

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC

**FORM 10-Q**

QUARTERLY REPORT  
Under Section 13 or 15(d) of the Securities Exchange Act of 1934

**FOR THREE AND NINE MONTHS ENDED**

SEPTEMBER 30, 2004

**Commission File: 0-1999**

**KENTUCKY INVESTORS, INC.**  
(Exact Name of registrant as specified in Charter)

**KENTUCKY**  
(State of Other Jurisdiction of Incorporation or Organization)

**61-6030333**  
(IRS Employer Identification Number)

**200 Capital Avenue, P. O. Box 717**  
**Frankfort, Kentucky 40602**  
(Address of Principal Executive Offices)

**Registrant's Telephone Number - (502) 223-2361**

Securities registered pursuant to Section 13(g) of the Act:

**Common Capital Stock par value \$1.00 per share**  
(Title of Class)

**Number of outstanding shares as of September 30, 2004 - 1,129,924.72**

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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## PART I – FINANCIAL INFORMATION

### ITEM 1. Consolidated Financial Statements

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#### KENTUCKY INVESTORS, INC.

#### Condensed Consolidated Balance Sheets

	(Unaudited) <u>September 30, 2004</u>	<u>December 31, 2003</u>
<b>Assets</b>		
Investments		
Securities available for sale, at fair value:		
Fixed maturities (amortized cost 2004-\$269,568,083; 2003 - \$265,097,987)	\$287,550,049	\$284,531,244
Equity securities (cost: 2004 - \$4,997,915; 2003 - \$4,997,915)	5,955,159	5,872,424
Mortgage loans on real estate	24,478,146	25,749,708
Other long term investments	750,957	557,461
Short term investments	884,399	813,000
Policy loans	<u>7,522,699</u>	<u>7,918,258</u>
Total investments	327,141,409	325,442,095
Cash and cash equivalents	3,084,645	5,844,281
Due and deferred premiums	4,251,882	4,441,828
Deferred acquisition costs	22,800,044	23,298,369
Present value of future profits	414,033	482,721
Leased property under capital leases	138,415	227,822
Other assets	20,216,658	9,272,869
Amounts recoverable from reinsurers	<u>58,492,712</u>	<u>60,465,147</u>
Total assets	<u>\$436,539,798</u>	<u>\$429,475,132</u>
<b>Liabilities and Stockholders' Equity</b>		
Liabilities		
Policy liabilities		
Benefit reserves	\$331,968,629	\$335,604,439
Unearned premium reserves	15,803,097	17,014,697

Other policyholders' funds	<u>3,699,911</u>	<u>3,728,729</u>
Total policy liabilities	351,471,637	356,347,865
Federal income taxes	9,530,898	9,673,564
Obligations under capital leases	134,939	224,628
Notes payable	8,915,444	9,033,355
Other liabilities	<u>16,158,434</u>	<u>4,041,199</u>
Total liabilities	386,211,352	379,320,611
Stockholders' Equity		
Common Stock (shares issued: 2004 – 1,129,925, 2003 - 1,136,361)	1,129,925	1,136,361
Paid-in surplus	8,549,970	8,549,970
Accumulated other comprehensive income	11,506,539	12,139,714
Retained earnings	<u>29,142,012</u>	<u>28,328,476</u>
Total stockholders' equity	<u>\$ 50,328,446</u>	<u>\$ 50,154,521</u>
Total liabilities and stockholders' equity	<u>\$436,539,798</u>	<u>\$429,475,132</u>

See accompanying notes.

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**KENTUCKY INVESTORS, INC.**

**Condensed Consolidated Income Statements  
(Unaudited)**

	Three Months Ended September 30	
	<u>2004</u>	<u>2003</u>
REVENUES		
Premiums and other considerations	\$ 9,125,243	\$10,699,479
Investment income, net of expenses	4,647,233	4,386,931
Realized gain on investments, net	2,050	343,948
Other income	<u>276,080</u>	<u>243,853</u>
Total revenues	<u>\$14,050,606</u>	<u>\$15,674,211</u>

## BENEFITS AND EXPENSES

Death and other policyholder benefits	14,255,743	8,092,330
Guaranteed annual endowments	148,037	153,555
Dividends to policyholders	137,782	170,111
Increase (decrease) in benefit reserves and unearned premiums	(4,438,301)	3,445,070
Amortization of deferred acquisition costs, net	278,720	365,997
Commissions	611,571	820,692
Other insurance expenses	<u>2,321,643</u>	<u>2,909,933</u>
Total benefits and expenses	<u>\$13,315,195</u>	<u>\$15,957,688</u>
Income (loss) from operations before federal income tax	<u>\$ 735,411</u>	<u>\$ (283,477)</u>
Provision (benefit) for income taxes:		
Current	\$ 15,418	\$ (178,081)
Deferred	<u>38,000</u>	<u>102,000</u>
	<u>\$ 53,418</u>	<u>\$ (76,081)</u>
Net income (loss)	<u>\$ 681,993</u>	<u>\$ (207,396)</u>
Earnings per share, basic and diluted	<u>\$ 0.60</u>	<u>\$ (0.18)</u>
Dividends per share	<u>\$ 0.00</u>	<u>\$ 0.00</u>

See accompanying notes.

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## KENTUCKY INVESTORS, INC.

### Condensed Consolidated Income Statements (Unaudited)

Nine Months Ended September 30  
2004                      2003

## REVENUES

Premiums and other considerations	\$28,341,874	\$31,932,317
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Investment income, net of expenses	13,690,102	13,617,978
Realized gain on investments, net	156,351	869,028
Other income	<u>1,042,314</u>	<u>802,574</u>
Total revenues	<u>\$43,230,641</u>	<u>\$47,221,897</u>
<b>BENEFITS AND EXPENSES</b>		
Death and other policyholder benefits	33,296,340	24,971,581
Guaranteed annual endowments	506,940	518,703
Dividends to policyholders	501,047	535,485
Increase (decrease) in benefit reserves and unearned premiums	(2,730,773)	8,775,856
Amortization of deferred acquisition costs, net	907,525	763,588
Commissions	1,930,072	2,655,419
Other insurance expenses	<u>7,121,869</u>	<u>8,650,792</u>
Total benefits and expenses	<u>\$41,533,020</u>	<u>\$46,871,424</u>
Income from operations before federal income tax	<u>\$ 1,697,621</u>	<u>\$ 350,473</u>
Provision for income taxes:		
Current	\$ 47,483	\$ 44,077
Deferred	<u>207,000</u>	<u>41,000</u>
	<u>\$ 254,483</u>	<u>\$ 85,077</u>
Net income	<u>\$ 1,443,138</u>	<u>\$ 265,396</u>
Earnings per share, basic and diluted	<u>\$ 1.27</u>	<u>\$ 0.23</u>
Dividends per share	<u>\$ 0.38</u>	<u>\$ 0.38</u>

See accompanying notes.

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**KENTUCKY INVESTORS, INC.**

**Condensed Consolidated Statements of Cash Flow (Unaudited)**

Nine Months Ended September 30  
2004                      2003

Net cash provided by operating activities	\$ 1,402,647	\$ 9,552,300
Investing activities		
Securities available-for-sale:		
Purchases	(26,421,743)	(63,780,653)
Sales and maturities	21,799,264	54,081,908
Other investments:		
Cost of acquisition	(1,932,481)	(3,688,420)
Sales and maturities	3,334,707	3,215,695
Other investing activities	<u>35,712</u>	<u>(256,012)</u>
Net cash used by investing activities	(3,184,541)	(10,427,482)
Financing activities		
Receipts from universal life policies credited to policyholder account balances	6,008,518	5,873,353
Return of policyholder account balances on universal life policies	(6,232,310)	(5,773,247)
Payments on notes payable	(561,911)	(625,726)
Proceeds from notes payable	444,000	214,042
Other financing activities	<u>(636,039)</u>	<u>(303,484)</u>
Net cash used by financing activities	<u>(977,742)</u>	<u>(615,062)</u>
Decrease in cash and cash equivalents	(2,759,636)	(1,490,244)
Cash and cash equivalents at beginning of period	<u>5,844,281</u>	<u>7,773,597</u>
Cash and cash equivalents at end of period	<u>\$ 3,084,645</u>	<u>\$ 6,283,353</u>

See accompanying notes.

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**KENTUCKY INVESTORS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2004**  
**(Unaudited)**

**NOTE A - Nature of Operations:** Kentucky Investors, Inc. is the holding company of

Investors Heritage Life Insurance Company, Investors Heritage Printing, Inc., a printing company, Investors Heritage Financial Services Group, Inc., an insurance marketing company, and is the sole member of At Need Funding, LLC, a limited liability company that provides advance funding of funerals in exchange for the irrevocable assignment of life insurance policies from other nonaffiliated companies. These entities are collectively hereinafter referred to as the "Company". The operations of Kentucky Investors are principally that of its life insurance company, Investors Heritage Life. The operations of the non-insurance subsidiaries of Kentucky Investors account for less than 2% of the Company's total operations.

The Company's operations involve the sale and administration of various insurance and annuity products, including, but not limited to, participating, non-participating, whole life, limited pay, universal life, annuity contracts, credit life, credit accident and health and group insurance policies. The principal markets for the Company's products are in the Commonwealths of Kentucky and Virginia, and the states of North Carolina, South Carolina, Ohio, Indiana, Florida, Tennessee, Illinois, Georgia, West Virginia, Michigan, Mississippi, Alabama and Maryland.

**NOTE B - Basis of Presentation:** The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine months ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended December 31, 2003, as included in the Company's Annual Report on Form 10-K.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

**NOTE C - Earnings per Share:** Earnings per share of common stock were computed based on the weighted average number of common shares outstanding during each period.

	<u>Income</u>	<u>Shares</u>	<u>Per Share Amount</u>
<b>Three months ended September 30, 2004</b>			
<i>Basic EPS</i>			

Net income	\$ 681,993	1,129,925	\$ 0.60
Dilutive effect of common equivalent shares of stock options	<u>-</u>	<u>3,012</u>	<u>-</u>

*Diluted EPS*

Net income	<u>\$ 681,993</u>	<u>1,132,937</u>	<u>\$ 0.60</u>
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**Three months ended September 30, 2003**

*Basic EPS*

Net loss	\$ (207,396)	1,148,510	\$ (0.18)
Dilutive effect of common equivalent shares of stock options	<u>-</u>	<u>-</u>	<u>-</u>

*Diluted EPS*

Net loss	<u>\$ (207,396)</u>	<u>1,148,510</u>	<u>\$ (0.18)</u>
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<b><u>Income</u></b>	<b><u>Shares</u></b>	<b><u>Per Share Amount</u></b>
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**Nine months ended September 30, 2004**

*Basic EPS*

Net income	\$ 1,443,138	1,131,874	\$ 1.27
Dilutive effect of common equivalent shares of stock options	<u>-</u>	<u>3,012</u>	<u>-</u>

*Diluted EPS*

Net income	<u>\$ 1,443,138</u>	<u>1,134,886</u>	<u>\$ 1.27</u>
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**Nine months ended September 30, 2003**

*Basic EPS*

Net income	\$ 265,396	1,148,510	\$ 0.23
Dilutive effect of common equivalent shares of stock options	<u>-</u>	<u>9,778</u>	<u>-</u>

*Diluted EPS*

Net income loss	<u>\$ 265,396</u>	<u>1,158,288</u>	<u>\$ 0.23</u>
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Pursuant to the Company's stock option and stock appreciation rights plan, there were 66,000 outstanding options, having an exercise price of \$23.00 per share as of September 30, 2004. The Company's stock price decreased from \$26.55 per share at December 31, 2003 to \$24.10 at September 30, 2004. Accordingly, the Company recognized a decrease in stock compensation expense associated with such options of \$161,700 for the nine month period ended September 30, 2004.

**NOTE D - Segment Data:** The Company operates in four segments as shown in the following table. All segments include both individual and group insurance. Identifiable revenues and expenses are assigned directly to the applicable segment. Net investment income is generally allocated to the insurance and the corporate segments in proportion to policy liabilities and stockholders' equity, respectively. Corporate segment results for the parent company, Investors Heritage Printing, Inc., Investors Heritage Financial Services Group, Inc. and At Need Funding LLC, after elimination of intercompany amounts, are presented.

	<b>Three Months Ended</b>	
	<u>September 30, 2004</u>	<u>September 30, 2003</u>
Revenues:		
Preneed & Burial Products	\$10,620,866	\$12,004,079
Traditional & Universal Life Products	2,859,449	2,746,014
Credit Insurance Products & Administrative Services	45,086	78,474
Corporate & Other	<u>525,205</u>	<u>845,644</u>
	<u>\$14,050,606</u>	<u>\$15,674,211</u>

Pre-Tax Income (Loss) from Operations:		
Preneed & Burial Products	\$ 602,617	\$ (397,587)
Traditional & Universal Life Products	174,841	(184,079)
Credit Insurance Products & Administrative Services	10,947	6,218
Corporate & Other	<u>(52,994)</u>	<u>291,971</u>
	<u>\$ 735,411</u>	<u>\$ (283,477)</u>

	<b>Nine Months Ended</b>	
	<u>September 30, 2004</u>	<u>September 30, 2003</u>
Revenues:		
Preneed & Burial Products	\$32,086,609	\$35,412,122
Traditional & Universal Life Products	8,771,036	8,987,969
Credit Insurance Products & Administrative Services	133,211	235,343
Corporate & Other	<u>2,239,785</u>	<u>2,586,463</u>
	<u>\$43,230,641</u>	<u>\$47,221,897</u>

Pre-Tax Income (Loss) from Operations:		
Preneed & Burial Products	\$ 331,158	\$ (713,445)
Traditional & Universal Life Products	604,287	199,748
Credit Insurance Products & Administrative Services	36,195	22,542

Corporate & Other

725,981	841,628
<u>\$ 1,697,621</u>	<u>\$ 350,473</u>

**NOTE E – Federal Income Taxes:** Current taxes are provided based on estimates of the projected effective annual tax rate. Deferred taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Income before federal income taxes differs from taxable income principally due to the small life insurance company tax deduction and dividends-received tax deduction. Other factors affecting this difference during the nine month period include the following non taxable events: a death benefit received by the Company on a company owned life insurance policy; a decrease in stock compensation expense associated with the Company's stock option plan relative to a decline in the value of Company stock options; and the release of the Company's previously non taxable self insurance reserve.

**NOTE F – Comprehensive Income:** The components of comprehensive income, net of related tax, are as follows:

	<b>Three Months Ended</b>	
	<u>September 30, 2004</u>	<u>September 30, 2003</u>
Net income (loss)	\$ 681,993	\$ (207,396)
Net unrealized gains (losses) on available-for-sale securities, net of tax	<u>3,942,959</u>	<u>(3,590,451)</u>
Comprehensive income (loss)	<u>\$ 4,624,952</u>	<u>\$ (3,797,847)</u>

	<b>Nine Months Ended</b>	
	<u>September 30, 2004</u>	<u>September 30, 2003</u>
Net income	\$ 1,443,138	\$ 265,396
Net unrealized losses on available-for-sale securities, net of tax	<u>(633,175)</u>	<u>(684,072)</u>
Comprehensive income (loss)	<u>\$ 809,963</u>	<u>\$ (418,676)</u>

**NOTE G – Notes Payable:** Information relative to the Company's material notes payable at September 30, 2004 is as follows:

<b>Description</b>	<b>Outstanding Principal</b>	<b>Current Interest Rate</b>	<b>Interest Expense</b>	<b>Interest Paid</b>
Fifth Third Bank Note	\$3,000,000	4.25%	\$ 83,438	\$ 77,896
Cherokee National Note	4,000,000	4.75%	122,556	122,500
At Need Funding Line of Credit	336,000	4.75%	11,454	11,658
Fifth Third Bank Note	1,553,924	3.75%	39,295	39,203

Farmers Bank Line of Credit	1	3.75%	782	816
Chrysler Financial	25,519	-%	-	-

**NOTE H – Employee Benefit Plans:** The Company participates in a noncontributory retirement plan which covers substantially all employees. Benefits are based on years of service and the highest consecutive 60 months average earnings within the last 120 months of credited service. Benefits are funded based on actuarially-determined amounts.

The following table provides the components of the net periodic benefit cost:

	<b><u>Three Months Ended</u></b>	
	<b><u>September 30, 2004</u></b>	<b><u>September 30, 2003</u></b>
Service cost	\$ 80,391	\$ 92,175
Interest cost	160,876	164,624
Expected return on plan assets	(153,075)	(163,955)
Amortization of prior service cost	(5,265)	(8,775)
Amortization of net loss	<u>41,129</u>	<u>35,261</u>
Net periodic benefit cost	<u>\$ 124,056</u>	<u>\$ 119,330</u>

	<b><u>Nine Months Ended</u></b>	
	<b><u>September 30, 2004</u></b>	<b><u>September 30, 2003</u></b>
Service cost	\$ 241,174	\$ 276,527
Interest cost	482,630	493,871
Expected return on plan assets	(459,225)	(491,865)
Amortization of prior service cost	(15,794)	(26,327)
Amortization of net loss	<u>123,389</u>	<u>105,782</u>
Net periodic benefit cost	<u>\$ 372,174</u>	<u>\$ 357,988</u>

Effective August 10, 2004, the Company cash surrendered its deposit administration fund, which was the most significant component of plan assets, held with Investors Heritage and invested these proceeds with an outside advisor in a diversified pension portfolio predominantly including equity securities and bonds.

The Company previously disclosed in its financial statements for the year ended December 31, 2003, that it expected to contribute \$540,000 to its pension plan in 2004. As of September 30, 2004, \$405,000 had been contributed. The Company presently anticipates contributing an additional \$135,000 to fund its pension plan in 2004.

**NOTE I – Investments:** During the third quarter of 2004, the Company began participating in a securities lending program, primarily for investment yield enhancement purposes, with third parties, mostly large brokerage firms. Securities loaned are treated as financing arrangements and the unrestricted collateral received is recorded in other assets, with an offsetting liability recorded in other liabilities to account for the Company's

obligation to return the collateral. The Company obtains collateral in an amount equal to 102% of the fair value of domestic securities loaned, monitors the market value of securities loaned on a daily basis and obtains additional collateral as necessary. At September 30, 2004, fixed income securities with a carrying value of \$11,940,000 were on loan under this agreement. Income earned relative to this program was \$4,315 for the period ended September 30, 2004.

**NOTE J – Unusual or Infrequent Events:** During June 2004, the Company recognized approximately \$226,000 in miscellaneous income arising from the death proceeds payable to the Company as owner and beneficiary of a life insurance policy carried on a previous member of management.

## **ITEM 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations**

### **General**

Kentucky Investors is incorporated under the laws of the Commonwealth of Kentucky and wholly owns Investors Heritage Life Insurance Company, a life insurance company also incorporated under the laws of the Commonwealth of Kentucky. Kentucky Investors also wholly owns Investors Heritage Financial Services Group, Inc., a Kentucky insurance marketing company which was formed in 1994, Investors Heritage Printing, Inc., a Kentucky printing company that provides printing to Investors Heritage Life and other unaffiliated parties, and is the sole member of At Need Funding, LLC, a Kentucky limited liability company that provides advance funding of funerals in exchange for the irrevocable assignment of life insurance policies from other nonaffiliated companies.

Investors Heritage Life offers a full line of life insurance products including, but not limited to, whole life, term life, single premium life, multi-pay life and annuities. Investors Heritage Life’s primary lines of business are insurance policies and annuities utilized to fund preneed funeral contracts, credit life and credit disability insurance, and term life and reducing term life sold through financial institutions.

Investors Heritage Life introduced a new product series during the first quarter of 2003, the Legacy Protector and Legacy Preferred pre-need product series, which replaced the Legacy 2000 series. These new plans were designed to help combat a challenging economic environment and increased mortality anti-selection. In general, commissions are slightly lower, guaranteed benefits have been moved further from issue, reserves have been adjusted to better reflect experience, and an underwritten plan has been added.

Investors Heritage Life’s final expense product is the Heritage Final Expense, which was introduced during 2002 and replaced the Legacy 2000 Final Expense series. This product is being marketed through funeral homes and independent agencies. It is reinsured on an 80% quota share basis with Munich American Reassurance Company to help reduce first

year surplus strain associated with new sales and minimize fluctuations in future profits.

Investors Heritage Life also provides term insurance products, both on a decreasing and a level basis. The Term to 95 product provides level coverage. We will continue to provide our decreasing term policy that is primarily sold through financial institutions.

The Company's operating earnings are derived primarily from revenues generated from the sale of insurance products by Investors Heritage Life, plus the Company's investment results, including realized gains (losses), less interest credited to policyholders, benefits to policyholders and expenses.

While the Company continues to expand the operations of Investors Heritage Financial, Investors Heritage Printing and At Need Funding, less than 2% of the Company's total operations were generated by those subsidiaries. As expected, more than 10% of Investors Heritage Financial's revenues during the second quarter 2004 were derived from the sale of Investors Heritage Life's credit insurance products. During the third quarter of 2004, the Company received dividends from Investors Heritage Financial in the amount of \$40,000. The Company anticipates dividend payments from Investors Heritage Financial during the fourth quarter in 2004.

The Company's primary uses of cash are operating expenses, debt service and dividend payments, and the Company's principal sources of cash are the dividends paid to it by Investors Heritage Life, Investors Heritage Financial and Investors Heritage Printing. Investors Heritage Life's principal sources of cash are from the sale of life insurance policies and investment income, including realized gains (losses), less benefits to policyholders and expenses. Therefore, the remainder of the discussion will deal with the financial condition and results of operations of Investors Heritage Life.

### **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The Company's discussion and analysis of its financial condition and results of operations are based on its consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States.

Preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On a continuing basis, the Company evaluates its estimates, including those related to investments, deferred acquisition costs, present value of future profits, policy liabilities, income taxes, regulatory requirements, contingencies and litigation. The Company bases such estimates on historical experience and other assumptions believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The Company believes the following accounting policies, judgments and estimates are the most critical to the preparation of its consolidated financial statements.

### **Investment in Fixed Maturities, Equity Securities and Mortgage Loans**

The Company holds fixed maturities and equity interests in a variety of companies. Additionally, the Company originates, underwrites and manages mortgage loans. The Company continuously evaluates all of its investments based on current economic conditions, credit loss experience and other developments. The Company evaluates the difference between the cost/amortized cost and estimated fair value of its investments to determine whether any decline in value is temporary or other-than-temporary in nature. This determination involves a degree of uncertainty. If a decline in the fair value of a security is determined to be temporary, the decline is recorded as an unrealized loss in shareholders' equity. If a decline in a security's fair value is considered to be other-than-temporary and the Company has the intent and ability to hold the security until it recovers, the security is written down to the estimated fair value with a corresponding realized loss recognized in the consolidated statements of income.

The assessment of whether a decline in fair value is considered temporary or other-than-temporary includes management's judgment as to the financial position and future prospects of the entity issuing the security. It is not possible to accurately predict when it may be determined that a specific security will become impaired. Future adverse changes in market conditions, poor operating results of underlying investments and defaults on mortgage loan payments could result in losses or an inability to recover the current carrying value of the investments, thereby possibly requiring an impairment charge in the future.

### **Deferred Acquisition Costs**

At September 30, 2004, the balance of our deferred acquisition costs was \$22,800,000 compared to \$23,298,000 at December 31, 2003. The recovery of these costs is dependent on the future profitability of the related business. Periodically, we evaluate the recoverability of the unamortized balance of the deferred acquisition costs. We consider estimated future gross profits or future premiums, expected mortality or morbidity, interest earned and credited rates, persistency and expenses in determining whether the balance is recoverable. If we determine a portion of the unamortized balance is not recoverable, it is immediately charged to amortization expense. The assumptions we use to amortize and evaluate the recoverability of the deferred acquisition costs involve significant judgment. A significant revision to these assumptions will impact future financial results.

### **Policy Liabilities**

Establishing liabilities for the Company's long-duration insurance contracts requires various assumptions, including policyholder persistency, mortality rates, investment yields, discretionary benefit increases, new business pricing, and operating expense levels. The Company evaluates historical experience for these factors when assessing the need for changing current assumptions. However, since many of these factors are interdependent and subject to short-term volatility during the long-duration contract period, substantial estimates and judgment are required. Accordingly, if actual experience emerges differently from that assumed, material financial statement adjustments could be required.

## **Investments, Liquidity and Capital Resources**

Premiums, which include mortality and expense charges, and investment income are Investors Heritage Life's primary sources of cash flow used to meet short-term and long-term cash requirements.

Investors Heritage Life's short-term obligations consist primarily of policyholder benefits and operating expenses. Investors Heritage Life has historically been able to meet these obligations out of operating cash, premiums and investment income.

Management is not aware of any commitments or unusual events that could materially affect capital resources.

The Company has not had any material changes in its debt agreements since December 31, 2003. The Company and Investors Heritage Life will continue to explore various opportunities including corporate reorganizations, acquisitions and purchasing blocks of business from other companies, which may dictate an additional need for either long-term or short-term debt.

Investors Heritage Life has maintained a sound, conservative investment strategy. At September 30, 2004, 87.9% of invested assets consisted of fixed income public bonds compared to 87.4% at December 31, 2003. Fixed income assets are managed by Conning Asset Management Company, an independent portfolio manager.

During the third quarter of 2004 the Company began participating in a securities lending program, primarily for investment yield enhancement purposes, with third parties, mostly large brokerage firms. Securities loaned are treated as financing arrangements and the unrestricted collateral received is recorded in other assets, with an offsetting liability recorded in other liabilities to account for the Company's obligation to return the collateral.

Additionally, Investors Heritage Life also engages in commercial and residential mortgage lending with approximately 97.8% of these investments being in commercial properties. All mortgage loans are originated in-house and all loans are secured by first mortgages on the real estate. At September 30, 2004, 7.5% of invested assets consisted of mortgage loans compared to 7.9% at December 31, 2003. Management anticipates funding several new mortgage loan investments during the remainder of 2004 to maintain a similar to slightly higher percentage of mortgage loans to total invested assets.

Investors Heritage Life's conservative approach in the product development area and the strength and stability of its fixed income and mortgage loan portfolios provide adequate liquidity both in the short-term and the long-term. At September 30, 2004 and December 31, 2003, Investors Heritage Life's fixed income investments were 100% investment grade as rated by Standard & Poor's. None of Investors Heritage Life's fixed income assets are in

default and there has been no material change in the distribution of its fixed income portfolio.

Investors Heritage Life's principal long-term obligations are fixed contractual obligations incurred in the sale of its life insurance products. The premiums charged for these products are based on conservative and actuarially sound assumptions as to mortality, persistency and interest. Management believes these assumptions will produce revenues sufficient to meet its future contractual benefit obligations and operating expenses, and provide an adequate profit margin.

The Company continuously evaluates all of its investments based on current economic conditions, credit loss experience and other developments. The Company evaluates the difference between the cost/amortized cost and estimated fair value of its investments to determine whether a decline in value is temporary or other than temporary in nature. This determination involves a degree of uncertainty. If a decline in the fair value of a security is determined to be temporary, the decline is recorded as an unrealized loss in shareholders' equity. If a decline in a security's fair value is considered to be other than temporary and the Company has the intent and ability to hold the security until it recovers, the security is written down to the estimated fair value with a corresponding realized loss recognized in the consolidated statements of income.

The assessment of whether a decline in fair value is considered temporary or other than temporary includes management's judgment as to the financial position and future prospects of the entity issuing the security. It is not possible to accurately predict when it may be determined that a specific security will become impaired. Future impairment charges could be material to the results of operations of the Company. The amount of impairment charge before tax was \$-0- in the third quarter of 2004 and 2003, and \$-0- and \$300,000 for the first nine months of 2004 and 2003, respectively.

Management believes that it will recover the cost basis in the securities held with unrealized losses as it has both the intent and ability to hold the securities until they mature or recover in value. Securities are sold to achieve management's investment goals, which include the diversification of credit risk, the maintenance of adequate portfolio liquidity and the management of interest rate risk. In order to achieve these goals, sales of investments are based upon current market conditions, liquidity needs and estimates of the future market value of the individual securities.

## **Results of Operations**

Total premium income (net of reinsurance) for the third quarter 2004 decreased 14.7% when compared to the third quarter of 2003 and decreased 11.2% for the first nine months of 2004 when compared to the same period in 2003. The decrease was primarily due to lower sales in the pre-need segment. Net investment income increased 5.9% for the third quarter 2004 compared to the third quarter of 2003 and increased 0.5% for the first nine months of 2004 when compared to the same period in 2003. The increase is

primarily due to a larger asset base, however lower yield rates on new asset purchases have impacted the rate of return on our investment portfolio. Overall revenue for the third quarter 2004 decreased 10.4% when compared to the third quarter of 2003 and decreased 8.5% for the first nine months of 2004 when compared to the same period in 2003.

Total Benefits and Expenses were 16.6% lower in the third quarter of 2004 when compared to the same quarter of 2003 and 11.4% lower for the first nine months of 2004 when compared to the same period of 2003, primarily due to lower premium production in pre-need sales and the implementation of several cost containment measures. After providing for federal income taxes, the Company's Net Income was \$1,443,138 with Earnings per share of \$1.27 for the first nine months of 2004 as compared to Net Income of \$265,396 and Earnings per share of \$0.23 for the same period in 2003.

A dividend of \$0.38 per share was paid April 14, 2004, to shareholders of record on March 26, 2004.

## **Business Segments**

Management internally evaluates the performance of Investors Heritage Life operations by the following business segments:

Preneed & Burial Products include both life and annuity products sold by funeral directors or affiliated agents to fund prearranged funerals. Revenues for this segment were 11.5% lower for the third quarter of 2004 when compared to the same period of 2003 and 9.4% lower in the first nine months of 2004 when compared to the same period of 2003. The decrease is due primarily to increased competition in the marketplace and an uncertain economic environment. Pre-Tax Income (Loss) from Operations for the third quarter 2004 was \$602,617 compared to \$(397,587) for the same period for 2003 and \$331,158 for the first nine months of 2004 compared to \$(713,445) for the same period for 2003. The implementation of several cost containment measures have resulted in lower general expenses. Also, the Company's new product series introduced in 2003 has improved product profitability and has helped to offset the losses resulting on our previously sold preneed products. Investors Heritage Life plans to continue its expansion of territory and recruitment of agents in the Preneed and Burial insurance market.

Traditional & Universal Life Products include traditional life and group life insurance products, annuities (primarily qualified) and universal life products. Revenues for this segment were 4.1% higher for the third quarter of 2004 when compared to the third quarter of 2003 and 2.4% lower for the first nine months of 2004 when compared to the same period in 2003. Revenues on this segment are primarily derived from the sales of term insurance products through banks, which has been lower during 2004 due to less loan demand. Sales have also slowed due to new federal banking guidelines regarding predatory lending and the sale of credit insurance in conjunction with a real estate mortgage. In addition, several states, including Kentucky, have enacted or are considering predatory lending laws that prohibit the financing of single premium credit insurance as

part of a real estate mortgage transaction. Pre-Tax Income from Operations for the first nine months of 2004 was \$604,287 compared to \$199,748 for the same period for 2003 primarily because of general insurance expense savings and better than anticipated mortality. Effective January 1, 2004, the Company lowered its maximum retention level from \$100,000 to \$25,000 per life. This new retention level has already helped to stabilize earnings fluctuations in this segment.

Credit Insurance Products and Administrative Services include the marketing and administration of credit life and credit accident & health insurance products. Revenues were \$45,086 for the third quarter of 2004 compared to \$78,474 for the same period for 2003 and \$133,211 for the first nine months of 2004 compared to \$235,343 for the same period in 2003. Pre-Tax Income from Operations was \$10,947 for the third quarter of 2004 compared to \$6,218 for the third quarter of 2003 and \$36,195 for the first nine months of 2004 compared to \$22,542 for the same period in 2003. The revenues and income on the credit insurance line have been affected by the same factors that affect the Traditional & Universal Life products discussed above including consumer loan demand, new federal banking guidelines enacted or being considered by states, and expense savings within the Company. Overall income is higher for the nine month period because of the increased service fees generated on earned premiums. All of the related underwriting risk currently produced is being reinsured 100% with highly-rated life companies.

Corporate & Other consists of corporate accounts measured primarily by stockholders' paid-in capital, contributed surplus, earned surplus, property and equipment, and other minor business lines which include group annuities and group and individual accident and health products. Revenues were 37.9% lower and Pre-Tax Income from Operations was 118.2% lower for the third quarter of 2004 when compared to the third quarter 2003. Revenues were 13.4% lower for the first nine months of 2004 compared to the same period in 2003 and Pre-Tax Income from Operations was 13.7% lower for the first nine months of 2004 when compared to the same period in 2003. The decreases in revenue and pre-tax income for the third quarter in 2004 are primarily due to lower realized gains from the sale of investments in 2004 as compared to 2003.

## **Federal Income Taxes**

Current taxes are provided based on estimates of the projected effective annual tax rate. Deferred taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The effective tax rate was 15.0% for the nine months ended September 30, 2004 compared to 24.3% for the nine months ended September 30, 2003. The decrease in the effective tax rate is due primarily to the differences between book and tax reserve bases arising from the Company's section 807(f) tax election. In addition, there were permanent differences in the current tax resulting from the death benefit received by the Company on a company owned life policy, a reduction in stock compensation cost for a decline in the value of Company stock options, as well as the

release of the Company's previously non taxable self insurance reserve.

### **Forward Looking Information**

The Company cautions readers regarding certain forward-looking statements contained in this report and in any other statements made by, or on behalf of, the Company, whether or not in future filings with the Securities and Exchange Commission. Forward-looking statements are statements not based on historical information and which relate to future operations, strategies, financial results, or other developments. Statements using verbs such as "expect", "anticipate", "believe" or words of similar import generally involve forward-looking statements. Without limiting the foregoing, forward-looking statements include statements which represent the Company's beliefs concerning future levels of sales and redemptions of Investors Heritage Life's products, investment spreads and yields, or the earnings and profitability of the Company's or Investors Heritage Life's activities.

Forward-looking statements are necessarily based on estimates and assumptions that are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond the Company's control and many of which are subject to change. These uncertainties and contingencies could cause actual results to differ materially from those expressed in any forward-looking statements made by, or on behalf of, the Company. Whether or not actual results differ materially from forward-looking statements may depend on numerous foreseeable and unforeseeable factors and developments. Some of these may be national in scope, such as general economic conditions, changes in tax law and changes in interest rates. Some may be related to the insurance industry generally, such as pricing competition, regulatory developments, industry consolidation and the effects of competition in the insurance business from other insurance companies and other financial institutions operating in the Company's market area and elsewhere. Others may relate to the Company specifically, such as credit, volatility and other risks associated with the Company's investment portfolio. The Company cautions that such factors are not exclusive. The Company disclaims any obligation to update forward-looking information.

### **ITEM 3. Quantitative and Qualitative Disclosures about Market Risk**

There have been no significant or material changes in the Company's market risks since December 31, 2003. Measuring market risk is a key function of our asset/liability management process. To test financial risk and investment strategy, the Company performs an asset adequacy analysis each year. Dynamic models of both assets and liabilities are created to project financial results under several shifts in the current interest rate environment. Results show that the Company's exposure to a relative 10% increase or decrease in the interest rates prevalent at December 31, 2003 is a net loss of less than \$500,000. This analysis is not performed on a quarterly basis.

Items taken into account on the asset side include prepayment and liquidity risks, asset diversification and quality considerations. On the liability side, interest crediting strategies

and policyholder and agent behavior (lapses, loans, withdrawals and premium flow) are dynamically modeled in relationship to the particular interest rate environment tested. Although the Company is careful to ensure that these assumptions are consistent with the best available data, interest-sensitive cash flows cannot be forecast with certainty and can deviate significantly from the assumptions made.

Because asset and liability durations are continually changing as new policyholder contracts are issued and as new investments are added to the portfolio, the Company manages its balance sheet on an ongoing basis and its net exposure to changes in interest rates may vary over time. Although the asset adequacy analysis is not performed on a quarterly basis, management believes that the Company's asset base is sufficient to cover the minimal increases or decreases that would be expected to occur during any particular year.

In addition to these dynamic modeling techniques, the Company closely monitors its own business segments with respect to product performance and agent behavior. To that end, during 2002 we implemented a new system to assist in monitoring these areas. This new tool allows management to quickly isolate areas of strength and weakness and to take appropriate and timely action to exploit the strengths and improve the weaknesses.

#### **ITEM 4. Controls and Procedures**

As of the end of the period covered by this Form 10-Q, the Company performed an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in this Quarterly Report on Form 10-Q. There have been no significant changes in the Company's internal controls or in other factors which could significantly affect internal controls over financial reporting during this most recent quarter or subsequent to the date the Company carried out its evaluation.

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## **PART II – OTHER INFORMATION**

### **ITEM 1. Legal Proceedings**

The Company is not involved in any legal proceedings. From time to time

Investors Heritage Life is involved in litigation relating to claims arising out of its operations in the normal course of business. As of November 11, 2004, Investors Heritage Life is not a party to any legal proceedings, the adverse outcome of which, in management's opinion, individually or in the aggregate, would have a material adverse effect on Investors Heritage Life's or the Company's financial condition or results of operations.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**

No share repurchases were made pursuant to a publicly announced plan or program. All share repurchases were shares tendered by employees as part of the Company's 401(k) plan.

**ITEM 3. Defaults Upon Senior Securities**

None

**ITEM 4. Submission of Matters to a Vote of Security Holders**

None

**ITEM 5. Other Information**

None

**ITEM 6. Exhibits and Reports on Form 8-K**

a) Exhibits

No exhibits were filed for the quarter ended September 30, 2004.

b) Reports on form 8-K

None

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**SIGNATURES**

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

**KENTUCKY INVESTORS, INC.**

BY:



Harry Lee Waterfield II  
President

DATE: August 11, 2004

BY:



Raymond L. Carr  
Vice President - Chief Financial Officer

DATE: August 11, 2004