

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

**FORM 10-Q**

QUARTERLY REPORT

Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Quarterly Period Ended June 30, 2006

**Commission File Number: 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 No.)

**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 June 30, 2006 – 1,108,443.72**

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act. Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (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>June 30, 2006</u>	<u>December 31, 2005</u>
<b>Assets</b>		
<b>Investments</b>		
Securities available for sale, at fair value:		
Fixed maturities (amortized cost:		
\$273,948,650 and \$275,752,746)	\$270,631,443	\$283,342,803
Equity securities (cost:	3,545,649	3,392,822
\$2,892,355 and \$2,872,367)	22,230,437	22,893,966
Mortgage loans on real estate	7,302,694	7,438,128
Policy loans	1,780,044	2,268,714
Other long term investments	<u>540,000</u>	<u>575,001</u>
Short term investments		
Total investments	306,030,267	319,911,434
Cash and cash equivalents	6,827,169	1,994,032
Accrued investment income	4,508,288	4,654,762
Due premiums	3,817,649	4,089,627
Deferred acquisition costs	22,656,884	22,356,641
Present value of future profits	253,761	299,553
Leased property under capital leases	337,999	427,914
Property and equipment	1,595,952	1,567,392
Collateral on securities loaned	16,099,778	16,773,190
Cash value of company life insurance	6,104,044	6,178,136
Other assets	379,340	299,328
Amounts recoverable from reinsurers	<u>54,507,910</u>	<u>54,899,396</u>
Total assets	<u>\$423,119,041</u>	<u>\$433,451,405</u>



## KENTUCKY INVESTORS, INC.

### Condensed Consolidated Income Statements (Unaudited)

	Three Months Ended June 30	
	<u>2006</u>	<u>2005</u>
Revenue		
Premiums and other considerations	\$11,928,628	\$12,528,051
Premiums ceded	<u>(3,544,952)</u>	<u>(3,444,839)</u>
Net premiums earned	8,383,676	9,083,212
Investment income, net of expenses	4,527,945	4,611,245
Realized gain on investments, net	71,073	107,253
Other income	<u>268,806</u>	<u>245,583</u>
Total revenue	<u>13,251,500</u>	<u>14,047,293</u>
Benefits and expenses		
Death and other benefits	7,861,876	7,998,526
Guaranteed annual endowments	170,193	179,246
Dividends to policyholders	150,137	159,825
Increase in benefit reserves and unearned premiums	1,309,277	1,746,383
Acquisition costs deferred	<u>(1,261,506)</u>	<u>(1,280,848)</u>
Amortization of deferred acquisition costs	1,514,427	1,566,289
Commissions	529,230	599,832
Other insurance expenses	<u>2,534,406</u>	<u>2,280,097</u>
Total benefits and expenses	<u>12,808,040</u>	<u>13,249,350</u>
Income from operations before provision for federal income taxes	<u>443,460</u>	<u>797,943</u>
Provision (benefit) for federal income taxes:		
Current	73,054	161,640
Deferred	<u>7,124</u>	<u>(18,000)</u>
Total provision for federal income taxes	<u>80,178</u>	<u>143,640</u>
Net income	<u>\$ 363,282</u>	<u>\$ 654,303</u>
Earnings per share	<u>\$ 0.33</u>	<u>\$ 0.59</u>
Dividends per share	<u>\$ -</u>	<u>\$ -</u>

See accompanying notes.

## KENTUCKY INVESTORS, INC.

### Condensed Consolidated Income Statements (Unaudited)

	Six Months Ended June 30	
	<u>2006</u>	<u>2005</u>
Revenue		
Premiums and other considerations	\$24,015,397	\$24,067,800
Premiums ceded	<u>(6,584,683)</u>	<u>(6,202,910)</u>
Net premiums earned	17,430,714	17,864,890
Investment income, net of expenses	9,027,774	9,059,640
Realized gain (loss) on investments, net	(58,644)	685,778
Other income	<u>516,704</u>	<u>466,931</u>
Total revenue	<u>26,916,548</u>	<u>28,077,239</u>
Benefits and expenses		
Death and other benefits	16,785,153	17,421,074
Guaranteed annual endowments	325,410	337,809
Dividends to policyholders	293,254	303,493
Increase in benefit reserves and unearned premiums	2,681,838	2,318,806
Acquisition costs deferred	(2,521,486)	(2,464,552)
Amortization of deferred acquisition costs	2,981,094	2,929,893
Commissions	1,127,645	1,216,629
Other insurance expenses	<u>4,865,969</u>	<u>4,843,589</u>
Total benefits and expenses	<u>26,538,877</u>	<u>26,906,741</u>
Income from operations before provision for federal income taxes	<u>377,671</u>	<u>1,170,498</u>
Provision (benefit) for federal income taxes:		
Current	148,066	182,862
Deferred	<u>(79,783)</u>	<u>63,000</u>
Total provision for federal income taxes	<u>68,283</u>	<u>245,862</u>
Net income	<u>\$ 309,388</u>	<u>\$ 924,636</u>
Earnings per share	<u>\$ 0.28</u>	<u>\$ 0.84</u>
Dividends per share	<u>\$ 0.38</u>	<u>\$ 0.38</u>

See accompanying notes.

**KENTUCKY INVESTORS, INC.**

**Condensed Consolidated Statements of Stockholders' Equity (Unaudited)**

	<b>Common Stock</b>	<b>Paid-in Surplus</b>	<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>Retained Earnings</b>	<b>Total Stockholders' Equity</b>
<b>BALANCE, JANUARY 1, 2005</b>	\$ 1,099,666	\$ 8,560,130	\$ 10,406,040	\$ 28,749,601	\$ 48,815,437
<b>Comprehensive income (loss):</b>					
Net income	-	-	-	924,636	924,636
Change in net unrealized appreciation on available-for-sale securities	-	-	(327,886)	-	(327,886)
Total comprehensive loss					(596,750)
Cash dividends paid (\$0.38 per share)	-	-	-	(454,016)	(454,016)
Issuances of common stock, net	929	3,019	-	19,509	23,457
<b>BALANCE, JUNE 30, 2005</b>	\$ 1,100,595	\$ 8,563,149	\$ 10,078,154	\$ 29,239,730	\$ 48,981,628
<b>BALANCE, JANUARY 1, 2006</b>	\$ 1,104,773	\$ 8,578,978	\$ 3,954,841	\$ 30,624,112	\$ 44,262,704
<b>Comprehensive income (loss):</b>					
Net income	-	-	-	309,388	309,388
Change in net unrealized appreciation on available-for-sale securities	-	-	(6,581,353)	-	(6,581,353)
Change in fair value of hedging instrument	-	-	18,236	-	18,236
Total comprehensive loss					(6,253,729)
Cash dividends paid (\$0.38 per share)	-	-	-	(455,604)	(455,604)
Issuances of common stock, net	3,671	12,738	-	71,878	88,287
<b>BALANCE, JUNE 30, 2006</b>	\$ 1,108,444	\$ 8,591,716	\$ (2,608,276)	\$ 30,549,774	\$ 37,641,658

See accompanying notes.

## KENTUCKY INVESTORS, INC.

### Condensed Consolidated Statements of Cash Flows (Unaudited)

	Six Months Ended June 30	
	<u>2006</u>	<u>2005</u>
Net cash provided by operating activities	\$ 3,955,676	\$ 4,344,480
Investing activities		
Securities available-for-sale:		
Purchases	(25,914,023)	(23,361,961)
Sales and maturities	27,442,552	20,126,347
Other investments:		
Cost of acquisition	(1,221,357)	(1,732,023)
Sales and maturities	2,543,991	2,280,741
Net additions to property and equipment	<u>(106,610)</u>	<u>(344,017)</u>
Net cash provided by (used in) investing activities	2,744,553	(3,030,913)
Financing activities		
Receipts from universal life policies credited to policyholder account balances	4,546,490	3,834,811
Return of policyholder account balances on universal life policies	(5,174,313)	(4,351,027)
Payments on notes payable	(4,352,828)	(3,594,931)
Proceeds from notes payable	3,480,876	4,470,000
Issuances of common stock	88,287	23,457
Dividends paid	<u>(455,604)</u>	<u>(454,016)</u>
Net cash used in financing activities	<u>(1,867,092)</u>	<u>(71,706)</u>
Increase in cash and cash equivalents	4,833,137	1,241,861
Cash and cash equivalents at beginning of period	<u>1,994,032</u>	<u>2,445,782</u>
Cash and cash equivalents at end of period	<u>\$ 6,827,169</u>	<u>\$ 3,687,643</u>

See accompanying notes.

## KENTUCKY INVESTORS, INC.

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2006  
(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 our consolidated revenue.

Our operations involve the sale and administration of various insurance and annuity products, including, but not limited to, participating and 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 products sold by Investors Heritage Life are in the commonwealths of Kentucky and Virginia, and the states of North Carolina, South Carolina, Ohio, Indiana, Florida, Tennessee, Georgia, and Michigan.

**NOTE B - Basis of Presentation:** The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles 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 U.S. generally accepted accounting principles 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 six months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended December 31, 2005, as included in our Annual Report on Form 10-K.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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.

Certain reclassifications have been made to the amounts previously reported for the prior periods shown herein to conform to the current period presentation.

**NOTE C - Earnings per Share and Stock-Based Compensation:** Earnings per share of common stock were computed based on the weighted average number of common shares outstanding during each period. The weighted average number of shares outstanding for the three months ended June 30, 2006 and 2005 were 1,107,153 and 1,100,595, respectively. The weighted average number of shares outstanding for the six months ended June 30, 2006 and 2005 were 1,105,969 and 1,100,185, respectively.

Effective January 1, 2006, we began accounting for stock-based incentive programs under Statement of Financial Accounting Standard (“SFAS”) No. 123(R), “*Share-Based Payment*.” SFAS No. 123(R) superseded Accounting Principles Board Opinion No. 25, “*Accounting for Stock Issued to Employees*,” and requires all share-based payments to employees to be recognized as compensation expense in the consolidated income statement. We adopted the provisions of SFAS No. 123(R) using the modified prospective method in which compensation expense is recognized based on the requirements of SFAS No. 123, “*Accounting for Stock-Based Compensation*,” for all awards granted to employees prior to January 1, 2006. Under this method, our stock-based compensation is reported in the balance sheets as a liability based on the intrinsic value of the compensation, and compensation expense is measured as the change in intrinsic value. Prior to the adoption of SFAS No. 123(R) on January 1, 2006, we also accounted for stock-based compensation in accordance with SFAS No. 123, under which we recognized compensation expense based on the intrinsic value of stock-based compensation. Implementation of this new standard did not have a material impact on our financial condition or our operations based on our current use of the liability method.

The Company’s only outstanding stock options and stock appreciation rights were issued in 1999. Pursuant to our stock option and stock appreciation rights plan, there were 61,125 outstanding options, having an exercise price of \$23.00 per share as of June 30, 2006. Our stock price changed from \$23.50 per share at December 31, 2005 to \$23.60 per share at March 31, 2006 and \$24.20 at June 30, 2006. Accordingly, we recognized an increase of \$36,675 and \$42,788, respectively, in stock compensation expense associated with such options for the three month and six month periods ended June 30, 2006. We recognized a decrease of \$77,850 and an increase of \$7,950, respectively, in stock compensation expense associated with such options for the three month and six month periods ended June 30, 2005.

**NOTE D - Segment Data:** We operate 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>June 30, 2006</u>	<u>June 30, 2005</u>
Revenue:		
Preneed and Burial Products	\$9,886,413	\$10,620,671
Traditional and Universal Life Products	2,886,868	2,915,895
Credit Insurance Products and Administrative Services	54,388	46,367
Corporate and Other	<u>423,831</u>	<u>464,360</u>
	<u>\$13,251,500</u>	<u>\$14,047,293</u>

Six Months Ended	
<u>June 30, 2006</u>	<u>June 30, 2005</u>
Income from operations before federal income taxes:	
\$ 59,569	\$ 90,433
160,511	317,823
10,582	10,706
<u>212,798</u>	<u>378,981</u>
<u>\$ 443,460</u>	<u>\$ 797,943</u>
Revenue:	
\$ 20,414,678	\$ 21,055,601
5,759,421	5,897,462
91,384	77,664
<u>651,065</u>	<u>1,046,512</u>
<u>\$ 26,916,548</u>	<u>\$ 28,077,239</u>
Income (loss) from operations before federal income taxes:	
\$ (74,654)	\$ (244,855)
213,758	485,713
38,356	59,565
<u>200,211</u>	<u>870,075</u>
<u>\$ 377,671</u>	<u>\$ 1,170,498</u>

**NOTE E – Federal Income Taxes:** Federal income 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 dividends--received deduction and the small life insurance company tax deduction. At June 30, 2006 and December 31, 2005, the Company's deferred tax liability as recorded on the balance sheet was \$2,348,836 and \$5,861,848, respectively.

At December 31, 2005, \$689,535 of the retained earnings of the Company represented earnings prior to 1984 which accumulated in an account known as policyholders' surplus, which was not subject to income taxation. The American Jobs Creation Act of 2004 eliminated the tax associated with distributions from this policyholders' surplus account made during specified tax years. Under the American Jobs Creation Act of 2004, any distributions to shareholders made during the 2005 and 2006 tax years are treated as being made first out of policyholders' surplus. Accordingly, Investors Heritage Life paid a dividend in the amount of \$728,768 to Kentucky Investors on April 6, 2006. As a result of this dividend, the balance of this policyholders' surplus account has been eliminated.



**NOTE H – Investments:** We participate 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 as an asset, with an offsetting liability recorded for our obligation to return the collateral. We obtain collateral in an amount equal to 102% of the fair value of domestic securities loaned, monitor the market value of securities loaned on a daily basis and obtain additional collateral as necessary. At June 30, 2006, fixed income securities with a carrying value of \$15,568,580 were on loan under this agreement, with associated collateral held of \$16,099,778. At December 31, 2005, fixed income securities with a carrying value of \$16,444,304 were on loan under this agreement, with associated collateral held of \$16,773,190. Income earned relative to this program was \$6,349 and \$13,099, respectively, for the three month and six month periods ended June 30, 2006. Income earned relative to this program was \$9,417 and \$19,179, respectively, for the three month and six month periods ended June 30, 2005.

**NOTE I – Notes Payable:** Effective May 30, 2006, the Company renewed the Kentucky Investors Line of Credit and the At Need Funding Line of Credit with Republic Bank and Trust Company, Louisville, Kentucky. The terms of the lines of credit remain the same as the terms previously in place with the exception that the At Need Funding Line of Credit has been increased from \$2,000,000 to \$4,000,000. The Kentucky Investors Line of Credit matures May 30, 2007 and the At Need Funding Line of Credit matures June 30, 2007.

## **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, 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.

The Legacy Protector and Legacy Preferred life insurance and annuity products were introduced in 2003 and are marketed exclusively in conjunction with pre-arranged funerals. These products allow for competitive commissions and death benefit growth to provide adequate proceeds to cover funeral expenses while allowing individuals to purchase affordable benefits that meet their personal needs. Underwritten and guaranteed issue options are available.

The Heritage Final Expense product is sold in the final expense markets. Introduced in 2002, it is reinsured on an 80% quota share basis. This reinsurance arrangement has helped to reduce first year statutory surplus strain associated with new sales, as well as provide a stable profit stream for the future.

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.

Our income is derived primarily from the sale of insurance products by Investors Heritage Life, plus investment results, including realized gains (losses), less interest credited to policyholders, benefits to policyholders and expenses.

While we continue to expand the operations of Investors Heritage Financial, Investors Heritage Printing and At Need Funding, less than 2% of our consolidated revenues were generated by those subsidiaries. As anticipated, approximately 16% of Investors Heritage Financial's revenues for the six month period ended June 30, 2006 were derived from the sale of Investors Heritage Life's credit insurance products. During the first six months of 2006, Kentucky Investors received dividends from Investors Heritage Financial totaling \$164,000 and received distributions from At Need Funding of \$72,000. We anticipate further dividend payments from Investors Heritage Financial and distributions from At Need Funding during the remainder of 2006.

Our primary uses of cash are operating expenses, debt service and dividend payments, and our principal sources of cash are the dividends paid to us by Investors Heritage Life and Investors Heritage Financial. Investors Heritage Life's principal sources of cash are from the sale of life insurance policies and investment income, including sales and maturities of investments, 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 discussion and analysis of our financial condition and results of operations is based on our consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. Preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On a continuing basis, we evaluate our estimates, including those related to investments, deferred acquisition costs, present value of future profits, policy liabilities, income taxes, pension plan liabilities, regulatory requirements, contingencies and litigation. We base 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. We believe the following accounting policies, judgments and estimates are the most critical to the preparation of our consolidated financial statements.

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

We hold fixed maturities and equity interests in a variety of issuers. Additionally, we originate, underwrite and manage mortgage loans. We continuously evaluate all of our investments based on

current economic conditions, credit loss experience and other developments. We evaluate the difference between the cost/amortized cost and estimated fair value of our 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 stockholders' equity. If a decline in a security's fair value is considered to be other-than-temporary, the security is written down to the estimated fair value with a corresponding realized loss recognized in the consolidated income statement.

The assessment of whether a decline in fair value is considered temporary or other-than-temporary includes our 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 June 30, 2006, the balance of our deferred acquisition costs was approximately \$22,657,000 compared to \$22,357,000 at December 31, 2005. The recovery of these costs is dependent on the future profitability of the related business. Each reporting period, 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 revision to these assumptions may impact future financial results.

### **Policy Liabilities**

Establishing liabilities for our long-duration insurance contracts requires various assumptions, including policyholder persistency, mortality rates, investment yields, discretionary benefit increases, new business pricing, and operating expense levels. We evaluate 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 judgments are required. Actual experience may emerge differently from that assumed. Any such difference would be recognized in the current period's consolidated income statement.

### **Income Taxes**

We evaluate our deferred income tax assets, which partially offset our deferred tax liabilities, for any necessary valuation allowances. In doing so, we consider our ability and potential for recovering income taxes associated with such assets, which involve significant judgment. Revisions to our assumptions associated with any necessary valuation allowances would be recognized in the financial statements in the period in which such revisions are made.

### **Accrued Pension Expense**

We maintain a defined benefit retirement plan on behalf of our employees. Measurement of the future benefit obligations associated with this plan involve significant judgment, particularly with regard to the expected long-term rate of return on plan assets, rate of compensation increases and the current discount rate used to calculate the present value of our future obligations. Changes in these assumptions can significantly impact the accrued pension expense and additional minimum pension liability required to be recorded in the financial statements. Additionally, proposed legislative and accounting changes, if adopted, have the potential to adversely impact the funding and accounting for our defined benefit plan.

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

#### **Investments**

Investors Heritage Life has maintained a sound, conservative investment strategy. At June 30, 2006, 88.4% of invested assets consisted of fixed income public bonds compared to 88.5% at December 31, 2005. Fixed income assets are managed by Conning Asset Management Company, an independent portfolio manager.

We recognized no other-than-temporary impairment losses during the six months ended June 30, 2006 or the corresponding period in 2005. We believe that we will recover the cost basis in the securities held with unrealized losses as we have both the intent and ability to hold the securities until they mature or recover in value.

We participate 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 as an asset, with an offsetting liability recorded for our obligation to return the collateral.

Additionally, Investors Heritage Life engages in commercial and residential mortgage lending with approximately 93.7% 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 June 30, 2006, 7.3% of invested assets consisted of mortgage loans compared to 7.2% at December 31, 2005. We anticipate funding several new mortgage loan investments during the remainder of 2006 to maintain a similar to slightly higher percentage of mortgage loans to total invested assets. As of June 30, 2006, Investors Heritage Life had no non-performing mortgage loans, which would include loans past due 90 days or more, loans in process of foreclosure, restructured loans and real estate acquired through foreclosure.

#### **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.

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. We believe these assumptions will produce revenues sufficient to meet its future contractual benefit obligations and operating expenses, and provide an adequate profit margin.

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 June 30, 2006, Investors Heritage Life's fixed income investments were 100% investment grade as compared to 99.6% investment grade at December 31, 2005, 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.

Kentucky Investors principal sources of cash flow are rental income and dividends from its subsidiaries. Kentucky Investors principal long-term obligations are payments on long-term debt.

We are not aware of any commitments or unusual events that could materially affect capital resources.

We 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.

## **Results of Operations**

### **Overview**

Premiums earned (net of reinsurance) were \$8,383,676 for the second quarter of 2006 (a decrease of 7.7% compared to the second quarter of 2005) and \$17,430,714 for the first six months of 2006 (a decrease of 2.4% compared to the same period in 2005). The decrease was primarily due to lower sales in the pre-need and burial segment during the second quarter of 2006. Net investment income was \$4,527,945 for the second quarter of 2006 (a decrease of 1.8% compared to the second quarter of 2005) and \$9,027,774 for the first six months of 2006 (a decrease of 0.4% compared to the same period in 2005). The decrease for the second quarter is primarily due to low yield rates on newer investments impacting the rate of return on our investment portfolio. Total revenue was \$13,251,500 for the second quarter of 2006 (a decrease of 5.7% compared to the second quarter of 2005) and \$26,916,548 for the first six months of 2006 (a decrease of 4.1% compared to the same period in 2005). This decrease is primarily due to the previously described lower sales in the pre-need and burial segment during the second quarter of 2006 coupled with realized gains recognized during the first quarter of 2005 on the sales of significantly appreciated common stocks.

Total benefits and expenses were \$12,808,040 in the second quarter of 2006 (a decrease of 3.3% compared to the second quarter of 2005) and \$26,538,877 for the first six months of 2006 (a decrease of 1.4% compared to the same period in 2005). The decrease in benefits and expenses is

primarily due to lower pre-need production. After providing for federal income taxes, our net income was \$363,282 with earnings per share of \$0.33 for the second quarter of 2006 as compared to \$654,303 and earnings per share of \$0.59 for the second quarter of 2005. Our net income was \$309,388 with earnings per share of \$0.28 for the first six months of 2006 as compared to \$924,636 and earnings per share of \$0.84 for the same period in 2005. The decrease in net income for the first six months of 2006 is due primarily to the previously mentioned realized gains recognized during the first quarter of 2005 on the sales of significantly appreciated common stocks.

A dividend of \$0.38 per share was paid April 7, 2006, to shareholders of record on March 24, 2006.

### **Business Segments**

We internally evaluate the performance of our 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 \$9,886,413 for the second quarter of 2006 (a decrease of 6.9% compared to the second quarter of 2005) and \$20,414,678 for the first six months of 2006 (a decrease of 3.0% compared to the same period of 2005). The decrease for the second quarter of 2006 is due primarily to decreased premium production from lower sales of the preneed and burial products. Pre-tax income (loss) from operations was \$59,569 for the second quarter of 2006 compared to \$90,433 for the same period for 2005 and \$(74,654) for the first six months of 2006 compared to \$(244,855) for the same period for 2005. Our Legacy Preferred product series continues to improve product profitability.

Traditional & Universal Life Products include traditional life and group life insurance products, annuities (primarily qualified) and universal life products. Revenues for this segment were \$2,886,868 for the second quarter of 2006 (a decrease of 1.0% compared to the second quarter of 2005) and \$5,759,421 for the first six months of 2006 (a decrease of 2.3% compared to the same period of 2005). Revenues on this segment are primarily derived from the sale of term insurance products through banks, which have experienced lower demand during 2006 compared to the prior year. Pre-tax income from operations was \$160,511 for the second quarter of 2006 compared to \$317,823 for the same period for 2005 and \$213,758 for the first six months of 2006 compared to \$485,713 for the same period for 2005, primarily because of the lower revenue.

Credit Insurance Products and Administrative Services include the marketing and administration of credit life and credit accident & health insurance products. Revenues for this segment were \$54,388 for the second quarter of 2006 (an increase of 17.3% compared to the second quarter of 2005) and \$91,384 for the first six months of 2006 (an increase of 17.7% compared to the same period of 2005). Pre-tax income from operations was \$10,582 for the second quarter of 2006 compared to \$10,706 for the same period for 2005 and \$38,356 for the first six months of 2006 compared to \$59,565 for the same period for 2005. 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 for this segment were \$423,831 for the second quarter of 2006 (a decrease of 8.7%

compared to the second quarter of 2005) and \$651,065 for the first six months of 2006 (a decrease of 37.8% compared to the same period of 2005). Pre-tax income from operations was \$212,798 for the second quarter of 2006 compared to \$378,981 for the same period of 2005 and \$200,211 for the first six months of 2006 compared to \$870,075 for the same period for 2005. The decrease in revenues and pre-tax income for the first six months of 2006 is primarily due to realized gains from the sales of significantly appreciated common stock investments during the first quarter of 2005.

### **Federal Income Taxes**

Federal income taxes are provided based on estimates of the projected annual effective 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 18.1% for the six months ended June 30, 2006 compared to 21.0% for the six months ended June 30, 2005. The decrease in the effective tax rate is primarily due to taxes incurred during the first three months of 2005 associated with realized gains on sales of significantly appreciated common stocks.

### **Forward Looking Information**

We caution readers regarding certain forward-looking statements contained in this report and in any other statements made by us or on our behalf, 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 our beliefs concerning future levels of sales and redemptions of Investors Heritage Life’s products, investment spreads and yields, or our earnings and profitability.

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 our 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 us or on our behalf. 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 our market area and elsewhere. Others may relate to us specifically, such as credit, volatility and other risks associated with our investment portfolio. We caution that such factors are not exclusive. We disclaim 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 our market risks since December 31, 2005. Measuring market risk is a key function of our asset/liability management process. To test financial risk and investment strategy, we perform 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 our exposure to a relative 10% increase or decrease in the interest rates prevalent at December 31, 2005 is a net loss of less than \$500,000. This analysis is performed annually.

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 we are 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, we manage our 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, we believe that our asset base is sufficient to cover the minimal increases or decreases that would be expected to occur during any particular year.

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

As of the end of the period covered by this Form 10-Q, we performed an evaluation, under the supervision and with the participation of management, including our Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our 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 our 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 our 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 we carried out our evaluation.

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## PART II – OTHER INFORMATION

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

Kentucky Investors 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 August 8, 2006, 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 our financial condition or results of operations.

### **ITEM 1A. Risk Factors**

There have been no material changes from risk factors as previously disclosed in our Annual Report on Form 10-K.

### **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 our 401(k) plan.

### **ITEM 3. Defaults Upon Senior Securities**

None

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

(a) The annual meeting of the stockholders was held May 11, 2006 at 11:00 a.m. The purpose of the meeting was to elect directors.

(b) Three (3) directors were elected to hold office for a term of three (3) years or until their successors are duly elected and qualified.

The following individuals were elected for a term of three (3) years and the number of votes cast were as follows

Howard L. Graham - Number of Votes Cast FOR – 931,316.118; WITHHELD – 3,334.54

Robert M. Hardy, Jr. - Number of Votes Cast FOR – 931,398.358; WITHHELD - 3,252.3

Dr. Jerry F. Howell, Jr. - Number of Votes Cast FOR – 931,321.638; WITHHELD - 3,329.02

The other directors whose terms will continue after the meeting are:

Gordon C. Duke  
Harry Lee Waterfield II  
Michael F. Dudgeon, Jr.  
Harold G. Doran, Jr.  
Helen S. Wagner  
David W. Reed

#### **ITEM 5. Other Information**

None

#### **ITEM 6. Exhibits**

- 31.1 & 31.2 Certifications pursuant to Securities and Exchange Act Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certifications Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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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: /s/Harry Lee Waterfield II  
Harry Lee Waterfield II  
President

DATE: August 8, 2006

BY: /s/Raymond L. Carr  
Raymond L. Carr  
Vice President - Chief Financial Officer

DATE: August 8, 2006