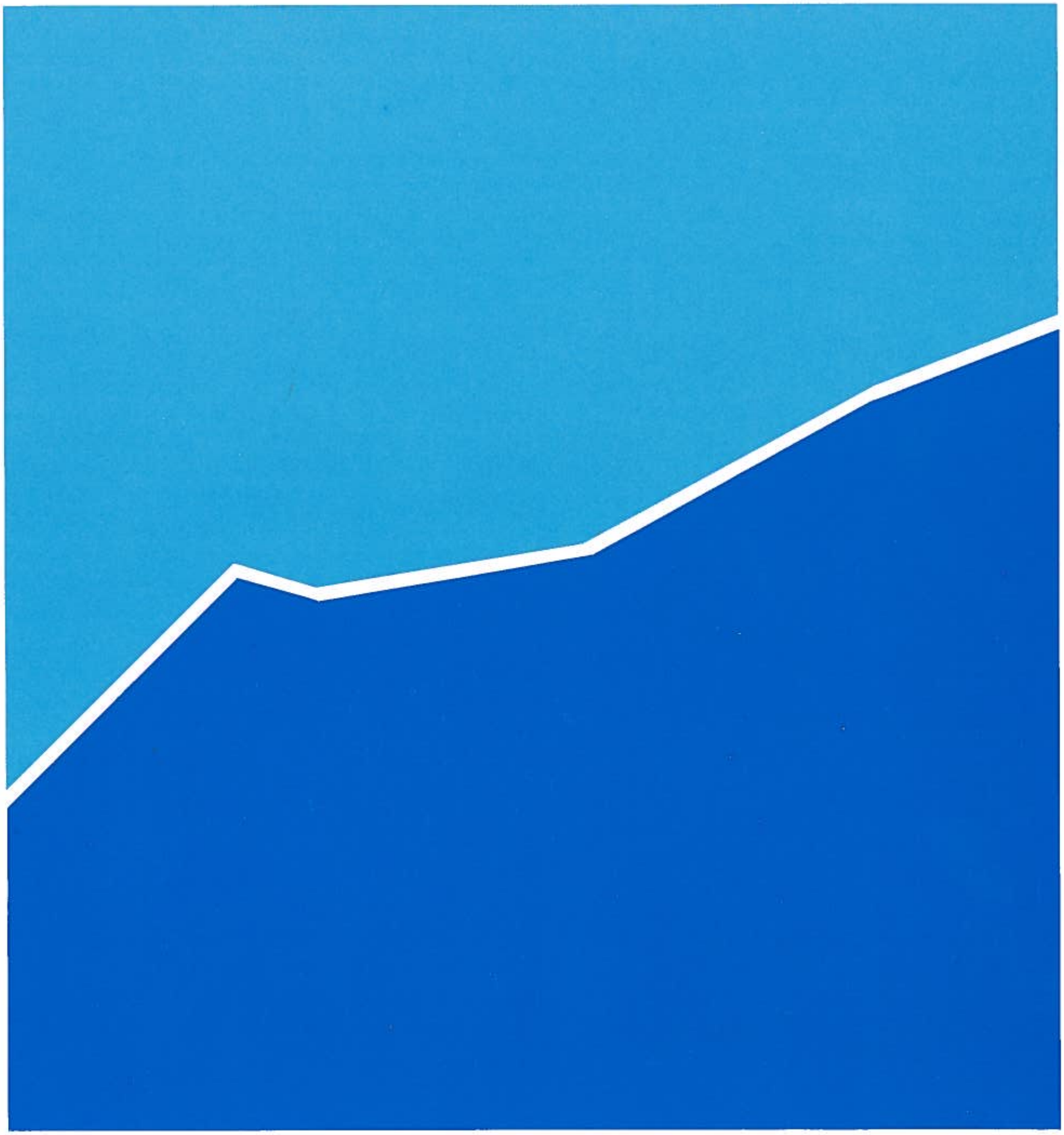
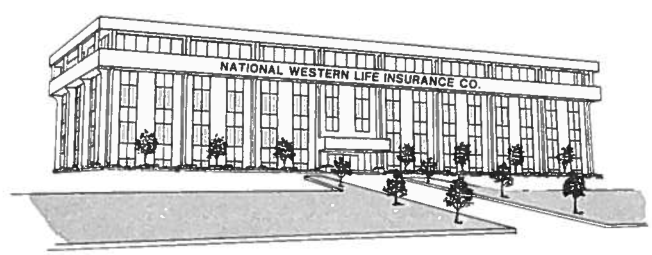
NATIONAL WESTERN LIFE INSURANCE COMPANY



1985 ANNUAL REPORT



National Western Life Insurance Company
Austin, Texas

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EXECUTIVE OFFICES
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ACCOUNTANTS
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TRANSFER AGENTS/REGISTRARS
Manufacturers Hanover Trust Company, Box 24935, Church Street Station, New York, New York 10249
First City National Bank, Post Office Box 2127, Austin, Texas 78768

SUBSIDIARIES
Commercial Adjusters, Inc., Austin, Texas
    Principal activity: Premium Financing
    Inactive
The Westcap Corporation, Houston, Texas
    Principal activity: U.S. Government and Municipal Securities Dealer

10-K Report Available

National Western Life Insurance Company's operations and financial position for the year ended December 31, 1985, have been presented in your Annual Report as well as in the Form 10-K report filed with the Securities and Exchange Commission. If you wish a copy of the 10-K report, one will be furnished upon request to the Treasurer, National Western Life Insurance Company, 850 East Anderson Lane, Austin, Texas 78776.

To Our Stockholders:

We are pleased to present the 1985 financial results of National Western Life Insurance Company in the accompanying statements. It was another exceptionally good year from the standpoint of profitability and growth. It is gratifying to report the Company exceeded 1984 results in all areas of comparability.

Net Earnings increased to $9.5 million, an increase of 144% over the previous year, net of a onetime special tax benefit resulting from the 1984 Life Insurance Company Tax Act which was realized in 1984.

Total Assets increased to well over ½ billion dollars ($594,554,000), an increase of 27% over the previous year.

Stockholders' Equity increased to $72.6 million, or $20.87 per share, an increase of 16% compared to $62.4 million, or $17.94 per share, in 1984.

Total Premium Income increased to $182.2 million, an increase of 49% over the previous year. Of the total, Life Insurance Premiums increased to $75.2 million, an increase of 61%, and annuity premiums, primarily from the sale of Tax-Sheltered Annuities issued to teachers to supplement retirement benefits, increased to $106.9 million, an increase of 42% over 1984.

As a result of continued aggressive marketing, the Company again issued in excess of $1.1 billion in face amount of new life insurance during 1985. Total life insurance in force was in excess of $3.3 billion at year-end 1985.

The Company's totally owned brokerage subsidiary, The Westcap Corporation, experienced another excellent and profitable year. National Western Life's equity interest in the earnings from the subsidiary, which is located in Houston, Texas, amounted to approximately $2.5 million in 1985, compared to $0.4 million in 1984. Earnings from the subsidiary vary directly with trading activity in the Government Securities market. Thus far in 1986, the subsidiary continues to enjoy excellent results.

Net Investment Income increased to $47.5 million, an increase of 33% over the previous year, reflecting an increase in invested assets resulting from increased Premium Income produced by the Company's strong marketing results. The ratio of Statutory Net Investment Income to Statutory Mean Assets increased to 10.10%, which is well in excess of the 1984 industry average of 9.2% and close to ½% above the Company's 1984 results.

We believe the excellent earnings and growth rates being achieved by the Company are reflected in the market price of our common stock. During the period of 1981 through the first two months of 1986, the market price advanced from a low of 3¼ bid to a high of 19⅛ bid. There are usually ten to fourteen active market makers. Several brokerage firm analysts regularly follow and report on the Company's progress.

The life insurance industry has been undergoing rapid changes in the past few years, and there is no reason to believe that consumers' switch from traditional life insurance products to interest-sensitive life insurance products is going to decline. We feel confident that National Western Life is in the mainstream of the life insurance industry, and the Company has successfully made the transition from traditional life insurance products to interest-sensitive products better than most companies in our size category.

Unquestionably, profit margins associated with interest-sensitive products are going to be smaller than profit margins of traditional products of the past. As a result, we are required to operate smarter with larger volume and smaller profit margins in order to continue good patterns of growth and to maintain our excellent profitability patterns. We believe that National Western Life will continue the trend toward becoming a major life insurance company. We expect the momentum generated in 1985, and prior years, to carry forward throughout 1986.

With your continued loyalty and the support and efforts of our marketing organizations, employees, Officers, and Directors, it is anticipated 1986 will be another year of excellent growth and accomplishment.

Robert L. Moody
Chairman of the Board
and Chief Executive Officer

Robert L. Moody

Harry L. Edwards
President and
Chief Operating Officer

Harry L. Edwards

Consolidated Balance Sheets

ASSETS	December 31, 1985	1984
Investments:		
Fixed maturities, primarily bonds, at amortized cost (market: $346,165,011 and $216,843,474)	$ 336,108,339	233,036,904
Preferred stocks, at market value (cost: $7,358,005 and $5,550,702)	6,748,624	4,367,281
Common stocks, at market value (cost: $2,901,555 and $2,710,734)	3,332,200	3,016,443
Mortgage loans, net	76,961,772	66,802,279
Policy loans	69,936,961	60,845,346
Investment in subsidiary, at equity	10,920,964	8,740,321
Life interest in Libbie Shearn Moody Trust	7,894,805	8,149,834
Other invested assets	16,578,831	18,892,433
Total investments	528,482,496	403,850,841
Cash	3,643,191	3,066,320
Insurance receivables, net	1,504,288	2,568,785
Accrued investment income	10,444,012	7,367,539
Deferred policy acquisition costs	47,564,181	47,129,705
Property and equipment, net	738,644	589,935
Other assets	2,176,947	2,776,227
	$ 594,553,759	467,349,352

See accompanying notes to consolidated financial statements.

Consolidated Balance Sheets

LIABILITIES AND STOCKHOLDERS' EQUITY	December 31, 1985	1984
LIABILITIES:		
Future policy benefits	$ 472,537,259	361,706,711
Policy and contract claims	3,029,382	1,576,666
Policyholders' dividends, coupons, and endowment accumulations	11,876,695	13,287,515
Other policyholders' funds	8,896,001	6,273,491
Deferred Federal income taxes payable	10,862,000	7,862,000
Other liabilities	14,789,280	14,241,042
Total liabilities	521,990,617	404,947,425
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Common stock:		
Class A of $1 par value, authorized 7,500,000 shares; issued and outstanding 3,277,819, 1985 and 1984	3,277,819	3,277,819
Class B of $1 par value, authorized, issued, and outstanding 200,000 shares	200,000	200,000
Additional paid-in capital	24,065,352	24,065,352
Net unrealized losses on investments in equity securities (note 8)	(178,736)	(877,712)
Retained earnings	45,198,707	35,736,468
Total stockholders' equity	72,563,142	62,401,927
	$ 594,553,759	467,349,352

See accompanying notes to consolidated financial statements.

Consolidated Statements of Operations

	Years Ended December 31, 1985	1984	1983
Premiums and other revenue:			
Premiums:			
Life	$ 75,280,376	46,704,082	38,715,499
Annuities	106,938,767	75,163,740	40,812,012
	182,219,143	121,867,822	79,527,511
Investment income, net	47,547,208	35,510,437	27,205,917
Other income	765,276	700,546	1,196,694
Total premiums and other revenue	230,531,627	158,078,805	107,930,122
Benefits and expenses:			
Life	35,307,654	30,772,035	30,031,751
Other	31,123,769	19,099,441	13,385,214
Increase in liabilities for future policy benefits	110,830,548	64,094,525	31,763,177
Amortization of deferred policy acquisition costs	13,080,845	14,415,866	11,888,142
Other operating expenses	30,745,753	20,066,892	13,139,281
Total benefits and expenses	221,088,569	148,448,759	100,207,565
Earnings before Federal income taxes and other items	9,443,058	9,630,046	7,722,557
Deferred Federal income tax adjustment	—	19,984,000	—
Deferred Federal income taxes	(3,000,000)	(3,341,000)	(2,900,000)
Earnings from insurance operations	6,443,058	26,273,046	4,822,557
Equity in net earnings of subsidiary	2,523,978	424,456	2,504,780
Realized gains (losses) on investments, less income taxes	495,203	(2,847,447)	(220,834)
Net earnings	$ 9,462,239	23,850,055	7,106,503
Earnings per share of common stock:			
Earnings from insurance operations	$ 1.85	7.56	1.39
Equity in net earnings of subsidiary	.73	.12	.72
Realized gains (losses) on investments	.14	(.82)	(.07)
Net earnings	$ 2.72	6.86	2.04

See accompanying notes to consolidated financial statements.

Consolidated Statements of Stockholders' Equity

	Years Ended December 31,		
	1985	1984	1983
Common stock:			
Balance at beginning of year	$ 3,477,819	3,477,950	3,477,950
Par value of 131 shares cancelled in 1984	—	(131)	—
Balance at end of year	3,477,819	3,477,819	3,477,950
Additional paid-in capital:			
Balance at beginning of year	24,065,352	24,066,498	24,066,498
Value in excess of par on 131 shares cancelled in 1984	—	(1,146)	—
Balance at end of year	24,065,352	24,065,352	24,066,498
Net unrealized losses on investments in equity securities:			
Balance at beginning of year	(877,712)	(1,258,653)	(1,448,398)
Decrease in unrealized losses on investments in equity securities during the year	698,976	380,941	189,745
Balance at end of year	(178,736)	(877,712)	(1,258,653)
Retained earnings:			
Balance at beginning of year	35,736,468	11,886,413	4,779,910
Net earnings	9,462,239	23,850,055	7,106,503
Balance at end of year	45,198,707	35,736,468	11,886,413
Total stockholders' equity	$ 72,563,142	62,401,927	38,172,208

See accompanying notes to consolidated financial statements.

Consolidated Statements of Changes in Financial Position

	Years Ended December 31, 1985	1984	1983
Funds provided:			
From operations:			
Net earnings	$ 9,462,239	23,850,055	7,106,503
Charges (credits) not affecting funds:			
Deferred Federal income tax adjustment	—	(19,984,000)	—
Deferred Federal income taxes	3,000,000	3,341,000	2,900,000
Amortization of deferred policy acquisition costs	13,080,845	14,415,866	11,888,142
Increase in liability for future policy benefits	110,830,548	64,094,525	31,763,177
Amortization of bond discount	(1,960,375)	(2,420,059)	(2,056,464)
Other	(2,758,673)	8,927,730	3,722,556
	131,654,584	92,225,117	55,323,914
Cost of investments sold and loans matured:			
Bonds and notes	32,085,254	144,022,499	46,923,059
Mortgage loans	8,671,945	10,047,608	5,491,731
Other	3,565,669	1,175,458	557,251
	44,322,868	155,245,565	52,972,041
Decrease (increase) in cash	1,457,835	(2,152,690)	1,290,229
Other, net	3,356,494	(4,626,585)	(692,397)
Total funds provided	$ 180,791,781	240,691,407	108,893,787
Funds used:			
Increase (decrease) in policy loans	$ 9,091,615	6,048,386	(389,048)
Cost of investments purchased or loans disbursed:			
Bonds and notes	133,196,314	189,832,903	75,144,261
Stocks	4,305,500	1,312,996	3,812,103
Mortgage loans	18,651,443	14,792,738	14,200,984
Real estate held for investment	435,580	1,057,255	346,772
Collateral loans and other	116,150	4,717,032	4,042,996
	165,796,602	217,761,310	97,158,068
Additions to deferred policy acquisition costs	13,515,321	21,742,847	14,557,524
Other, net	1,479,858	1,187,250	(2,821,805)
Total funds used	$ 180,791,781	240,691,407	108,893,787

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Years Ended December 31, 1985, 1984, and 1983

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying consolidated financial statements include the accounts of National Western Life Insurance Company and its wholly-owned subsidiary (the Company). The Company's wholly-owned subsidiary, The Westcap Corporation and subsidiaries (Westcap), is not consolidated into these financial statements because of the nature of its operations. The earnings of Westcap are recognized by the equity method. All significant intercompany transactions and accounts have been eliminated in consolidation.

(A) Basis of Presentation—The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles which vary in certain respects from reporting practices prescribed or permitted by insurance regulatory authorities. The following are major differences between generally accepted accounting principles and accounting principles prescribed by insurance regulatory authorities:

1. Commissions and certain expenses related to policy issuance and underwriting, all of which generally vary with and are related to the production of new business, have been deferred. These costs are being amortized over the premium-paying period of the related policies in proportion to the ratio of the premium earned to the total premium revenue anticipated, using the same assumptions as to interest, mortality, and withdrawals as were used in calculating the liability for future policy benefits.

   A summary of information relative to deferred acquisition costs and premiums follows:

	1985	1984	1983
Costs deferred:			
Agents' commissions	$ 11,944,563	13,642,877	9,665,098
Other	1,570,758	1,674,611	1,473,312
	$ 13,515,321	15,317,488	11,138,410
Amounts amortized	$ 13,080,845	14,415,866	11,888,142
First-year and single premiums	$ 122,641,406	79,073,370	40,858,292
Renewal premiums	$ 59,577,737	42,794,452	38,669,219

2. The liability for future policy benefits has been calculated by the net level method using assumptions as to future mortality, interest, and withdrawals which were used or which were being experienced at the time that policies were issued.

3. Deferred Federal income taxes are provided for income and deductions which are recognized in the financial statements in a different period than for Federal income tax purposes. Investment tax credits are being accounted for by the flow-through method.

4. Investments in subsidiaries are recorded at admitted asset value for statutory purposes, whereas the financial statements of the wholly-owned subsidiary have been consolidated with those of the Company under generally accepted accounting principles. The Company has an investment in Westcap, a non-insurance subsidiary, which is recorded on the equity basis in the accompanying consolidated financial statements.

5. Realized investment gains or losses from the sale or write-down of investments, less the related Federal income tax effect, if any, have been included in net earnings rather than being credited or charged directly to statutory retained earnings.

6. The Mandatory Securities Valuation Reserve, a contingency reserve required by insurance regulatory authorities, has been eliminated, as it is not required under generally accepted accounting principles.

7. The recorded value of the life interest in the Libbie Shearn Moody Trust (the Trust) is reported at its initial valuation, net of accumulated amortization. The initial valuation was based on the assumption that the Trust would provide certain income to the Company at an assumed interest rate and is being amortized over 53 years, the life expectancy of Mr. Robert L. Moody at the date he contributed the life interest to the Company. In the Company's annual statements to insurance departments, the life interest is reflected at an amount based on existing insurance in force on the life of Robert L. Moody net of the cash surrender value of the life insurance policies on Mr. Moody's life. The statutory amount is not being amortized.

8. Certain reinsurance transactions effected in 1980, which caused direct credits to surplus for statutory reporting purposes, have been treated differently under generally accepted accounting principles. The net effect of these transactions is reflected in the risk and expense charges to other operating expenses in the accompanying consolidated statements of operations.

Reconciliations of net gain from operations and stockholders' equity (determined pursuant to statutory accounting requirements), as included in the annual statements filed with the Colorado Insurance Commission, to the respective amounts as reported in the accompanying consolidated financial statements are as follows:

	Net Earnings for Year Ended December 31,		
	1985	1984	1983
Per annual statement to insurance department	$ 7,015,805	(11,434,921)	5,900,155
Statutory net earnings of subsidiary	2,017	2,056	1,612
Consolidated statutory net gain (loss) from operations	7,017,822	(11,432,865)	5,901,767
Adjustments:			
Deferral of policy acquisition costs	434,476	901,622	(749,732)
Adjustment of future policy benefits	1,458,303	(128,595)	719,618
Adjustment for portfolio reinsurance	—	20,477,850	2,000,000
Amortization of investment in Trust	(255,029)	(252,599)	(250,194)
Deferred Federal income taxes	(3,000,000)	(3,341,000)	(2,900,000)
Deferred Federal income tax adjustment	—	19,984,000	—
Realized gains (losses) on investments, net	495,203	(2,847,447)	(220,834)
Other, net	3,311,464	489,089	2,605,878
Amounts per consolidated financial statements	$ 9,462,239	23,850,055	7,106,503

	Stockholders' Equity as of December 31,		
	1985	1984	1983
Per annual statement to insurance department	$ 39,410,022	32,847,856	40,621,469
Adjustments:			
Difference in initial valuation of investment in Libbie Shearn Moody Trust, net of amortization	(3,734,591)	(3,492,196)	(3,234,722)
Deferral of policy acquisition costs, net of amortization	47,564,181	47,129,705	46,228,083
Adjustment of future policy benefits	(5,333,889)	(7,640,824)	(7,381,325)
Adjustment for portfolio reinsurance (note 8)	—	—	(20,477,850)
Deferred Federal income taxes	(10,862,000)	(7,862,000)	(26,135,000)
Adjustment to report preferred stocks at market value	(625,863)	(1,042,649)	(1,323,826)
Transfer of Mandatory Securities Valuation Reserve to appropriated retained earnings	6,492,271	2,007,396	6,152,511
Reinstatement of non-admitted assets	2,468,193	3,270,211	3,035,604
Other, net	(2,815,182)	(2,815,572)	687,264
Amounts per consolidated financial statements	$ 72,563,142	62,401,927	38,172,208

(B) Investments—Investments in bonds are stated principally at amortized cost, and investments in preferred and common stocks are stated at market values. Investments in specific securities having a permanent loss in value have been written down to their estimated realizable value, and losses thereon have been included in realized investment losses. Net unrealized investment gains and losses on marketable equity securities are accounted for as direct increases or decreases in stockholders' equity. At December 31, 1985, gross unrealized investment gains and losses on marketable equity securities were $1,144,061 and $1,322,797, respectively.

Mortgage loans and other investments are stated at cost, less unamortized discounts and allowances for uncollectible loans. Discounts on mortgage loans are amortized using the interest method over the lives of the respective loans.

(C) Matching of Revenue and Expense—Premiums are recognized as revenues as they become due or, for short duration contracts, over the contract periods. Benefits and expenses are matched with premiums in arriving at profits by providing for policy benefits over the lives of the policies and by amortizing acquisition costs over the premium-paying periods of the policies.

(D) Depreciation of Property and Equipment—Depreciation is based on the estimated useful lives of the assets and is calculated on the straight-line basis.

(E) Classification—Certain reclassifications have been made to the prior years to conform to the reporting categories used in 1985.

(2) INVESTMENT IN SUBSIDIARY, AT EQUITY

Westcap, a brokerage firm, is subject to the net capital rules adopted and administered by the Securities and Exchange Commission. These capital rules may restrict retained earnings as to the payment of dividends if certain financial ratios are not met.

A summary of the most recent audited financial information is as follows:

	September 30,		
	1985	1984	1983
Assets:			
Cash	$ 2,965,605	1,717,895	2,934,290
Receivables	25,154,243	17,330,428	15,712,254
Trading inventory	30,267,046	8,532,551	9,655,353
Other assets	10,037,969	41,775,035	12,458,690
	$ 68,424,863	69,355,909	40,760,587
Liabilities:			
Notes payable	$ 26,657,456	6,241,007	2,460,047
Payables to customers and brokers	17,872,930	10,964,414	12,952,381
Other liabilities	13,302,064	43,776,700	17,272,000
Stockholders' equity	10,592,413	8,373,788	8,076,159
	$ 68,424,863	69,355,909	40,760,587
Revenues	$ 28,095,080	14,021,051	26,365,455
Income before extraordinary items	$ 2,483,791	297,629	3,300,843
Extraordinary items	—	—	396,089
Net income	$ 2,483,791	297,629	3,696,932

(3) DEPOSITS WITH REGULATORY AUTHORITIES

The following assets were on deposit with state and other regulatory authorities as required by law:

	December 31,	
	1985	1984
Bonds, at amortized cost	$ 57,495,583	56,785,025
Mortgage loans on real estate	$ 2,530,038	2,956,589
Certificates of deposit	$ 282,474	282,474

(4) STOCKHOLDERS' EQUITY

Dividends to stockholders can be paid only from the Company's statutory unassigned surplus as determined by accounting principles prescribed by insurance regulatory authorities. Statutory unassigned surplus amounted to approximately $23,181,000 at December 31, 1985, and stockholders' equity in that amount was available for dividends subject to the tax effects of distributions from the "policyholders' surplus account."

(5) NET INVESTMENT INCOME AND CONCENTRATION OF INVESTMENTS

The major components of net investment income are as follows:

	Year Ended December 31,		
	1985	1984	1983
Investment income:			
Interest on bonds	$ 31,908,440	23,091,699	17,535,742
Interest on mortgage loans	8,124,956	7,359,655	5,779,645
Interest on policy loans	4,350,856	3,424,135	2,979,137
Other investment income	4,198,130	3,623,334	3,044,920
Total investment income	48,582,382	37,498,823	29,339,444
Investment expenses	1,035,174	2,183,386	2,133,527
Net investment income	$ 47,547,208	35,315,437	27,205,917

Investments of the following amounts were non-income producing:

	December 31,	
Type of Investment	1985	1984
Bonds	$ 120,000	92,000
Common stock	$ 359,919	143,818
Real estate	$ 633,154	2,569,739

The Life Interest in Libbie Shearn Moody Trust is the only investment other than real estate amounting to 10% or more of total stockholders' equity. In the case of real estate, no investments in excess of 10% were acquired within the previous five years.

(6) ANALYSIS OF INVESTMENT GAINS AND LOSSES

The table below presents an analysis of realized investment gains and losses and the increase or decrease in unrealized losses on bonds and investments in marketable equity securities:

	Net Realized Investment Gains (Losses) Net of Tax	(Increase) Decrease in Unrealized Losses on Investments	Total Investment Gains (Losses)
Year Ended December 31, 1985			
Bonds	$(116,782)	26,250,102	26,133,320
Stocks	355,588	698,976	1,054,564
Other	118,397	—	118,397
Total	$ 357,203	26,949,078	27,306,281
Year Ended December 31, 1984			
Bonds	$(4,584,672)	8,085,110	3,500,438
Stocks	(236,610)	380,941	144,331
Other	1,973,835	—	1,973,835
Total	$(2,847,447)	8,466,051	5,618,604

	Net Realized Investment Gains (Losses) Net of Tax	(Increase) Decrease in Unrealized Losses on Investments	Total Investment Gains (Losses)
Year Ended December 31, 1983			
Bonds	$(211,539)	(1,921,211)	(2,132,750)
Stocks	13,953	189,745	203,698
Other	(23,248)	—	(23,248)
Total	$(220,834)	(1,731,466)	(1,952,300)

(7) PARTICIPATING POLICIES

The Company has issued participating policies which entitle the policyholders to participate in cash and, in certain instances, in stock dividends paid to stockholders. The participating preferences of these special policy plans are as follows:

(A) Certain participating policies require payment of dividends to policyholders of not less than a specified percentage of dividends paid to stockholders. Holders of such policies at December 31, 1985, are entitled to dividends equal to an aggregate maximum of approximately 1% of dividends paid to holders of the Company's common stock.

(B) Certain participating policies are entitled to receive policyholder dividends at least equivalent to stockholders' dividends paid on a designated number of shares of common stock of the Company. Holders of such policies at December 31, 1985, are entitled to receive dividends equivalent to less than 1% of dividends paid to holders of the Company's common stock.

All other policyholders' dividends are apportioned for payment by the Company's Board of Directors at the beginning of certain periods of time on participating policies having anniversary dates during such designated periods. These policyholders' dividends are at various rates based upon factors such as the policy plan, loading factor of the plan, and issue date of policies, and the provision for policyholders' dividend liability is included in the future policy benefit liabilities.

Retained earnings are allocable to participating policies only when dividends thereon are specifically declared by the Company's Board of Directors except as noted above. At December 31, 1985, no retained earnings were so allocated.

Participating business constitutes approximately 7% and 9% of the Company's life insurance in force, 8% and 22% of the policies in force, and 8% and 9% of the premium income for the years ended December 31, 1985 and 1984, respectively.

(8) REINSURANCE

The Company is party to several reinsurance agreements. The Company's general policy is to reinsure that portion of any risk in excess of $150,000 on the life of any one individual. Life insurance in force in the amounts of $280,000,000 and $270,000,000 is ceded on a yearly renewable term basis, $1,400,000 and $1,400,000 is ceded on a modified coinsurance basis, and $102,000,000 and $73,000,000 is ceded on a coinsurance basis at December 31, 1985 and 1984, respectively. In accordance with the reinsurance contracts, credits in the amounts of approximately $1,500,000 and $1,400,000 were taken against the liability for future policy benefits at December 31, 1985 and 1984, respectively. A contingent liability exists with respect to such reinsurance which could become a liability of the Company in the event such reinsurance companies are unable to meet their obligations under existing reinsurance agreements.

On May 22, 1980, the Company entered into a portfolio reinsurance agreement consisting of both coinsurance and modified coinsurance. The coinsurance portion of the agreement increased statutory unassigned surplus by approximately $27,941,000. Under the provisions of this agreement, risk and expense charges of approximately $1,002,000 and $1,120,000 were paid during the years ended December 31, 1984 and 1983, respectively. These amounts were charged to other expense. This agreement was terminated on December 31, 1984.

(9) FEDERAL INCOME TAXES

On July 18, 1984, the Tax Reform Act of 1984 (1984 Act), which significantly changed the Federal income tax provisions that govern the taxation of life insurance companies, was signed into law. The 1984 Act is applicable for taxable years beginning after December 31, 1983. The 1984 Act eliminated certain specific deductions applicable to insurance companies in lieu of a single special life insurance company deduction equal to 20% of life insurance company taxable income. Also, an additional deduction is available to small life insurance companies to the extent taxable income is less than $15,000,000.

The 1984 Act also requires life insurance companies to recompute policy reserves for tax purposes as of the beginning of the first taxable year beginning after December 31, 1983, and provides that tax on income arising from that recomputation is referred to as "the fresh start adjustment." At December 31, 1984, the Company determined the effect of the fresh start provision and recognized the reduction of deferred taxes previously provided as a reduction of income tax expense in the fourth quarter of 1984.

For Federal income tax purposes during the year ended December 31, 1983, the Company was taxed on the lesser of taxable investment income or gain from operations, plus one-half of any excess of gain from operations over taxable investment income. The one-half of any excess of gain from operations over taxable investment income not currently taxed, plus certain special deductions allowed in computing the gain from operations, is accumulated in a special memorandum tax account entitled policyholders' surplus.

At December 31, 1985, the Company had accumulated approximately $2,446,000 in its policyholders' surplus account. Under the provisions of the 1984 Act, the policyholders' surplus account is frozen at its December 31, 1983, balance. In general, amounts accumulated in the policyholders' surplus account are subject to Federal income taxation (a) to the extent that policyholders' surplus exceeds a specified maximum; (b) if distributions to stockholders are made in excess of the shareholders' surplus account; or (c) if a company ceases to be a life insurance company as defined by the Internal Revenue Code. Deferred Federal income taxes have not been provided on the amounts accumulated in the policyholders' surplus account, since the Company does not anticipate any other transactions that would cause any part of this amount to become taxable. Should the balance in the policyholders' surplus account at December 31, 1985, become taxable, the Federal income tax computed at present rates would be approximately $1,125,000.

The Company and Westcap file separate income tax returns for Federal income tax purposes.

Deferred Federal income taxes result from timing differences in the recognition of certain items for tax and financial statement purposes. The sources of these differences and the approximate tax effect of each are as follows:

	December 31,		
	1985	1984	1983
Policy acquisition costs expensed for tax purposes and deferred for financial accounting purposes	$ 164,000	410,000	(350,000)
Excess of the increase in the liability for future policy benefits for tax purposes over the increase for financial accounting purposes	892,000	9,360,000	1,251,000
Net level premium election	—	—	(514,000)
Use of tax operating loss deduction	1,330,000	(7,053,000)	1,896,000
Other	614,000	624,000	(617,000)
	$ 3,000,000	3,341,000	2,900,000

For financial reporting purposes, in 1984 the Company deferred approximately $3,251,000 of the gain on the sale of its office building under a sale-leaseback agreement. Deferred Federal income taxes of approximately $911,000 were provided on the deferred gain.

The provisions for Federal income taxes vary from amounts computed by applying the statutory income tax rate to earnings before Federal income taxes and realized investment gains and losses. The reasons for the differences, and the tax effects thereof, are as follows:

Description	December 31, 1985	1984	1983
Income taxes at the statutory rate	$ 5,505,000	4,624,000	4,705,000
Special life insurance company deductions	(591,000)	(706,000)	(370,000)
Dividends received deductions	(510,000)	(118,000)	(407,000)
Amortization of life interest in Libbie Shearn Moody Trust	117,000	116,000	115,000
Equity in net earnings of subsidiary	(1,161,000)	(195,000)	(1,152,000)
Capital gains rate difference	(357,000)	(335,000)	(283,000)
Other	(3,000)	(45,000)	292,000
Federal income tax provision	$ 3,000,000	3,341,000	2,900,000

At December 31, 1985, the Company had loss carryforwards of approximately $23,000,000 which the Company has treated on its Federal income tax return as expiring 1986 through 1999. The Company also has unused tax credits of approximately $260,000.

(10) EARNINGS PER SHARE

Earnings per share of common stock are based on the weighted average number of such shares outstanding during each year. The weighted average shares outstanding were 3,477,819, 3,477,900, and 3,477,950 for the years ended December 31, 1985, 1984, and 1983, respectively.

(11) TRANSACTIONS WITH CONTROLLING STOCKHOLDER AND AFFILIATES

(A) Life Interest in Libbie Shearn Moody Trust—The Company is the beneficial owner of a life interest (1/8 share), previously owned by Mr. Robert L. Moody, Chairman of the Board of Directors of the Company, in the trust estate of Libbie Shearn Moody.

The recorded amount of the Company's life interest in the Trust is summarized below:

	December 31, 1985	1984
Original valuation of life interest at February 26, 1960	$ 13,793,149	13,793,149
Less accumulated amortization	5,898,344	5,643,315
Net asset value of life interest in Trust	$ 7,894,805	8,149,834

The Company is the beneficiary of life insurance on Mr. Moody's life in the amount of $12,775,000, all of which was issued by the Company and is reinsured through agreements with unaffiliated insurance companies.

Income from the Trust and related expenses reflected in the accompanying consolidated statements of operations are summarized as follows:

	Year Ended December 31,		
	1985	1984	1983
Income distributions received	$ 1,466,000	1,308,000	1,167,000
Add (deduct):			
Amortization	(255,000)	(252,000)	(250,000)
Reinsurance premiums	(97,000)	(89,000)	(83,000)
Increase in surrender value of life insurance policies	12,000	(4,000)	65,000
Net income from life interest in the Trust	$ 1,126,000	963,000	899,000

The accompanying statements also reflect an increase in the liability for future policy benefits related to Company-issued policies on Mr. Moody's life in the amount of $27,000 in 1985, $34,000 in 1984, and $40,000 in 1983, and liabilities for future policy benefits related to these policies in the amounts of $1,219,000, $1,192,000, and $1,158,000 at December 31, 1985, 1984, and 1983, respectively.

(B) Common Stock—Mr. Robert L. Moody, Chairman of the Board of Directors, owns 198,074 of the total outstanding shares of the Company's Class B common stock and 1,161,760 of the Class A common stock.

Holders of the Company's Class A common stock elect one-third of the Board of Directors of the Company, and holders of the Company's Class B common stock elect the remainder of the Company's Board of Directors. Any cash or in-kind dividends paid on each share of Class B common stock shall be only one-half of the cash or in-kind dividends paid on each share of Class A common stock. In addition, upon liquidation of the Company, the Class A stockholders shall first receive the par value of their shares; then the Class B stockholders shall receive the par value of their shares; and the remaining net assets of the Company shall be divided between the shareholders of both Class A and Class B common stock, based on the number of shares held.

(12) PENSION PLAN

The National Western Life Insurance Company Pension Plan is a noncontributory pension plan covering substantially all full-time employees who have completed one year of service.

The pension plan expense was $296,000, $279,000, and $246,000 in 1985, 1984, and 1983, respectively, including all current service costs and provisions to amortize all prior service costs and actuarial gains and losses over periods not exceeding 30 years.

The Company's practice has been to fund pension expense accrued each year. Assets of the pension trust are managed by Texas Commerce Bank—Austin.

The weighted average assumed rate of return used in in determining the actuarial present value of accumulated plan benefits was 4.5% for 1985 and 1984. January 1 is the date used to determine contributions and the actuarial present value of accumulated plan benefits.

The table below includes data with respect to continuing operations.

	January 1, 1985	January 1, 1984
Vested	$ 2,337,611	1,968,721
Nonvested	2,480,649	2,072,956
	$ 4,818,260	4,041,677
Net assets	$ 2,740,196	2,226,690

(13) CONTINGENCIES

The Company and certain of its past and present directors were involved in a lawsuit seeking certain claims. The lawsuit was primarily in the nature of a derivative stockholder claim against the defendant directors and sought alleged damages in excess of $50,000,000. The complaint alleged that the directors were negligent and grossly negligent in discharging their duties to the Company. On March 5, 1986, the judge of the United States District Court granted the Company's Motion for Summary Judgment dismissing the lawsuit. No provision has been made in the accompanying financial statements for damages, if any, that may result from any appeal.

The Company is a defendant in several other lawsuits, substantially all of which are in the normal course of the insurance business. In the opinion of management of the Company, the liability, if any, which may arise from these lawsuits would not be material.

(14) FOREIGN SALES

Total premium income related to life insurance written in foreign countries, primarily Central and South America, was approximately $20,500,000, $17,500,000, and $17,000,000 for the years ended December 31, 1985, 1984, and 1983, respectively.

(15) UNAUDITED QUARTERLY FINANCIAL DATA

Quarterly results of operations are summarized as follows:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(thousands except for per share amounts)			
1985				
Revenues	$ 50,457	58,113	56,889	65,073
Earnings from insurance operations	1,949	2,048	1,386	1,060
Equity in net earnings of subsidiary	575	776	564	609
Net earnings	2,606	3,363	1,723	1,770
Per share:				
Earnings from insurance operations	.56	.59	.40	.17
Equity in net earnings of subsidiary	.17	.22	.16	.18
Net earnings	.75	.97	.49	.51
1984				
Revenues	$ 33,551	38,131	42,755	43,642
Earnings from insurance operations	1,712	1,071	1,711	21,779
Equity in net earnings of subsidiary	140	(195)	44	435
Net earnings	1,825	998	1,573	19,454
Per share:				
Earnings from insurance operations	.49	.31	.50	6.26
Equity in net earnings of subsidiary	.04	(.06)	.01	.13
Net earnings	.52	.29	.45	5.60

During the fourth quarter of 1985, the Company changed its method of computing the reserve for its single premium life product. Net earnings for the first three quarters of 1985 were retroactively increased (decreased) $553,000, $300,000, and ($166,000), respectively, from the amounts previously reported. The effective Federal income tax rate in the fourth quarter was less than the rates applied during the first three quarters due principally to the recognition of the dividends received deduction.

Report of Independent Certified Public Accountants

The Board of Directors and Stockholders
National Western Life Insurance Company
Austin, Texas

We have examined the consolidated balance sheets of National Western Life Insurance Company and subsidiary as of December 31, 1985 and 1984, and the related statements of operations, stockholders' equity and changes in financial position for each of the three years in the period ended December 31, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above present fairly the financial position of National Western Life Insurance Company and subsidiary as of December 31, 1985 and 1984, and the consolidated results of their operations and the changes in their financial position for the three years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Touche Ross & Co.

March 19, 1986
Austin, Texas

Summary of Operations

	Years Ended December 31,				
	1985	1984	1983	1982	1981
Premium income	$ 182,219,143	121,867,822	79,527,511	78,254,641	47,374,317
Net investment income	47,547,208	35,510,437	27,205,917	20,920,342	16,741,471
Other income	765,276	700,546	1,196,694	257,590	429,604
Total income	230,531,627	158,078,805	107,930,122	99,432,573	64,545,392
Policyowner benefits	(177,261,971)	(113,966,001)	(75,180,142)	(68,126,320)	(40,877,577)
Commissions and other expenses	(43,826,598)	(34,482,758)	(25,027,423)	(25,503,599)	(18,213,893)
Total expenses	(221,088,569)	(148,448,759)	(100,207,565)	(93,629,919)	(59,091,470)
Deferred Federal income tax adjustment	—	19,984,000	—	—	—
Provision for deferred Federal income taxes	(3,000,000)	(3,341,000)	(2,900,000)	(1,888,000)	(1,730,000)
Earnings from insurance operations	6,443,058	26,273,046	4,822,557	3,914,654	3,723,922
Equity in earnings of brokerage subsidiary	2,523,978	424,456	2,504,780	3,086,540	1,060,459
Realized gains (losses) on investments	495,203	(2,847,447)	(220,834)	(554,482)	(117,131)
Net earnings	$ 9,462,239	23,850,055	7,106,503	6,446,712	4,667,250
Per Share:					
Earnings from insurance operations	$ 1.85	7.56	1.39	1.14	1.09
Equity in earnings of brokerage subsidiary	.73	.12	.72	.90	.31
Realized gains (losses) on investments	.14	(.82)	(.07)	(.16)	(.03)
Net earnings	$ 2.72	6.86	2.04	1.88	1.37

Management's Discussion and Analysis of Financial Condition and Results of Operations

Summary

The following table sets forth for the periods indicated (1) percentages which certain items reflected in the financial data bear to total revenues of the Company and (2) the percentage increase or decrease of such items as compared to the indicated prior period:

	Relationship to Total Revenues Year Ended December 31,			Period to Period Increase (Decrease) Years Ended	
	1983	1984	1985	1983-84	1984-85
Premiums	73.7%	77.0%	79.0%	53.2%	49.5%
Investment income	25.2	22.5	20.6	30.5	33.9
Other income	1.1	0.5	0.4	(41.5)	9.2
Total revenues	100.0	100.0	100.0	46.5	45.8
Policyowner benefits	(69.7)	(72.1)	(76.9)	51.6	55.5
Commissions and other expenses	(23.1)	(21.8)	(19.0)	37.8	27.1
Deferred Federal income tax adjustment	—	12.6	—	100.0	(100.0)
Provision for deferred Federal income taxes	(2.7)	(2.1)	(1.3)	15.2	(10.2)
Equity earnings of brokerage subsidiary	2.3	0.3	1.1	(83.1)	494.6
Realized gains (losses) on investments	(0.2)	(1.8)	0.2	1,189.4	112.5
Net earnings	6.6%	15.1%	4.1%	235.6	(60.3)

Results of Operations

Premium Income: Total premium income increased to $182.2 million in 1985 from $121.8 million in 1984 and $79.5 million in 1983. The major growth area continues to be in annuity considerations, which increased to $106.9 million in 1985 from $75.1 million in 1984 and $40.8 million in 1983.

Life premiums for 1985 increased by $28.6 million or 61% over 1984. In addition to continuing production increases in its Universal Life product, most of the new life premium production is derived from a single premium product that was developed in 1984.

Investment Income: Net cash flow resulting from increasing life and annuity production has increased total invested assets to $528.4 million at the end of 1985, compared to $403.8 million in 1984 and $330.8 million in 1983. The increases in invested assets produced net investment income of $47.5 million in 1985, compared to $35.5 million in 1984 and $27.2 million in 1983. This growth trend is expected to continue as life and annuity production continues to increase.

Income from Subsidiary: The Company's equity interest in the earnings of The Westcap Corporation, a brokerage company located in Houston, Texas, amounted to approximately $2.5 million in 1985 as compared to $0.4 million in 1984 and $2.5 million in 1983. Earnings from this subsidiary vary directly with trading activity in the government securities market.

Policyowner Benefits: A 56% increase was reflected in this item. Total benefits were $177.2 million in 1985, with most of the increase relating to the increase in the liability for future policy benefits. The increase in this liability follows closely the increase in premium and annuity considerations. Total benefits for 1984 were $113.9 million compared to $75.1 million in 1983.

Commissions and Other Expenses: Amounts for this expense category were $43.8 million, $34.5 million, and $25.0 million for 1985, 1984, and 1983, respectively. Increased commission expense in 1984 and 1985 relate to production of the flexible premium annuities. The 1985 amount includes a 72% increase in state premium taxes. This was caused primarily from increasing production in the Universal Life and single premium life products.

Provision for Federal Income Tax: The provision for deferred Federal income tax as related to pre-tax income has remained relatively constant for the last three years. In 1984, however, the Company recognized the onetime adjustment permitted under the Deficit Reduction Act of 1984. This adjustment amounted to $19.9 million or $5.75 per share.

Realized Losses on Investments: Net gains (losses) were $495,203 for 1985, ($2,847,447) for 1984, and ($220,834) for 1983. The amounts for 1985 and 1983 were results of normal investment activities. In 1984, however, the Company sold a substantial amount of investments having an unrealized loss in order to offset a taxable capital gain realized on the sale of its home office building. Most of this gain, for reporting purposes, was deferred and is being recognized ratably over a ten-year period.

Liquidity and Capital Resources:

Stockholders' equity increased to $72.5 million as of December 31, 1985. The book value per share was $20.87 compared to $17.94 at the end of 1984, a 16% increase.

At year-end 1985, policy loans had increased by approximately $9 million or 15% from 1984. Most of this loan demand has arisen from the loan availability granted by TEFRA in the tax-sheltered annuity area. These particular loans are made at an interest rate substantially higher than the average of all other types of policy loans. Accordingly, the demand would not be expected to exceed amounts that could be handled from the Company's normal cash flow.

The Company has not incurred material short-term debt during 1984 or 1985 and had none outstanding at either year-end. There are no present material commitments for capital expenditures in 1986, and the Company does not anticipate incurring any such commitments through the balance of 1986.

Common Stock Prices

Quarter Ending		High	Low
3-31	1985	15-5/8	10-7/8
6-30	1985	16-7/8	14-5/8
9-30	1985	15-3/4	12-3/8
12-31	1985	17-5/8	13-1/8
3-31	1986	20-1/4	16-1/4

Statutory Balance Sheets

	(Unaudited) December 31, 1985	1984
ASSETS		
Bonds	$ 337,512,978	234,215,755
Preferred stocks	16,118,867	13,777,038
Common stocks	4,815,390	3,049,584
Mortgage loans	80,187,128	69,997,097
Real estate	3,196,702	3,311,490
Policy loans	69,936,961	60,845,345
Collateral loans	2,127,882	2,246,708
Income interest in Libbie Shearn Moody Trust	11,629,396	11,642,030
Cash on hand and in banks	3,930,378	3,355,748
Short-term investments	9,927,790	11,962,495
Premiums deferred and uncollected	9,986,886	10,897,165
Investment income due and accrued	10,443,572	7,366,982
Other assets	2,091,258	2,530,637
	$ 561,905,188	435,198,074
LIABILITIES, SURPLUS, AND OTHER FUNDS		
Aggregate reserve for life policies	$ 476,360,261	364,061,021
Aggregate reserve for accident and health policies	297,897	308,286
Supplementary contracts without life contingencies	936,326	561,882
Life claims	2,953,791	1,576,666
Accident and health claims	—	—
Policyholders' dividend, coupon, and endowment accumulations	11,788,493	13,130,951
Policyholders' dividend liability	346,400	372,350
Other liabilities to policyholders	8,777,509	6,560,522
Commissions, expenses, and taxes due or accrued	2,121,899	1,699,820
Borrowed money	3,223,481	3,251,806
Other liabilities	9,196,838	8,819,518
Mandatory Securities Valuation Reserve	6,492,271	2,007,396
Total liabilities	522,495,166	402,350,218
Capital paid up	3,477,819	3,477,819
Paid-in and contributed surplus	12,750,763	12,750,763
Unassigned surplus	23,181,440	16,619,274
Total capital and surplus	39,410,022	32,847,856
	$ 561,905,188	435,198,074

Statutory Statements of Operations

	(Unaudited) Years Ended December 31,	
	1985	1984
Premiums and annuity considerations	$ 127,951,028	75,491,557
Annuity and other fund deposits	52,573,283	35,687,485
Considerations for supplementary contracts, dividend, coupon, and endowment accumulations	1,775,418	1,469,828
Reserve adjustment on reinsurance ceded	—	92,772,415
Commission and expense allowances on reinsurance ceded	—	1,687,439
Net investment income	47,327,319	35,041,026
Other income	669,054	640,419
Total income	230,296,102	242,790,169
Death claims	10,811,696	5,975,569
Accident and health claims	135,112	148,912
Surrender benefits	23,324,699	10,474,218
Coupons and endowments to policyholders	923,833	1,147,179
Payments on supplementary contracts, dividend, coupon, and endowment accumulations	3,071,211	3,035,103
Other policy benefits	30,283,962	16,895,697
Increase in life and accident and health reserves	112,288,851	84,443,780
Decrease in other reserves	(969,320)	(1,067,490)
Reserves transferred and adjustments on reinsurance	—	100,011,527
Commissions	31,706,836	23,498,787
General expenses, taxes, and other expenses	12,138,989	10,420,891
Decrease in loading	(784,552)	(1,127,766)
Total benefits and expenses	222,931,317	253,856,407
Net gain (loss) before dividends and Federal income taxes	7,364,785	(11,066,238)
Dividends to policyholders	348,980	368,683
Net gain (loss) before Federal income taxes	7,015,805	(11,434,921)
Federal income taxes	—	—
Net gain (loss) from operations	$ 7,015,805	(11,434,921)

Statutory Statements of Capital and Surplus

	(Unaudited) Years Ended December 31,	
	1985	1984
Balance at beginning of year	$ 32,847,857	40,621,468
Additions (deductions):		
Net gain (loss) from operations	7,015,805	(11,434,922)
Net capital gains	3,432,254	93,561
Net gain (loss) from non-admitted assets	772,154	(283,010)
Decrease (increase) in Mandatory Securities Valuation Reserve	(4,484,875)	4,145,115
Other increases (decreases)	(173,173)	(294,355)
Balance at end of year	$ 39,410,022	32,847,857

Directors

Robert L. Moody
Chairman of the Board, Chief Executive Officer, National Western Life Insurance Company
Investments, Galveston, Texas
NWL Director—1964 to present

Harry L. Edwards
President and Chief Operating Officer, National Western Life Insurance Company
NWL Director—1969 to present

Arthur O. Dummer
Chief Executive Officer
The Donner Company
Salt Lake City, Utah
NWL Director—1980 to present

Gerald A. Levy
Vice President, North American Reassurance Company
New York, New York
NWL Director—1980 to present

E. Douglas McLeod
Director of Development
Moody Foundation
Galveston, Texas
NWL Director—1979 to present

Charles D. Milos, Jr.
Vice President and Investment Analyst, National Western Life Insurance Company
NWL Director—1981 to present

Ross R. Moody
Corporate Financial Analyst
Drexel Burnham Lambert
New York, New York
NWL Director—1981 to Present

Louis Pauls, Jr.
President, Louis Pauls & Company
Investments, Galveston, Texas
NWL Director—1971 to present

Officers

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Chairman of the Board and Chief Executive Officer

Harry L. Edwards
President and Chief Operating Officer

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Executive Vice President
Administration
Assistant Secretary

Richard C. Andrews, CLU
Vice President
Employee Benefits

Charles P. Baley, FLMI, CLU
Vice President
Data Processing

Richard L. Boswell, FSA, MAAA
Vice President
Actuary

Robert L. Busby, III, CPA, FLMI, CLU, ChFC
Vice President
Controller

David G. Caldwell
Vice President
Legal Counsel

Richard M. Edwards
Vice President
International Marketing Department

Dr. Jose M. Galano
Vice President
Latin American Operations

Andrew M. Hansen
Vice President
Domestic Marketing Department

John R. Howard, CPA
Vice President—Finance
Treasurer
Assistant Secretary

Weldon K. Huffman
Vice President
Systems Management
Assistant Secretary

James A. Kincl
Vice President
Special Markets

Bob Laughlin
Vice President
General Agencies

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Vice President
Investment Analyst

James R. Naiser, FLMI
Vice President
Systems Development

Harold L. Ponder
Vice President
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Policyowner Services

Robert J. Dicks, FLMI
Assistant Vice President
Underwriting

Doris Kruse
Assistant Vice President
Policy Benefits

Lee E. Posey, FLMI
Assistant Vice President
Administrative Services

B. Ben Taylor, ASA, MAAA
Assistant Vice President
Assistant Actuary

Hans W. Weber
Assistant Vice President
Assistant Treasurer

Agnes B. Connolly
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Mary L. Smith
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