KANSAS CITY LIFE INSURANCE CO
Form 10-Q
July 30, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2010 or

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

For the transition period from_______to______

Commission File Number 2-40764

KANSAS CITY LIFE INSURANCE COMPANY
(Exact name of registrant as specified in its charter)

Missouri (State or other jurisdiction of incorporation or organization)	44-0308260 (I.R.S. Employer Identification No.)
3520 Broadway, Kansas City, Missouri (Address of principal executive offices)	64111-2565 (Zip Code)

816-753-7000
Registrant's telephone number, including area code

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes [X] No [ ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes [ ] No [ ]

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

Large accelerated filer [ ]　　Accelerated filer [X]

Non-accelerated filer [ ]　　Smaller reporting company [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes [ ]　　No [X]

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

Common Stock, $1.25 par	11,467,473 shares
Class	Outstanding June 30, 2010

KANSAS CITY LIFE INSURANCE COMPANY
TABLE OF CONTENTS

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

	June 30 2010 (Unaudited)	December 31 2009
ASSETS		
Investments:		
Fixed maturity securities available for sale, at fair value	$2,652,110	$2,469,272
Equity securities available for sale, at fair value	37,527	36,876
Mortgage loans	463,953	457,582
Real estate	117,683	114,076
Policy loans	84,877	85,585
Short-term investments	82,453	138,704
Total investments	3,438,603	3,302,095
Cash	8,940	4,981
Accrued investment income	34,413	32,989
Deferred acquisition costs	190,057	209,495
Value of business acquired	54,109	66,114
Reinsurance receivables	182,366	179,365
Property and equipment	23,807	24,393
Income taxes	1,754	8,784
Other assets	31,112	35,145
Separate account assets	297,269	312,824
Total assets	$4,262,430	$4,176,185
LIABILITIES		
Future policy benefits	$878,062	$866,889
Policyholder account balances	2,048,604	2,048,828
Policy and contract claims	33,512	33,484
Other policyholder funds	147,676	137,847
Income taxes	46,683	21,851
Other liabilities	134,396	126,099
Separate account liabilities	297,269	312,824
Total liabilities	3,586,202	3,547,822
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	41,076	41,068
Retained earnings	762,041	757,225

Accumulated other comprehensive income (loss)	9,637	(36,477)
Treasury stock, at cost (2010 - 7,029,207 shares;		
2009 - 6,931,589 shares)	(159,647)	(156,574)
Total stockholders' equity	676,228	628,363
Total liabilities and stockholders' equity	$4,262,430	$4,176,185

See accompanying Notes to Consolidated Financial Statements (Unaudited)

Table of Contents

Kansas City Life Insurance Company
Consolidated Statements of Income

	Quarter Ended June 30		Six Months Ended June 30	
	2010	2009	2010	2009
REVENUES	(Unaudited)		(Unaudited)	
Insurance revenues:				
Premiums	$48,251	$43,176	$96,180	$89,716
Contract charges	26,661	26,202	53,340	52,970
Reinsurance ceded	(14,730)	(13,599)	(28,032)	(26,138)
Total insurance revenues	60,182	55,779	121,488	116,548
Investment revenues:				
Net investment income	43,272	44,605	86,576	87,744
Realized investment gains, excluding impairment losses	1,493	2,592	2,816	4,006
Net impairment losses recognized in earnings:				
Total other-than-temporary impairment losses	(1,458)	(4,425)	(3,049)	(25,831)
Portion of impairment losses recognized in other comprehensive income	134	403	139	15,691
Net impairment losses recognized in earnings	(1,324)	(4,022)	(2,910)	(10,140)
Total investment revenues	43,441	43,175	86,482	81,610
Other revenues	2,361	2,485	4,781	4,916
Total revenues	105,984	101,439	212,751	203,074
BENEFITS AND EXPENSES				
Policyholder benefits	42,622	36,400	90,413	85,087
Interest credited to policyholder account balances	21,540	21,700	42,740	42,874
Amortization of deferred acquisition costs and value of business acquired	3,711	6,727	14,230	19,206
Operating expenses	22,276	24,132	46,566	50,386
Total benefits and expenses	90,149	88,959	193,949	197,553
Income before income tax expense	15,835	12,480	18,802	5,521
Income tax expense	5,775	4,436	7,779	2,025
NET INCOME	$10,060	$8,044	$11,023	$3,496
Comprehensive income, net of taxes:				
Change in net unrealized gains and (losses) on securities available for sale	$30,358	$44,689	$46,114	$45,131
Other comprehensive income	30,358	44,689	46,114	45,131
COMPREHENSIVE INCOME	$40,418	$52,733	$57,137	$48,627

Basic and diluted earnings per share:				
Net income	$0.88	$0.70	$0.96	$0.30

See accompanying Notes to Consolidated Financial Statements (Unaudited)

Table of Contents

Kansas City Life Insurance Company
Consolidated Statement of Stockholders' Equity

	Six Months Ended 2010 (Unaudited)
COMMON STOCK, beginning and end of period	$ 23,121
ADDITIONAL PAID IN CAPITAL	
Beginning of period	41,068
Excess of proceeds over cost of treasury stock sold	8
End of period	41,076
RETAINED EARNINGS	
Beginning of period	757,225
Net income	11,023
Stockholder dividends of $0.54 per share	(6,207)
End of period	762,041
ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)	
Beginning of period	(36,477)
Other comprehensive income	46,114
End of period	9,637
TREASURY STOCK, at cost	
Beginning of period	(156,574)
Cost of 98,144 shares acquired	(3,080)
Cost of 526 shares sold	7
End of period	(159,647)
TOTAL STOCKHOLDERS' EQUITY	$ 676,228

See accompanying Notes to Consolidated Financial Statements (Unaudited)

5

Table of Contents

Kansas City Life Insurance Company
Consolidated Statements of Cash Flows

	Six Months Ended June 30	
	2010	2009
	(Unaudited)	
OPERATING ACTIVITIES		
Net income	$11,023	$3,496
Adjustments to reconcile net income to		
net cash provided by operating activities:		
Amortization of investment premium	1,315	2,476
Depreciation	1,483	1,342
Acquisition costs capitalized	(17,507)	(14,890)
Amortization of deferred acquisition costs	11,125	18,513
Amortization of value of business acquired	3,105	1,278
Realized investment losses	94	6,134
Changes in assets and liabilities:		
Reinsurance recoverable	(3,001)	25
Future policy benefits	2,862	(6,122)
Policyholder account balances	(6,835)	(13,238)
Income taxes payable and deferred	9,762	9,634
Other, net	11,720	10,654
Net cash provided	25,146	19,302
INVESTING ACTIVITIES		
Purchases of investments:		
Fixed maturity securities	(209,849)	(138,414)
Equity securities	(401)	(1,054)
Mortgage loans	(38,186)	(17,910)
Real estate	(7,069)	(12,036)
Other investment assets	-	(27,919)
Sales of investments:		
Fixed maturity securities	14,888	25,631
Equity securities	198	4,231
Real estate	-	2,065
Other investment assets	56,959	1,418
Maturities and principal paydowns of investments:		
Fixed maturity securities	124,584	108,092
Mortgage loans	31,814	20,981
Net dispositions (acquisitions) of property and equipment	(166)	304
Net cash used	(27,228)	(34,611)

See accompanying Notes to Consolidated Financial Statements (Unaudited)

Table of Contents

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

	Six Months Ended June 30	
	2010	2009
	(Unaudited)	
FINANCING ACTIVITIES		
Proceeds from borrowings	3,000	-
Repayment of borrowings	(3,000)	(2,900)
Deposits on policyholder account balances	110,518	122,858
Withdrawals from policyholder account balances	(61,438)	(100,653)
Net transfers to separate accounts	(41,921)	(1,206)
Change in other deposits	8,155	4,267
Cash dividends to stockholders	(6,208)	(6,221)
Net acquisition of treasury stock	(3,065)	(319)
Net cash provided	6,041	15,826
Increase in cash	3,959	517
Cash at beginning of year	4,981	9,720
Cash at end of period	$ 8,940	$ 10,237

See accompanying Notes to Consolidated Financial Statements (Unaudited)

Table of Contents

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 consolidated entity (the Company) which primarily consists of three life insurance companies. Kansas City Life Insurance Company (Kansas City Life) is the parent company. Sunset Life Insurance Company of America (Sunset Life) and Old American Insurance Company (Old American) are wholly-owned subsidiaries.

The unaudited interim consolidated financial statements have been prepared on the basis of U.S. generally accepted accounting principles (GAAP) for interim financial reporting 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 2009 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 June 30, 2010 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
The Company has identified, below, three of its Significant Accounting Policies for disclosure as they are specifically pertinent to the second quarter, 2010. For a full discussion of significant accounting policies, please refer to the Company's 2009 Form 10-K as filed with the Securities and Exchange Commission.

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

Profit expectations are based upon assumptions of future interest spreads, mortality margins, expense margins and policy and premium persistency experience. Mortality relates to the occurance 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. 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.

Table of Contents

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 and VOBA are 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 assumptions related to 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 with adjustments reducing amortization limited to amounts previously deferred plus interest accrued through the date of the adjustment. 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.

In addition, the Company may consider refinements in estimates due to improved capabilities resulting from administrative or actuarial system upgrades. The Company considers such enhancements to determine whether they are indicative of errors in prior periods or simply improvements in the projection of future expected gross profits due to improved functionality. To the extent they represent such improvements, these items are applied to the appropriate financial statement line items in a manner similar to unlocking adjustments.

DAC and VOBA are also reviewed on an ongoing basis to determine that the unamortized portion does not exceed the expected recoverable amounts. If it is determined from emerging experience that the premium margins or gross profits are insufficient to amortize deferred acquisition costs, then the asset will be adjusted downward with the adjustment recorded as an expense in the current period. No impairment adjustments have been recorded in the years presented. The DAC and VOBA assets are also adjusted at each reporting date to reflect the impact of unrealized gains and losses on fixed maturity and equity securities available for sale as though such gains and losses had been realized.

The amortization of DAC decreased $5.3 million or 71% in the second quarter and $6.9 million or 38% in the six months compared to one year ago. These decreases are primarily the result of a refinement in methodology (resulting in a change in estimate) and an unlocking of certain assumptions. The Company refined its estimate as a result of the implementation of an actuarial system upgrade. This upgrade allowed the Company to refine its projection of future expected gross profits on investment-type contracts which impacted the calculation of DAC amortization. The effect of the change in estimate was an increase in the DAC asset and a reduction in current period DAC amortization of $1.1 million.

The other factor impacting the amortization of DAC was an unlocking that occurred in the second quarter of 2010. The unlocking primarily related to a change in the estimated future gross profits associated with the mortality assumption for certain universal life and variable universal life products. This unlocking adjustment reflects actual experience from mortality results that have emerged and which have been better than assumed in expected future profits previously established. The unlocking of the mortality assumption on the variable universal life product included a change to a more recent mortality table. This table is also currently used by the Company in the mortality assumption for universal life and allows the Company enhanced consistency with mortality assumptions on other interest-sensitive products. In addition, the Company also unlocked an interest rate assumption on selected fixed deferred annuity products. The impact of unlocking was an increase in the DAC asset and a corresponding decrease in the amortization of DAC of $5.8 million. No DAC unlocking or change in estimate occurred in 2009.

The amortization of VOBA increased $2.3 million in the second quarter of 2010 and $2.0 million for the six months compared to the same periods in the prior year. This increase was due primarily to two factors, both which occurred in the prior year. First, in the second quarter of 2009, the Company refined its method for calculating VOBA from a premium-based method to a volume-based method for certain traditional life products. Since the establishment of the VOBA, the Company had used the measure of premium in-force which had been inconsistent from period to period due to the way the premium in-force was identified and captured. This resulted in a corresponding volatile amortization of the VOBA related to the actual run off of the in-force policies. Accordingly, the Company refined its method of estimating VOBA to the use of volume in-force. This refinement in estimate reduced VOBA amortization $2.5 million in both the second quarter and the six months of 2009. Second, the Company had an unlocking adjustment on interest-sensitive products, which decreased VOBA amortization $0.2 million in both the second quarter and the six months of 2009. There was no unlocking or refinement in methodology in 2010.

Table of Contents

Kansas City Life Insurance Company
Notes to Consolidated Financial Statements (Unaudited)-Continued

The following table identifies the effects of the DAC and VOBA change in estimate and unlocking in the Consolidated Statements of Income for the second quarters and the six months ended June 30, 2010 and 2009.

	Six Months and Second Quarter Ended June 30	
	2010	2009
DAC:		
Change in estimate	$1,118	$-
Unlocking	5,831	-
Total	$6,949	$-
VOBA:		
Change in estimate	$-	2,477
Unlocking	-	163
Total	$-	$2,640

Contract Charges
Contract charges consist of cost of insurance, expense loads, the amortization of unearned revenues and surrender charges. Cost of insurance relates to charges for mortality. These charges are applied to the excess of the mortality benefit over the account value for universal life policies. Expense loads are amounts that are assessed against the policyholder balance as consideration for origination of the contract. Certain contract charges for universal life insurance are not recognized in income immediately but are deferred as unearned revenues and amortized into income in a manner similar to the amortization of DAC and VOBA. These contract charges, which are recorded as unearned revenues, are recognized into income in proportion to the expected future gross profits of the business. Profit expectations are based upon assumptions of future interest spreads, mortality margins, expense margins and policy and premium persistency experience. Surrender charges are fees imposed on policyholders upon cancellation of a policy.

Unlocking or other events may also have an impact on products and policies. If it is determined that it is appropriate to change the assumptions of future experience, then an unlocking adjustment is recognized for the block of business being evaluated. Certain assumptions, such as interest spreads and surrender rates, may be interrelated. As such, unlocking adjustments often reflect revisions to multiple assumptions. In addition, the Company may also consider refinements in estimates for other unusual or one-time occurrences for events such as administrative or actuarial system upgrades. These items are applied to the appropriate financial statement line items similar to unlocking adjustments.

One component of contract charges is the recognition over time of the deferred revenue liability (DRL) from certain universal life policies. This liability arises from front end loads on such policies and is recognized into the Consolidated Statements of Income in concert with the future expected gross profits, similar to the amortization of DAC. In the second quarter of 2010, the Company had a refinement in methodology resulting in a change in estimate. The Company refined its methodology primarily as a result of the implementation of an actuarial system upgrade. This upgrade allowed the Company to refine its calculation of the DRL liability. The effect of the refinement in estimate on the DRL was an increase in the liability and a reduction to contract charges of $0.5 million.

At least annually, a review is performed regarding the assumptions related to profit expectations. If it is determined that the assumptions should be revised, an adjustment may be recorded to contract charge deferred revenues in the current period as an unlocking adjustment. The Company had an unlocking in the DRL in the second quarter of 2010. When the Company has a change in the future expected gross profits related to changes in assumptions, a corresponding change in deferred revenue liability is also recognized as an unlocking. The 2010 unlocking adjustment reflects actual experience from mortality results, premium persistency, and surrender rates that have emerged. The impact of the unlocking on DRL was a decrease in the liability and a corresponding increase in the recognition of deferred revenue in the current period of $1.1 million. No changes in estimate or unlocking on the DRL occurred during 2009.

Table of Contents

Kansas City Life Insurance Company
Notes to Consolidated Financial Statements (Unaudited)-Continued

The following table identifies the effect of the deferred revenue change in estimate and unlocking recognized in contract charges in the Consolidated Statements of Income.

	Six Months and Second Quarter Ended June 30	
	2010	2009
Deferred Revenue Charges		
Change in estimate	$(530)	$-
Unlocking	1,107	-
Total	$577	$-

Separate Accounts

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

The Company introduced a guaranteed minimum withdrawal benefit (GMWB) rider in 2007 that can be added to new or existing variable annuity contracts. The rider provides an enhanced withdrawal benefit that guarantees a stream of income payments to an owner or annuitant, regardless of the contract account value. The current value of variable annuity separate accounts with the GMWB rider was $65.4 million (December 31, 2009 - $57.9 million) and the guarantee liability was $(0.9) million at June 30, 2010 (December 31, 2009 – ($1.6) million). The value of the GMWB rider is recorded at fair value. The change in this value is included in policyholder benefits in the Consolidated Statements of Income. The value of variable annuity separate accounts with the GMWB rider is recorded in separate account liabilities and the value of the rider is included in other policyholder funds in the Consolidated Balance Sheets. The determination of fair value of the GMWB liability requires models that use actuarial and financial market assumptions, which reflect the assumptions market participants would use in pricing the contract, including adjustments for risk and issuer non-performance. The Company refined its process in the second quarter of 2010 to incorporate an index from an industry-recognized actuarial consulting firm that the Company believes is more consistent with the attributes of the product.

Guarantees are offered under variable universal life and variable annuity contracts: a guaranteed minimum death benefit (GMDB) rider is available on certain variable universal life contracts, and GMDB are provided on all variable annuities. The GMDB rider for variable universal life and variable annuity contracts guarantees the death benefit for specified periods of time, regardless of investment performance, provided cumulative premium requirements are met. The total reserve held for the variable annuity GMDB at June 30, 2010 was $0.5 million (December 31, 2009 - $0.3 million).

2. New Accounting Pronouncements and Other Regulatory Activity

New Accounting Pronouncements

For a full discussion of new accounting pronouncements, please refer to the Company's 2009 Form 10-K. Presented below are new accounting pronouncements issued during 2010 that are applicable to the Company.

In January 2010, the FASB issued amendments to existing guidance regarding accounting and reporting for decreases in ownership of a subsidiary. The amendments affect entities that experience a decrease in ownership in a subsidiary that is a
business or nonprofit activity. The amendments also affect entities that exchange a group of assets that constitutes a business or nonprofit activity for an equity interest in another entity. This guidance became effective for interim and annual reporting periods ending after December 15, 2009 for the Company since it had previously adopted SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements." The Company adopted the amendment on January 1, 2010 with no material impact to the consolidated financial statements.

Table of Contents

Kansas City Life Insurance Company
Notes to Consolidated Financial Statements (Unaudited)-Continued

In January 2010, the FASB issued new guidance to improve disclosures about fair value measurements. This guidance requires new disclosures and clarification of existing disclosures regarding Levels 1, 2 and 3 in the fair value hierarchy. The majority of this guidance became effective for interim and annual reporting periods beginning after December 15, 2009. However, disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements will become effective for fiscal years beginning after December 15, 2010 and for interim periods within those years. The Company adopted the guidance on January 1, 2010 with no material impact to the consolidated financial statements.

All other new accounting standards and updates of existing standards issued during the six months ended June 30, 2010 did not relate to accounting policies and procedures pertinent to the Company at this time.

Other Regulatory Activity

Health Care Reform
The Company has assessed, based upon the information available, the Health Care Reform Act, as passed in the first quarter 2010. The Company has considered its medical and dental plans provided for employees, agents and retirees. While the Company will incur additional costs associated with the implementation of this Act, it does not believe these costs or ongoing costs associated with this Act will have a material impact to the consolidated financial statements. The Company does not provide a separate prescription drug plan to its retirees. In addition, the Company does not sell any medical insurance or prescription drug coverage. However, the Company does sell dental insurance but believes that the impact of this Act is immaterial to this product. The Company will continue to assess the information contained in this Act as additional guidance becomes available and as additional implications are understood or clarified.

Financial Reform
The Dodd-Frank Bill was passed in July of 2010. This Bill focuses on financial reform, specifically changes to derivatives regulation, regulatory framework for executive pay, corporate governance, investor protection, clawback provisions, mortgage reform, and numerous other issues. The Company will continue to assess the information contained in this Bill as additional guidance becomes available and as additional implications are clarified.

3. Fair Values

Fair Values Hierarchy
In accordance with FASB ASC 820, “Fair Value Measurements and Disclosures,” 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 2 – Valuations are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market. Valuations are obtained from third-party pricing services or inputs that are observable or derived principally from or corroborated by observable market data.

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

Determination of Fair Value

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. Accordingly, the Company utilizes independent third-party pricing services to determine the majority of its fair values.

The Company reviews prices received from service providers for unusual fluctuations but generally accepts the price identified from the primary pricing service. However, if the primary pricing service does not provide a price, the Company utilizes a second pricing service if a price is available. In the event a price is not available from either third-party pricing service, the Company pursues external pricing from brokers. Generally, the Company pursues and utilizes only one broker quote per security. In doing so, the Company solicits only brokers which have previously demonstrated knowledge and experience of the subject security. If a broker price is not available, the Company determines a carrying value through various valuation techniques that include using option pricing models, discounted cash flows, spread-based models or similar techniques depending upon the specific security to be priced. These techniques are primarily applied to private placement securities. The Company utilizes available market information, wherever possible, to identify inputs into the fair value determination, primarily including prices and spreads on comparable securities.

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, the Company analyzes the third-party pricing services' methodologies and related inputs and also evaluates the various types of securities in its investment portfolio to determine an appropriate fair value hierarchy.

The Company owned two issues of similar securities for which values were not provided from the Company's primary pricing service as of June 30, 2010. The Company used the most recent price for similar issues to determine the fair value of these securities. In addition, the Company had one security where the fair value utilized was different from the independent pricing service. The fair value was developed through internal estimates and resulted in an increase in the recorded fair value of $0.2 million.

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, and other items, if applicable; 3) discounted cash flow models and margin spreads; 4) bond yield curves; 5) observable market prices and exchange transaction information not provided by external pricing services; 6) statement values provided to the Company by fund managers; and 7) 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 but for which fair value is disclosed.

Assets

Securities Available for Sale

Fixed maturities and equity 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 purpose of disclosure.

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

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. 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 offers a GMWB rider that can be added to new or existing variable annuity contracts. The rider provides an enhanced withdrawal benefit that guarantees a stream of income payments to an owner or annuitant, regardless of the contract account value. The value of variable annuity separate accounts with the GMWB rider was $65.4 million and the guarantee liability was $(0.9) million at June 30, 2010 compared to $57.9 million and $(1.6) million, respectively, at December 31, 2009. The value of the GMWB rider is recorded at fair value, and the change in this value is included in policyholder benefits in the Consolidated Statements of Income. The value of variable annuity separate accounts with the GMWB rider is recorded in separate account liabilities and the value of the rider is included in other policyholder funds in the Consolidated Balance Sheets. Fair value for GMWB rider contracts results in a Level 3 valuation as it is based on models which utilize significant unobservable inputs. These models require actuarial and financial market assumptions, which reflect the assumptions market participants would use in pricing the contract, including adjustments for risk and issuer non-performance.

Notes Payable

The Company had no short-term borrowings at June 30, 2010 or December 31, 2009.

Table of Contents

Kansas City Life Insurance Company
Notes to Consolidated Financial Statements (Unaudited)-Continued

Categories Reported at Fair Value

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

	June 30, 2010			
Assets:	Level 1	Level 2	Level 3	Total
Bonds:				
U.S. Treasury securities and				
obligations of U.S. Government	$6,245	$123,721	$4,160	$134,126
Federal agencies 1	-	29,107	-	29,107
Federal agency issued				
residential mortgage-backed securities 1	-	161,572	-	161,572
Subtotal	6,245	314,400	4,160	324,805
Corporate obligations:				
Industrial	-	454,674	2,729	457,403
Energy	-	199,643	2,363	202,006
Technology	-	37,718	-	37,718
Communications	-	87,247	-	87,247
Financial	-	378,635	2,791	381,426
Consumer	-	287,079	22,555	309,634
Public utilities	-	301,088	-	301,088
Subtotal	-	1,746,084	30,438	1,776,522
Corporate private-labeled residential				
mortgage-backed securities	-	202,048	-	202,048
Other	-	328,441	6,314	334,755
Redeemable preferred stocks	13,980	-	-	13,980
Subtotal	20,225	2,590,973	40,912	2,652,110
Equity securities	3,377	28,148	6,002	37,527
Total	$23,602	$2,619,121	$46,914	$2,689,637
Percent of Total	1 %	97 %	2 %	100 %
Liabilities:				
Other policyholder funds				
Guaranteed minimum withdrawal benefits	$-	$-	$(856)	$(856)
Total	$-	$-	$(856)	$(856)

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

Table of Contents

Kansas City Life Insurance Company
Notes to Consolidated Financial Statements (Unaudited)-Continued

	December 31, 2009			
Assets:	Level 1	Level 2	Level 3	Total
Bonds:				
U.S. Treasury securities and				
obligations of U.S. Government	$9,939	$97,723	$14,275	$121,937
Federal agencies 1	-	28,321	-	28,321
Federal agency issued				
residential mortgage-backed securities 1	-	172,515	-	172,515
Subtotal	9,939	298,559	14,275	322,773
Corporate obligations:				
Industrial	-	412,292	3,654	415,946
Energy	-	200,340	-	200,340
Technology	-	40,864	-	40,864
Communications	-	86,264	-	86,264
Financial	-	361,768	2,840	364,608
Consumer	-	284,910	22,596	307,506
Public utilities	-	287,687	-	287,687
Subtotal	-	1,674,125	29,090	1,703,215
Corporate private-labeled residential				
mortgage-backed securities	-	200,002	-	200,002
Other	-	220,572	9,109	229,681
Redeemable preferred stocks	13,601	-	-	13,601
Subtotal	23,540	2,393,258	52,474	2,469,272
Equity securities	3,400	27,427	6,049	36,876
Total	$26,940	$2,420,685	$58,523	$2,506,148
Percent of Total	1 %	97 %	2 %	100 %
Liabilities:				
Other policyholder funds				
Guaranteed minimum withdrawal benefits	$-	$-	$(1,642)	$(1,642)
Total	$-	$-	$(1,642)	$(1,642)

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

Table of Contents

Kansas City Life Insurance Company
Notes to Consolidated Financial Statements (Unaudited)-Continued

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

	June 30, 2010			
	Level 1	Level 2	Level 3	Total
Fixed maturities available for sale:				
Priced from external pricing services	$20,225	$2,458,844	$-	$2,479,069
Priced from independent broker quotations	-	123,636	-	123,636
Priced from internal matrices and calculations	-	8,493	40,912	49,405
Subtotal	20,225	2,590,973	40,912	2,652,110
Equity securities available for sale:				
Priced from external pricing services	3,377	2,727	-	6,104
Priced from independent broker quotations	-	-	-	