ 66,132	\$ -	\$ 3,094	\$
Renewal deposits	28,113	-	7,245	
Total deposits	\$ 94,245	\$ -	\$ 10,339	\$

	Kansas City Life		Sunset	Old
	<u>Individual</u>	<u>Group</u>	<u>Life</u>	<u>Americ</u>
2004 (nine months):				
Premiums:				
New premiums	\$ 16,046	\$ 10,838	\$ 300	\$ 5,4
Renewal premiums	27,369	29,484	4,155	49,9
Total premiums	43,415	40,322	4,455	55,3
Contract charges	70,180	-	17,147	
Reinsurance ceded	(17,487)	(8,042)	(10,629)	(4,5
Total insurance revenues	\$ 96,108	\$ 32,280	\$ 10,973	\$ 50,8
Net investment income	117,120	230	20,859	9,7
Realized investment gains (losses)	4,448	-	220	(3
Other revenues	3,647	1,828	718	
Policyholder benefits and interest credited to policyholder account balances	140,318	22,633	16,750	33,7
Expenses and taxes	63,974	13,679	10,728	22,2
Net income (loss)	\$ 17,031	\$ (1,974)	\$ 5,292	\$ 4,3

Deposits:				
New deposits	\$ 86,408	\$ -	\$ 3,637	\$
Renewal deposits	92,307	-	23,368	
Total deposits	\$ 178,715	\$ -	\$ 27,005	\$

	Kansas City Life		Sunset	Old
	<u>Individual</u>	<u>Group</u>	<u>Life</u>	<u>Americ</u>
2003 (nine months):				
Premiums:				
New premiums	\$ 34,947	\$ 9,904	\$ 1,177	\$ 5,2
Renewal premiums	21,304	31,003	4,091	51,8
Total premiums	56,251	40,907	5,268	57,1
Contract charges	63,687	-	17,256	
Reinsurance ceded	(16,266)	(4,544)	(10,265)	(5,1
Total insurance revenues	\$ 103,672	\$ 36,363	\$ 12,259	\$ 52,0

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

Net investment income	111,739	220	22,171	10,5
Realized investment gains (losses)	(26,142)	-	(6,083)	(3,9
Other revenues	4,854	2,170	258	
Policyholder benefits and interest credited to policyholder account balances	144,738	26,500	17,774	36,8
Expenses and taxes	<u>50,021</u>	<u>14,897</u>	<u>7,281</u>	<u>20,3</u>
Net income (loss)	<u>\$ (636)</u>	<u>\$ (2,644)</u>	<u>\$ 3,550</u>	<u>\$ 1,5</u>
Deposits:				
New deposits	\$ 140,164	\$ -	\$ 12,695	\$
Renewal deposits	<u>81,406</u>	<u>-</u>	<u>22,039</u>	<u>-</u>
Total deposits	<u>\$ 221,570</u>	<u>\$ -</u>	<u>\$ 34,734</u>	<u>\$</u>

Kansas City Life Insurance Company - Individual Insurance

Insurance revenues for this segment decreased 12% in the third quarter and 7% in the nine months, primarily reflecting a decline in immediate annuity premiums. New premiums decreased 54% for the nine months compared with a year ago, again primarily due to a 62% decrease in sales of immediate annuity premiums. New individual life premiums increased 46%.

For the nine months new deposits decreased 38%, reflecting the decrease in fixed and variable annuity sales. However, new deposits for universal life increased 47% and variable universal life increased 7%.

Contract charges decreased 3% in the third quarter but increased 10% for the nine months. The increase in the nine months was largely due to the addition of the GuideOne portfolio of universal life and annuity products.

Net investment income for this segment declined 5% for the third quarter but increased 5% for the nine months. The increase for the year reflects the growth in investable assets from the prior year due to the GuideOne acquisition and sales growth, more than offsetting the impact of a declining interest rate environment in recent periods. Realized investment gains totaled \$3.1 million in the third quarter and \$4.4 million for the nine months of 2004. This is an improvement of \$6.4 million over the third quarter of 2003 and \$30.6 million over the first nine months of 2003.

Policyholder benefits and interest credited to policyholder account balances decreased 15% in the third quarter and 3% for the nine months relative to 2003 results. Other benefits, which are included in policyholder benefits, declined 4% for the third quarter but increased 17% for the nine months compared with 2003. The increase in other benefits is due, in part, to the high volume of immediate annuity sales in 2003. Surrender benefits, which are part of policyholder benefits, declined 14% in the third quarter and 6% for the nine months compared with 2003. Interest credited to policyholder account balances was flat in the third quarter and increased 11% in the nine months. The increase in the nine months was driven from the GuideOne acquired block of business, which added nearly \$280 million in policyholder account balances as of June 30, 2003. Thus, there were nine months of interest crediting on the GuideOne business acquired during 2004 versus only three months during 2003.

The amortization of deferred acquisition cost increased 8% in the third quarter and 7% for the nine months compared with 2003. This increase is primarily the result of unlocking DAC assumptions in the prior year's second quarter of \$1.3 million. The Company regularly evaluates the assumptions used in the amortization of DAC and unlocks the assumptions when warranted.

Net income for this segment increased \$4.3 million in the third quarter and \$17.7 million for the nine months versus 2003. As discussed above, these improvements were largely due to the change in realized investment gains and losses.

Kansas City Life Insurance Company - Group Insurance

Insurance revenues for the Group insurance segment decreased 20% in the third quarter and 11% for the nine months. These decreases were largely attributable to lower premiums in the dental line, which terminated a large third party marketing arrangement at December 31, 2003. However, the Company's other third party marketing arrangements produced strong sales of long-term disability products and stop loss products. Direct premiums from the long-term disability line increased \$2.0 million over the nine months last year. The stop loss line, which was reintroduced as a new product in the fourth quarter of 2003, generated \$2.0 million in premiums in the first nine months of 2004. The Company has used reinsurance in several of its group product lines to achieve improved profitability. Reinsurance on premiums increased 77% versus 2003, primarily as a result of changes in the long-term disability and stop loss lines.

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

Policyholder benefits decreased 25% in the third quarter and 15% in the nine months of 2004 compared with 2003. These decreases were primarily due to increased reinsurance ceded benefits on group disability and stop loss insurance and decreased dental benefit payments due to the terminated third party marketing arrangement. Overall, the claims ratio (total benefits divided by total insurance revenues) for this segment improved versus last year, falling from 73% in 2003 to 70% in 2004.

For the third quarter of 2004, the net loss decreased \$0.4 million to \$0.6 million. In the first nine months of 2004, the net loss decreased \$0.7 million to \$2.0 million.

Sunset Life Insurance Company of America

Insurance revenues for this segment decreased 18% in the third quarter and 11% for the nine months compared with 2003. Total life and annuity premiums decreased 25% for the third quarter and 15% for the nine months, largely due to reduced immediate annuity sales.

Net investment income declined 6% in both the third quarter and nine months compared with 2003, as a result of declines in both investable assets and the lower interest rate environment. However, realized investment losses for the third quarter improved \$1.0 million versus last year's third quarter. In the nine months, realized investment gains of \$0.2 million were a \$6.3 million improvement over a realized investment loss of \$6.1 million experienced during 2003.

Policyholder benefits decreased 8% for the third quarter and 6% for the nine months, in large part due to improved mortality. Additionally, insurance operating expenses declined for the nine-month period, primarily due to the release of an accrued expense associated with a legal settlement from 2001.

Net income for this segment was \$1.4 million in the third quarter, a \$1.0 million decrease from 2003. The improvement of realized investment gains was offset by the decrease in insurance revenues discussed above. However, the change in net income for the third quarter period was largely due to the tax benefit of \$1.5 million recorded in 2003, from the reversal of an accrued contingent tax liability. Net income for the nine months totaled \$5.3 million, a \$1.7 million improvement versus the prior year period. As discussed above, this increase was largely the result of the change in realized investment gains.

Old American Insurance Company

Insurance revenues decreased 3% in the third quarter and 2% in the nine months. New life premiums in this segment decreased 2% in the third quarter but increased 2% in the nine months. Renewal life premiums decreased 3% in both the third quarter and nine months. Policyholder benefits decreased 7% for the third quarter versus a year ago and 8% for the nine months compared with 2003, largely due to improved mortality experience.

Net investment income declined 3% in the third quarter and 7% for the nine months compared with 2003, as a result of declines in both investable assets and the recent interest rate environment. However, realized investment losses declined \$0.5 million in the third quarter of 2004 and \$3.6 million for the nine months compared with 2003.

Net income for this segment was \$2.1 million in the third quarter, an increase from \$1.8 million in the prior year. Net income for the nine months increased \$3.6 million versus the prior year to total \$4.3 million. This change largely reflected reduced realized losses and improved mortality experience.

Liquidity and Capital Resources

Liquidity

Statements made in the Company's Form 10-K and the 2003 Annual Report to Stockholders remain pertinent, as the Company's liquidity position is materially unchanged from year-end.

The Company and each insurance subsidiary meet liquidity requirements primarily through positive cash flows from operations. The Company has sufficient sources of liquidity to satisfy operational requirements. Primary sources of cash flow are premiums, other insurance considerations and deposits, receipts for policyholder accounts, investment sales and maturities, investment income and access to credit from other financial institutions. The principal uses of cash are for the insurance operations, including the purchase of investments, payments of insurance benefits, operating expenses, withdrawals from policyholder accounts, costs related to acquiring new business, dividends and income taxes.

Cash provided from operations totaled \$27.2 million for the nine months ended September 30, 2004, down from \$54.8 million a year ago. This decrease is primarily the result of a decline in premiums for the first nine months. As described above, premiums decreased from 2003 levels for immediate annuities, group accident and health (specifically related to the terminated marketing arrangement) and individual accident and health.

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

Net cash used in investing activities was \$58.0 million for the nine months, which was down from \$183.2 million in 2003. Cash resulting from investment maturities and principal paydowns declined \$219.7 million versus the prior year. This, combined with the decline in both immediate and fixed deferred annuity sales, has significantly reduced the amount available for purchases of investments. Purchases of investment securities declined \$243.8 million versus the prior year. Purchases of other investments has declined \$71.4 million, as the funding of mortgage loans and investment in real estate have decreased. Finally, the net cash used in the GuideOne acquisition in 2003 totaled \$52.3 million.

Net cash provided from financing activities was \$11.2 million in 2004, versus \$132.9 million in 2003. This decrease is primarily the result of three factors. First, reduced deposits on policyholder contracts resulted in decreased cash flow of \$50.6 million. Second, withdrawals on policyholder account balances increased \$25.4 million. And, third, the Company reduced its outstanding borrowings by \$26.2 million versus 2003. In addition, the Company also had a reduction in the proceeds from borrowings of \$12.3 million versus 2003.

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

Debt and Short-term Borrowing

The Company and certain subsidiaries have access to borrowing capacity through their membership affiliation with the Federal Home Loan Bank. At September 30, 2004, outstanding balances under this agreement totaled \$91.1 million in maturities of less than one year. The primary purpose for these borrowings is to ensure access to liquidity. This is accomplished through the purchase of highly liquid, marketable securities from the proceeds of these borrowings.

The Company established a two-year note payable for \$2.0 million associated with the GuideOne purchase, due in June 2005. Outstanding borrowings of \$17.3 million are related to real estate ownership, and the Company has one construction loan totaling \$0.5 million.

Borrowings totaled \$110.9 million at September 30, 2004, down \$22.8 million from year-end 2003. The Company has unsecured revolving lines of credit of \$60 million with two major commercial banks with no balances outstanding.

Capital Resources

The Company considers existing capital resources to be more than adequate to support the current level of business activities.

The following table shows the capital adequacy for the Company.

	September 30 <u>2004</u>	December 31 <u>2003</u>
Total assets less separate accounts	\$ 4,281,663	\$ 4,247,221
Total stockholders' equity	665,159	644,438
Ratio of stockholders' equity to assets less separate accounts	16%	15%

The ratio of equity to assets less separate accounts has remained relatively constant, as identified above. Unrealized investment gains on available for sale securities, which are included as a part of stockholders' equity, totaled \$52.2 million at September 30, 2004 (net of related taxes, policyholder account balances and deferred acquisition costs), a \$5.3 million increase from year-end 2003. This change is the result of an increase in interest rates during the year.

Stockholders' equity increased \$20.7 million from year-end. This increase is primarily the result of an increase in retained earnings, reflecting the increased net income during 2004. Consolidated book value per share equaled \$55.72 at September 30, 2004, a 3% increase from year-end 2003.

During the first nine months of 2004, the Company did not purchase any of its shares under the stock repurchase program. Under this program, the Company may purchase up to one million shares on the open market during 2004.

On October 25, 2004, the Board of Directors declared a quarterly dividend of \$0.27 per share, unchanged from the prior year, that will be paid November 22, 2004 to stockholders of record as of November 8, 2004.

Current legislative activities are not expected to have a significant impact on the ongoing operations of the Company.

Asset/Liability Management

Kansas City Life's asset/liability management programs and procedures involve the monitoring of asset and liability durations for various product

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

lines, cash flow testing under various interest rate scenarios to evaluate the potential sensitivity of assets and liabilities to interest rate movements, and the continuous rebalancing of assets and liabilities with respect to yield, risk, and cash flow characteristics.

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

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

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

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Statements made in the Company's Form 10-K and the 2003 Annual Report to Stockholders regarding the market and interest rate risk analysis remain pertinent.

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

Interest rate risk arises from the price sensitivity of investments to changes in interest rates. Coupon and dividend income represent the greatest portion of an investment's total return for most fixed income instruments in stable interest rate environments. The changes in the fair market price of such investments are inversely related to changes in market interest rates. As interest rates fall, the coupon and dividend streams of existing fixed rate investments become more valuable and market values rise. As interest rates rise, the opposite effect occurs.

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

As interest rates rise, policyholders may become more likely to surrender policies or to borrow against cash values, often to meet sudden needs in an inflationary environment or to invest in higher yielding opportunities elsewhere. This risk of disintermediation may force the Company to liquidate parts of its portfolio at a time when the fair market value of fixed income investments is falling. If interest rates fall, the Company may also be forced to invest new cash receipts at levels below the minimum guaranteed rates payable to policyholders, eroding profit margins. The Company can usually adapt to small sudden changes in interest rates, or even large changes that occur over longer periods of time. Cash flow may increase or decrease over the course of the business cycle. Therefore, the Company takes steps to ensure that adequate liquidity is available to meet obligations in a timely manner. To this end, the Company maintains lines of credit with commercial banks and other short-term borrowing arrangements with financial institutions.

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

The majority of the Company's investments are exposed to varying degrees of credit risk. Credit risk is the risk that the value of the investment may decline due to deterioration in the financial strength of the issuer and that the timely payment of principal or interest might not occur.

In recent years, credit defaults in the marketplace have increased significantly relative to historical norms. The increase in the default rate has been attributed to several factors, including the economic slowdown experienced by the U.S. economy, the increased use of leverage by corporate issuers, fraud and adverse legal judgments against corporations, among others. A default by a rated issuer usually involves some loss of principal to the investor, as evidenced by the write-downs taken by the Company. 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.

The Company mitigates credit risk by diversifying the investment portfolio across a broad range of issuers, investment sectors and security types, and by limiting the amount invested in any particular entity. With the exception of certain GSEs, there is no exposure to any single issuer greater than one percent of assets on a book value basis. The Company also invests in securities carrying a lien against physical assets. These securities can improve the likelihood of payment according to contractual terms and increase recovery amounts in the case of bankruptcy or restructuring.

As market interest rates fluctuate, so will the value of the Company's investment portfolio and its stockholders' equity. At September 30, 2004, the Company had an unrealized investment gain of \$52.2 million (net of related taxes, policyholder account balances and deferred acquisition costs), compared to \$46.9 million at year-end 2003. This increase is primarily the result of changes in the term structure of interest rates and the tightening in credit spreads within the corporate bond market. The Company continues its practice of the limited use of derivatives as a form of risk mitigation.

The Company markets certain variable products. The policyholder assumes essentially all the investment earnings risk for the portion of the account balance invested in the separate accounts. However, the Company assesses certain charges based on the policy account values and changes to the account values can affect the Company's earnings. The portion of the policyholder's account balance invested in the fixed general account, if any, is affected by the spreads between interest yields on investments and rates credited to the policyholder's accounts.

Item 4. Controls and Procedures

(a) *Evaluation of disclosure controls and procedures.* The Chief Executive Officer and Chief Financial Officer of Kansas City Life Insurance Company have concluded, based on their evaluation as of the end of the period covered by this report, that the Company's disclosure controls and procedures are effective for gathering, analyzing and disclosing the information the Company is required to disclose in the Company's reports under the Securities Exchange Act of 1934.

(b) *Changes in internal controls.* There were no significant changes in the Company's internal controls over financial reporting or in other factors that could significantly affect those controls made during the quarter covered by this report, that have, or are reasonably likely to materially affect the Company's internal control over financial reporting.

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.

In addition to the above, the Company and its subsidiaries are defendants in, or subject to other claims or legal actions. 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 have no material effect on the Company's business, results of operations or financial position.

Item 5. Other Information

3520 Broadway, Kansas City, MO 64111

Contact: Tracy W. Knapp, Chief Financial
(816) 753-7299, Extension

For Immediate Release: November 5, 2004, press release reporting financial results for the third quarter of 2004.

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

Kansas City Life Announces Third Quarter 2004 Results

Kansas City Life Insurance Company recorded an increase in third quarter net income of 49% to \$11.5 million or \$0.97 per share relative to the third quarter of 2003. The Company posted net income of \$24.7 million or \$2.07 per share for the nine months ended September 30, 2004, an improvement of \$22.8 million from the prior year. The largest factor contributing to the improved results was the favorable change in realized investment gains and losses. In addition, increased investment income from growth in invested assets enhanced the Company's year-to-date results.

The Company recognized realized investment gains of \$2.8 million for the quarter and \$4.3 million for the nine months, compared to realized investment losses of \$5.1 million and \$36.1 million for the same periods in 2003. These results reflect the improved economy and general progress in the performance of corporate credit markets, along with consistent gains on the sale of real estate.

Insurance premiums and deposits on policyholder contracts declined for the third quarter and the first nine months of 2004, compared to 2003. This decline was primarily due to lower sales of annuities, which were at an elevated level during 2003 due to strong customer preference for fixed-rate products. However, included in the 2004 results are significant year-to-date increases in premiums for traditional life insurance and deposits on policyholder contracts for universal life and variable universal life insurance. These results are due in large part to the addition of GuideOne Life, which was acquired on June 30, 2003, along with the Company's continuing emphasis on growth in the life protection product lines.

The Company also experienced favorable benefits and expenses, which declined by 12.3% for the third quarter and 3.9% for the nine-month period. Contributing to these changes are efficiencies being gained through the integration of operations from GuideOne Life, along with reduced sales of annuities.

On October 25, 2004, the Board of Directors declared a quarterly dividend of \$0.27 per share, payable on November 22, 2004 to stockholders of record on November 8, 2004.

Also on October 25, 2004, the Company entered into a definitive agreement to sell its bank subsidiary, Generations Bank, for \$10.1 million with an expected gain on the sale of approximately \$1.9 million. The sale of the Bank will allow us to improve our focus on our core business of providing life insurance. The sale is expected to close during the first quarter of 2005, subject to the required approval by the Office of Thrift Supervision.

While we are pleased with the Company's improved quarterly results, we certainly believe that the market and economic environment offer opportunities for continued improvements over time. Our concerted effort to expand life insurance sales will continue to yield benefits to our shareholders and policyowners, and we are committed to pursuing this course.

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 \$446 million in 2003, and assets and life insurance in force were \$4.6 billion and \$32.2 billion, respectively, as of December 31, 2003. The Company operates in 48 states and the District of Columbia. For further information please refer to the Company's Form 10-Q at www.kclife.com.

(Continued on next page)

Kansas City Life Announces
Third Quarter 2004 Results
November 5, 2004; Page Two

KANSAS CITY LIFE INSURANCE COMPANY CONDENSED CONSOLIDATED INCOME STATEMENT (Unaudited) (amounts in thousands, except share data)

	Quarter ended September 30		Nine months ended September 30	
	2004	2003	2004	2003
Revenues	\$ 117,814	\$ 121,350	\$ 348,767	\$ 320,197
Net income	\$ 11,533	\$ 7,728	\$ 24,650	\$ 1,805
Net income per share,				

Edgar Filing: KANSAS CITY LIFE INSURANCE CO - Form 10-Q

basic and diluted	\$ <u>0.97</u>	\$ <u>0.65</u>	\$ <u>2.07</u>	\$ <u>0.15</u>
Dividends paid	\$ <u>0.27</u>	\$ <u>0.27</u>	\$ <u>0.81</u>	\$ <u>0.81</u>

A quarterly dividend of \$.27 per share will be paid November 22, 2004 to shareholders of record as of November 8, 2004.

Average number of shares outstanding	11,931,172	11,929,321	11,928,520
--------------------------------------	------------	------------	------------

Item 6. Exhibits.

(a) Exhibits:

- (31)a Rule 13a-15(e)/15d-15(e) Certifications.
- (31)b Rule 13a-15(e)/15d-15(e) Certifications.
- (32) Item 32 - Section 906 Certification.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

KANSAS CITY LIFE INSURANCE COMPANY

/s/R. Philip Bixby

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

/s/Tracy W. Knapp

Tracy W. Knapp
Senior Vice President, Finance

Date: November 5, 2004