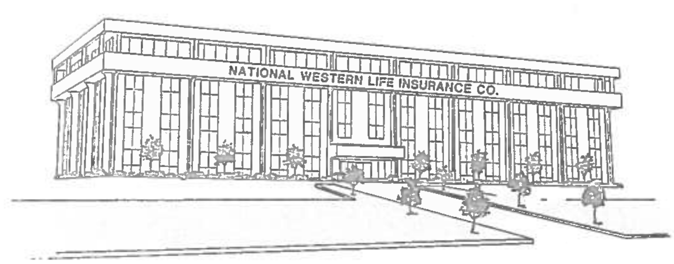
Annual Report

1986

NATIONAL WESTERN LIFE INSURANCE COMPANY



National Western Life Insurance Company
Austin, Texas

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10-K Report Available

National Western Life Insurance Company's operations and financial position for the year ended December 31, 1986, 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 78752-1602.

To Our Stockholders

We are pleased to report that 1986 operating results showed substantial improvement in all areas compared to last year. These gains and the gains of recent years are contributing to the Company's goal of taking its place among the major life insurers of America. Paying close attention to operating costs, and maximizing marketing and management strengths, contributed to the excellent overall results obtained in 1986.

Growth in new business continued the trend of the past few years. New premium from life insurance and annuity sales increased 54% and 41% respectively. This contributed to the 41.4% increase in total premium income of $257.7 million, compared to $182.2 million last year. It is anticipated that strong sales growth will continue throughout 1987 as the Company capitalizes on the ability to expand existing special markets and seek additional outlets for its competitively priced product lines. The Company's distribution system encompasses more than 6,000 representatives, most of whom sell in only one or two specific markets, resulting in a highly specialized sales organization.

As previously reported to you, the life insurance industry has been undergoing rapid changes. As the markets for life insurance have evolved from the traditional whole life policies of a few years ago to the current interest sensitive policies, management has been required to manage better in maintaining acceptable results from the new lower profit margin products. The Company's employees and management are well aware of the requirement to operate as efficiently and as cost sensitive as possible. The transition to the new generation products has successfully been made.

You will note the Company's consolidated net earnings amounted to $12.7 million in 1986, compared to $9.5 million in 1985. The Company's brokerage firm, The Westcap Corporation, contributed $4.3 million, and net realized gains on investments contributed $2.9 million of the total net earnings.

At year-end 1986, the Company's assets had grown to $819.7 million, a 38% increase over 1985. In the five-year period 1982 through 1986, assets have grown from $345 million, an increase of more than 137%.

In a recent published tabulation of company size, comparing premium income, National Western Life ranked 154 out of the more than 2,000 life insurance companies in the United States. This represented a gain of approximately 88 places in the past ten years.

Stockholder equity grew from $72.6 million in 1985 to $85 million in 1986, an increase of 17%. For the 1982-1986 period, stockholder equity grew 176% from $30.9 million to $85 million.

Life insurance-in-force reached $4.4 billion by year-end 1986, an increase of 31% over 1985, and a five-year increase from $2.3 billion amounting to 85.7%. The 1986 increase was contributed to by National Western Life's assumption of approximately 17,400 policies from a Pennsylvania company, effective December 31, 1986. The assumed business amounted to approximately $532 million of insurance-in-force. While the Company is not actively pursuing acquisitions at the present time, it remains alert to opportunities to grow and profit from favorable assumption agreements and acquisitions.

Without the capability of our outstanding marketing organization and the ability and the dedication to excellence of our employees, officers, and directors, the excellent 1986 results indicated in this report would not be possible. We gratefully acknowledge their contributions.

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

Robert Moody

Harry L. Edwards
President and
Chief Operating Officer

Harry L. Edwards

Consolidated Balance Sheets

ASSETS	December 31, 1986	1985
Investments:		
Fixed maturities, primarily bonds, at amortized cost (market: $522,096,988 and $346,165,011)	$ 496,037,738	336,108,339
Preferred stocks, at market value (cost: $6,176,910 and $7,358,005)	6,033,175	6,748,624
Common stocks, at market value (cost: $3,093,264 and $2,901,555)	2,891,244	3,332,200
Mortgage loans, net	89,095,646	76,961,772
Policy loans	83,992,357	69,936,961
Investment in subsidiary, at equity	12,679,000	10,920,964
Life interest in Libbie Shearn Moody Trust	7,637,325	7,894,805
Other invested assets	43,376,487	16,578,831
Total investments	741,742,972	528,482,496
Cash	5,600,216	3,643,191
Insurance receivables, net	2,074,389	1,504,288
Accrued investment income	14,459,408	10,444,012
Deferred policy acquisition costs	52,643,772	47,564,181
Property and equipment, net	843,506	738,644
Other assets	2,399,511	2,176,947
	$ 819,763,774	594,553,759

See accompanying notes to consolidated financial statements.

Consolidated Balance Sheets

LIABILITIES AND STOCKHOLDERS' EQUITY	December 31, 1986	December 31, 1985
LIABILITIES:		
Future policy benefits	$ 676,027,754	472,537,259
Policy and contract claims	3,584,407	3,029,382
Policyholders' dividends, coupons, and endowment accumulations	10,836,401	11,876,695
Other policyholder funds	9,182,403	8,896,001
Deferred Federal income taxes payable	14,662,000	10,862,000
Other liabilities	20,344,075	14,789,280
Total liabilities	734,637,040	521,990,617
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Common stock:		
Class A of $1 par value, authorized 7,500,000 shares; issued and outstanding 3,277,819 in 1986 and 1985	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 6)	(345,755)	(178,736)
Retained earnings	57,929,318	45,198,707
Total stockholders' equity	85,126,734	72,563,142
	$ 819,763,774	594,553,759

See accompanying notes to consolidated financial statements.

Consolidated Statements of Operations

	Years Ended December 31,		
	1986	1985	1984
Premiums and other revenue:			
Premiums:			
Life	$ 100,901,946	75,280,376	46,704,082
Annuities	156,789,145	106,938,767	75,163,740
	257,691,091	182,219,143	121,867,822
Investment income, net	62,136,811	47,547,208	35,510,437
Other income	744,565	765,276	700,546
Total premiums and other revenue	320,572,467	230,531,627	158,078,805
Benefits and expenses:			
Life	35,729,246	35,307,654	30,772,035
Other	39,871,095	31,123,769	19,099,441
Increase in liabilities for future policy benefits	180,763,027	110,830,548	64,094,525
Amortization of deferred policy acquisition costs	13,554,957	13,080,845	14,415,866
Other operating expenses	42,584,639	30,745,753	20,066,892
Total benefits and expenses	312,502,964	221,088,569	148,448,759
Earnings before Federal income taxes and other items	8,069,503	9,443,058	9,630,046
Deferred Federal income tax adjustment	—	—	19,984,000
Deferred Federal income taxes	(2,600,000)	(3,000,000)	(3,341,000)
Earnings from insurance operations	5,469,503	6,443,058	26,273,046
Equity in net earnings of subsidiary	4,324,413	2,523,978	424,456
Realized gains (losses) on	[illegible]	[illegible]	643,175
investments, less income taxes	2,936,695	495,203	(2,847,447)
Net earnings	$ 12,730,611	9,462,239	23,850,055
Earnings per share of common stock:			
Earnings from insurance operations	$ 1.57	1.85	7.56
Equity in net earnings of subsidiary	1.24	.73	.12
Realized gains (losses) on investments	.85	.14	(.82)
Net earnings	$ 3.66	2.72	6.86

See accompanying notes to consolidated financial statements.

Consolidated Statements of Stockholders' Equity

	Years Ended December 31,		
	1986	1985	1984
Common stock:			
Balance at beginning of year	$ 3,477,819	3,477,819	3,477,950
Par value of 131 shares cancelled in 1984	—	—	(131)
Balance at end of year	3,477,819	3,477,819	3,477,819
Additional paid-in capital:			
Balance at beginning of year	24,065,352	24,065,352	24,066,948
Value in excess of par on 131 shares cancelled in 1984	—	—	(1,596)
Balance at end of year	24,065,352	24,065,352	24,065,352
Net unrealized losses on investments in equity securities:			
Balance at beginning of year	(178,736)	(877,712)	(1,258,653)
Decrease (increase) in unrealized losses on investments in equity securities during the year	(167,019)	698,976	380,941
Balance at end of year	(345,755)	(178,736)	(877,712)
Retained earnings:			
Balance at beginning of year	45,198,707	35,736,468	11,886,413
Net earnings	12,730,611	9,462,239	23,850,055
Balance at end of year	57,929,318	45,198,707	35,736,468
Total stockholders' equity	$ 85,126,734	72,563,142	62,401,927

See accompanying notes to consolidated financial statements.

Consolidated Statements of Changes in Financial Position

	Years Ended December 31,		
	1986	1985	1984
Funds provided:			
From operations:			
Net earnings	$ 12,730,611	9,462,239	23,850,055
Charges (credits) not affecting funds:			
Deferred Federal income tax adjustment	—	—	(19,984,000)
Deferred Federal income taxes	2,600,000	3,000,000	3,341,000
Amortization of deferred policy acquisition costs	13,554,957	13,080,845	14,415,866
Increase in liability for future policy benefits	180,763,027	110,830,548	64,094,525
Amortization of bond discount	(682,512)	(1,960,375)	(2,420,059)
Other	(3,158,580)	(2,758,673)	8,927,730
	205,807,503	131,654,584	92,225,117
Cost of investments sold and loans matured:			
Bonds and notes	59,504,924	32,085,254	144,022,499
Mortgage loans	7,558,041	8,671,945	10,047,608
Other	8,184,992	3,565,669	1,175,458
	75,247,957	44,322,868	155,245,565
Decrease (increase) in cash	(27,589,900)	1,457,835	(2,152,690)
Other, net	22,293,621	3,356,494	(4,626,585)
Total funds provided	$ 275,759,181	180,791,781	240,691,407
Funds used:			
Increase in policy loans	$ 14,055,396	9,091,615	6,048,386
Cost of investments purchased or loans disbursed:			
Bonds and notes	218,751,811	133,196,314	189,832,903
Stocks	6,595,679	4,305,500	1,312,996
Mortgage loans	20,717,561	18,651,443	14,792,738
Real estate held for investment	1,737,175	435,580	1,057,255
Collateral loans and other	88,134	116,150	4,717,032
	261,945,756	165,796,602	217,761,310
Additions to deferred policy acquisition costs	18,634,548	13,515,321	15,317,488
Other, net	(4,821,123)	1,479,858	7,612,609
Total funds used	$ 275,759,181	180,791,781	240,691,407

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Years Ended December 31, 1986, 1985, and 1984

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying consolidated financial statements include the accounts of National Western Life Insurance Company and its inactive 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:

	1986	1985	1984
Costs deferred:			
Agents' commissions	$ 13,213,833	11,944,563	13,642,877
Other	5,420,715	1,570,758	1,674,611
	$ 18,634,548	13,515,321	15,317,488
Amounts amortized	$ 13,554,957	13,080,845	14,415,866
First-year and single premiums	$179,076,547	122,641,406	79,073,370
Renewal premiums	$ 78,614,544	59,577,737	42,794,452

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 statement 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,		
	1986	1985	1984
Per annual statement to insurance department	$ 5,239,889	7,015,805	(11,434,921)
Statutory net earnings of subsidiary	1,502	2,017	2,056
Consolidated statutory net gain (loss) from operations	5,241,391	7,017,822	(11,432,865)
Adjustments:			
Deferral of policy acquisition costs	5,079,591	434,476	901,622
Adjustment of future policy benefits	1,590,096	1,458,303	(128,595)
Adjustment for portfolio reinsurance	—	—	20,477,850
Amortization of investment in Trust	(240,535)	(255,029)	(252,599)
Deferred Federal income taxes	(2,600,000)	(3,000,000)	(3,341,000)
Deferred Federal income tax adjustment	—	—	19,984,000
Realized gains (losses) on investments, net	2,936,695	495,203	(2,847,447)
Other, net	723,373	3,311,464	489,089
Amounts per consolidated financial statements	$ 12,730,611	9,462,239	23,850,055

	Stockholders' Equity as of December 31,		
	1986	1985	1984
Per annual statement to insurance department	$ 38,896,230	39,410,022	32,847,856
Adjustments:			
Difference in initial valuation of investment in Libbie Shearn Moody Trust, net of amortization	(3,857,319)	(3,734,591)	(3,492,196)
Deferral of policy acquisition costs, net of amortization	52,643,772	47,564,181	47,129,705
Adjustment of future policy benefits	(3,413,507)	(5,333,889)	(7,640,824)
Deferred Federal income taxes	(14,662,000)	(10,862,000)	(7,862,000)
Adjustment to report preferred stocks at market value	(131,215)	(625,863)	(1,042,649)
Transfer of Mandatory Securities Valuation Reserve to appropriated retained earnings	15,042,227	6,492,271	2,007,396
Reinstatement of non-admitted assets	3,129,801	2,468,193	3,270,211
Other, net	(2,521,255)	(2,815,182)	(2,815,572)
Amounts per consolidated financial statements	$ 85,126,734	72,563,142	62,401,927

(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, 1986, gross unrealized investment gains and losses on marketable equity securities were $832,735 and $1,178,490, 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 1986.

(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,		
	1986	1985	1984
Assets:			
Cash	$ 1,578,431	2,965,605	1,717,895
Receivables	38,120,213	25,154,243	17,330,428
Trading inventory	41,050,330	30,267,046	8,532,551
Other assets	21,654,384	10,037,969	41,775,035
	$ 102,403,358	68,424,863	69,355,909
Liabilities:			
Notes payable	$ 38,612,420	26,657,456	6,241,007
Payables to customers and brokers	26,037,624	17,872,930	10,964,414
Other liabilities	26,175,036	13,302,064	43,776,700
Stockholders' equity	11,578,278	10,592,413	8,373,788
	$ 102,403,358	68,424,863	69,355,909
Revenues	$ 36,628,512	28,095,080	14,021,051
Net income	$ 4,045,126	2,483,791	297,629

(3) DEPOSITS WITH REGULATORY AUTHORITIES

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

	December 31,	
	1986	1985
Bonds, at amortized cost	$ 53,687,650	57,495,583
Mortgage loans on real estate	$ 1,999,924	2,530,038
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 $22,668,000 at December 31, 1986, 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, 1986	1985	1984
Investment income:			
Interest on bonds	$ 44,513,953	31,908,440	23,091,699
Interest on mortgage loans	8,831,358	8,124,956	7,114,690
Interest on policy loans	5,650,989	4,350,856	3,424,135
Other investment income	4,507,795	4,198,130	3,623,277
Total investment income	63,504,095	48,582,382	37,253,801
Investment expenses	1,367,284	1,035,174	1,743,364
Net investment income	$ 62,136,811	47,547,208	35,510,437

Investments of the following amounts were non-income producing:

Type of Investment	December 31, 1986	1985
Bonds	$ 2,046,960	120,000
Common stock	$ 507,961	359,919
Mortgage loans	$ 1,934,708	—
Real estate	$ 1,043,438	633,154

(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, 1986			
Bonds	$ 1,499,520	16,002,578	17,502,098
Stocks	347,371	(167,019)	180,352
Other	1,089,804	—	1,089,804
Total	$ 2,936,695	15,835,559	18,772,254
Year Ended December 31, 1985			
Bonds	$(116,782)	26,250,102	26,133,320
Stocks	355,588	698,976	1,054,564
Other	256,397	—	256,397
Total	$ 495,203	26,949,078	27,444,281
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

(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, 1986, 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, 1986, 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 the 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, 1986, no retained earnings were so allocated.

Participating business constitutes approximately 5% and 7% of the Company's life insurance in force, 10% and 8% of the policies in force, and 3% and 8% of the premium income for the years ended December 31, 1986 and 1985, 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 $407,000,000 and $280,000,000 is ceded on a yearly renewable term basis, $1,200,000 and $1,400,000 is ceded on a modified coinsurance basis, and $150,000,000 and $102,000,000 is ceded on a coinsurance basis at December 31, 1986 and 1985, respectively. In accordance with the reinsurance contracts, credits in the amounts of approximately $1,700,000 and $1,500,000 were taken against the liability for future policy benefits at December 31, 1986 and 1985, 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.

On December 31, 1986, a reinsurance agreement was effected whereby the Company received cash of approximately $18,700,000 and assumed reserves of approximately $22,700,000 on approximately $531,000,000 of face amount of universal life policies. The $4,000,000 net cost of the business has been deferred as a policy acquisition cost and is being amortized over the estimated life of the reinsured business.

(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 prior to January 1, 1984, 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, 1986, 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, 1986, 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,		
	1986	1985	1984
Policy acquisition costs expensed for tax purposes and deferred for financial accounting purposes	$ 371,000	164,000	410,000
Excess of the increase in the liability for future policy benefits for tax purposes over the increase for financial accounting purposes	680,000	892,000	9,360,000
Use of tax operating loss deduction	2,852,000	1,330,000	(7,053,000)
Other	(1,303,000)	614,000	624,000
	$ 2,600,000	3,000,000	3,341,000

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, 1986	1985	1984
Income taxes at the statutory rate	$ 5,701,000	5,505,000	4,624,000
Special life insurance company deductions	(805,000)	(591,000)	(706,000)
Dividends received deductions	(631,000)	(510,000)	(118,000)
Amortization of life interest in Libbie Shearn Moody Trust	118,000	117,000	116,000
Equity in net earnings of subsidiary	(1,989,000)	(1,161,000)	(195,000)
Capital gains rate difference	(392,000)	(357,000)	(335,000)
Other	598,000	(3,000)	(45,000)
Federal income tax provision	$ 2,600,000	3,000,000	3,341,000

At December 31, 1986, the Company had loss carryforwards of approximately $10,000,000 which the Company has treated on its Federal income tax return as expiring 1987 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, 3,477,819, and 3,477,900 for the years ended December 31, 1986, 1985, and 1984, 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, 1986	1985
Original valuation of life interest at February 26, 1960	$ 13,793,150	13,793,150
Less accumulated amortization	6,155,825	5,898,345
Net asset value of life interest in Trust	$ 7,637,325	7,894,805

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,		
	1986	1985	1984
Income distributions received	$ 1,614,000	1,466,000	1,308,000
Add (deduct):			
Amortization	(257,000)	(255,000)	(252,000)
Reinsurance premiums	(105,000)	(97,000)	(89,000)
Increase in surrender value of life insurance policies	134,752	12,000	(4,000)
Net income from life interest in the Trust	$ 1,386,752	1,126,000	963,000

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 $19,000 in 1986, $27,000 in 1985, and $34,000 in 1984, and liabilities for future policy benefits related to these policies in the amounts of $1,238,000, $1,219,000, and $1,192,000 at December 31, 1986, 1985, and 1984, 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 and $279,000 in 1985 and 1984, 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. As a result of actuarial recalculations, it was determined that no contribution was necessary for 1986.

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 determining the actuarial present value of accumulated plan benefits was 4.5% for 1985 and 1984. The average assumed rate of return used in 1986 was 6.0%. 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,	
		1986	1985
Accumulated plan benefits:			
Vested	$	2,354,368	1,918,717
Nonvested		533,835	561,931
	$	2,888,203	2,480,648
Net assets available for plan benefits	$	3,509,813	2,740,196

(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 Judgement dismissing the lawsuit, and that dismissal was affirmed by the United States Court of Appeals, 5th Circuit, on February 23, 1987. 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 $25,500,000, $20,500,000, and $17,500,000 for the years ended December 31, 1986, 1985, and 1984, 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)			
1986				
Revenues	$ 71,557	76,110	75,604	97,301
Earnings from insurance operations	2,234	547	1,353	1,336
Equity in net earnings of subsidiary	1,311	901	1,012	1,100
Net earnings	3,546	3,847	2,584	2,754
Per share:				
Earnings from insurance operations	.64	.16	.39	.38
Equity in net earnings of subsidiary	.38	.26	.29	.31
Net earnings	1.02	1.11	.74	.79
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	.30
Equity in net earnings of subsidiary	.17	.22	.16	.18
Net earnings	.75	.97	.49	.51

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, 1986 and 1985, 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, 1986. 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, 1986 and 1985, 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.

March 16, 1987
Austin, Texas

Touche Ross & Co.

Summary of Operations

	Years Ended December 31,				
	1986	1985	1984	1983	1982
Premium income	$257,691,091	182,219,143	121,867,822	79,527,511	78,254,641
Net investment income	62,136,811	47,547,208	35,510,437	27,205,917	20,920,342
Other income	744,565	765,276	700,546	1,196,694	257,590
Total income	320,572,467	230,531,627	158,078,805	107,930,122	99,432,573
Policyowner benefits	(256,363,368)	(177,261,971)	(113,966,001)	(75,180,142)	(68,126,320)
Commissions and other expenses	(56,139,596)	(43,826,598)	(34,482,758)	(25,027,423)	(25,503,599)
Total expenses	(312,502,964)	(221,088,569)	(148,448,759)	(100,207,565)	(93,629,919)
Deferred Federal income tax adjustment	—	—	19,984,000	—	—
Provision for deferred Federal income taxes	(2,600,000)	(3,000,000)	(3,341,000)	(2,900,000)	(1,888,000)
Earnings from insurance operations	5,469,503	6,443,058	26,273,046	4,822,557	3,914,654
Equity in earnings of brokerage subsidiary	4,324,413	2,523,978	424,456	2,504,780	3,086,540
Realized gains (losses) on investments	2,936,695	495,203	(2,847,447)	(220,834)	(554,482)
Net earnings	$ 12,730,611	9,462,239	23,850,055	7,106,503	6,446,712
Per Share:					
Earnings from insurance operations	$ 1.57	1.85	7.56	1.39	1.14
Equity in earnings of brokerage subsidiary	1.24	.73	.12	.72	.90
Realized gains (losses) on investments	.85	.14	(.82)	(.07)	(.16)
Net earnings	$ 3.66	2.72	6.86	2.04	1.88

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	
	1984	1985	1986	1984-85	1985-86
Premiums	77.0%	79.0%	80.4%	49.5%	41.4%
Investment income	22.5	20.6	19.4	33.9	30.7
Other income	0.5	0.4	0.2	9.2	(2.7)
Total revenues	100.0	100.0	100.0	45.8	39.1
Policyowner benefits	(72.1)	(76.9)	(80.0)	55.5	44.6
Commissions and other expenses	(21.8)	(19.0)	(17.5)	27.1	28.1
Deferred Federal income tax adjustment	12.6	—	—	(100.0)	—
Provision for deferred Federal income taxes	(2.1)	(1.3)	(0.7)	(10.2)	(13.3)
Equity earnings of brokerage subsidiary	0.3	1.1	1.3	(494.6)	71.3
Realized gains (losses) on investments	(1.8)	(0.2)	0.9	112.5	493.0
Net earnings	15.1%	3.7%	4.0%	(60.3)	34.5

Results of Operations

Premium Income: Total premium income increased to $257.7 million in 1986 from $182.2 million in 1985 and $121.9 million in 1984. The major growth area continues to be in annuity considerations, which increased to $156.8 million in 1986 from $106.9 million in 1985 and $75.1 million in 1984.

Life premiums for 1986 increased by $25.6 million or 34% over 1985. In addition to continuing production increases in the 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 $741.7 million at the end of 1986 compared to $528.4 million in 1985 and $403.8 million in 1984. The increases in invested assets produced net investment income of $62.1 million in 1986, compared to $47.5 million in 1985 and $35.5 million in 1984. 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 $4.3 million in 1986 as compared to $2.5 million in 1985 and $0.4 million in 1984. Earnings from this subsidiary vary directly with trading activity in the government securities market.

Policyowner Benefits: A 45% increase in this item was reflected by total benefits at $256.4 million in 1986, 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 1985 were $177.2 million compared to $113.9 million in 1984.

Commissions and Other Expenses: Amounts for this expense category were $56.1 million, $43.8 million, and $34.4 million for 1986, 1985, and 1984, respectively. Increased commission expense in 1985 and 1986 relate to production of the flexible premium annuity on which commission costs are not deferred, but are recognized currently. The 1986 amount includes a 56% 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 one-time adjustment permitted under the Deficit Reduction Act of 1984. This adjustment amounted to $19.9 million or $5.75 per share.

Realized Gains (Losses) on Investments: Net gains (losses) were $2,936,695 for 1986, $495,203 for 1985, and ($2,847,447) for 1984. The amounts for 1986 and 1985 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 $85.1 million as of December 31, 1986. The book value per share was $24.48 compared to $20.87 at the end of 1985, a 17% increase.

At year-end 1986, policy loans had increased by approximately $14 million or 20% from 1985. 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 1985 or 1986 and had none outstanding at either year-end. There are no present material commitments for capital expenditures in 1987, and the Company does not anticipate incurring any such commitments through the balance of 1987.

Common Stock Prices

Quarter	Ending	High	Low
3-31	1986	20-1/4	16-1/4
6-30	1986	22-3/4	17-3/8
9-30	1986	23	16-1/2
12-31	1986	21-1/8	16-1/4
3-31	1987	20-3/4	18

Statutory Balance Sheets

	(Unaudited) December 31, 1986	1985
ASSETS		
Bonds	$ 498,403,300	337,512,978
Preferred stocks	12,249,510	16,118,867
Common stocks	8,420,604	4,815,390
Mortgage loans	91,675,413	80,187,128
Real estate	4,356,302	3,196,702
Policy loans	83,992,357	69,936,961
Collateral loans	2,061,729	2,127,882
Income interest in Libbie Shearn Moody Trust	11,494,644	11,629,396
Cash on hand and in banks	6,186,052	3,930,378
Short-term investments	35,260,665	9,927,790
Premiums deferred and uncollected	9,596,006	9,986,886
Investment income due and accrued	14,459,059	10,443,572
Other assets	2,446,915	2,091,258
	$ 780,602,556	561,905,188
LIABILITIES, SURPLUS, AND OTHER FUNDS		
Aggregate reserve for life policies	$ 681,445,752	476,360,261
Aggregate reserve for accident and health policies	292,997	297,897
Supplementary contracts without life contingencies	567,662	936,326
Life claims	3,500,195	2,953,791
Accident and health claims	1.681	—
Policyholders' dividend, coupon, and endowment accumulations	10,777,875	11,788,493
Policyholders' dividend liability	320,000	346,400
Other liabilities to policyholders	9,394,185	8,777,509
Commissions, expenses, and taxes due or accrued	3,214,460	2,121,899
Borrowed money	3,190,309	3,223,481
Other liabilities	13,958,983	9,196,838
Mandatory Securities Valuation Reserve	15,042,227	6,492,271
Total liabilities	741,706,326	522,495,166
Capital paid up	3,477,819	3,477,819
Paid-in and contributed surplus	12,750,763	12,750,763
Unassigned surplus	22,667,648	23,181,440
Total capital and surplus	38,896,230	39,410,022
	$ 780,602,556	561,905,188

Statutory Statements of Operations

	(Unaudited) Years Ended December 31,	
	1986	1985
Premiums and annuity considerations	$ 182,833,936	127,951,028
Annuity and other fund deposits	73,905,747	52,573,283
Considerations for supplementary contracts, dividend, coupon, and endowment accumulations	1,621,134	1,775,418
Reserve adjustment on reinsurance ceded	—	—
Commission and expense allowances on reinsurance ceded	—	—
Net investment income	61,471,413	47,327,319
Other income	23,400,501	669,054
Total income	343,232,731	230,296,102
Death claims	11,363,792	10,811,696
Accident and health claims	132,803	135,112
Surrender benefits	51,320,965	23,324,699
Coupons and endowments to policyholders	742,848	923,833
Payments on supplementary contracts, dividend, coupon, and endowment accumulations	2,679,509	3,071,211
Other policy benefits	11,896,329	30,283,962
Increase in life and accident and health reserves	205,080,591	112,288,851
Decrease in other reserves	(1,380,595)	(969,320)
Reserves transferred and adjustments on reinsurance	—	—
Commissions	43,702,060	31,706,836
General expenses, taxes, and other expenses	12,707,085	12,138,989
Decrease in loading	(560,529)	(784,552)
Total benefits and expenses	337,684,858	222,931,317
Net gain (loss) before dividends and Federal income taxes	5,547,873	7,364,785
Dividends to policyholders	307,984	348,980
Net gain (loss) before Federal income taxes	5,239,889	7,015,805
Federal income taxes	—	—
Net gain (loss) from operations	$ 5,239,889	7,015,805

Statutory Statements of Capital and Surplus

	(Unaudited) Years Ended December 31,	
	1986	1985
Balance at beginning of year	$ 39,410,022	32,847,857
Additions (deductions):		
Net gain from operations	5,239,889	7,015,805
Net capital gains	7,824,189	3,432,254
Net gain (loss) from non-admitted assets	(670,989)	772,154
Increase in Mandatory Securities Valuation Reserve	(8,549,956)	(4,484,875)
Other decreases	(4,356,925)	(173,173)
Balance at end of year	$ 38,896,230	39,410,022

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

Officers

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

Harry L. Edwards
President and Chief Operating Officer

Robert R. Johnson, FLMI, CLU
Executive Vice President
Administration
Assistant Secretary

Richard C. Andrews, CLU
Vice President
Qualified Plans

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

Dr. Jose M. Galano
Vice President
Latin American Operations

Andrew M. Hansen
Vice President
Domestic Marketing

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

Weldon K. Huffman
Vice President
Systems Management
Assistant Secretary

James A. Kincl
Vice President
Salary Savings

Bob Laughlin
Vice President
General Markets

Charles D. Milos, Jr.
Vice President
Investment Analyst

James R. Naiser, FLMI
Vice President
Systems Development

Harold L. Ponder
Vice President
Risk Selection

James V. Robinson
Vice President
Secretary

Ralph K. Schmitz
Vice President
Federal Markets

Larry D. White, FLMI
Vice President
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

Mary L. Smith
Assistant Vice President
Assistant Secretary

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

Hans W. Weber
Assistant Vice President
Assistant Treasurer

Ellen C. Otte
Assistant Secretary

EXECUTIVE OFFICES

National Western Life Insurance Company, 850 East Anderson Lane, Austin, Texas 78752

ACCOUNTANTS

Touche Ross & Co., 919 Congress—Suite 700, Austin, Texas 78701

GENERAL COUNSEL

Will D. Davis, Heath, Davis & McCalla, Attorneys at Law, Austin, Texas 78701

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

STOCKHOLDER INFORMATION

Principal Transfer Agent (since May 2, 1987):
The First National Bank of Boston
Shareholder Services
P.O. Box 644
Boston, Massachusetts 02102
Telephone: 617/929-5445

Co-Transfer Agent:
First City National Bank
Stock Transfer Division
P. O. Box 2127
Austin, Texas 78768

Requests for information and assistance with transfer of stock should be directed to the Company's Principal Transfer Agent.

New Company Zip Code:

The Company's new zip code is 78752-1602.

NATIONAL WESTERN LIFE
INSURANCE COMPANY
850 E. Anderson Lane
Austin, Texas 78752