**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**



**FORM 10-Q**



* **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended June 30, 2006**

**OR**

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



**1-16725**

(Commission file number)

**PRINCIPAL FINANCIAL GROUP, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of

incorporation or organization)

**42-1520346**

(I.R.S. Employer

Identification Number)

**711 High Street, Des Moines, Iowa 50392**

(Address of principal executive offices)

**(515) 247-5111**

(Registrant’s telephone number, including area code)



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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer” and “large accelerated filer” in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer x Accelerated Filer o Non-accelerated Filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

The total number of shares of the registrant’s Common Stock, $0.01 par value, outstanding as of July 27, 2006 was 269,286,643.



**PRINCIPAL FINANCIAL GROUP, INC.**

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|  |  |  |  |  |  |  |  |  |  |  |  |  | **June 30,** | |  | **December 31,** | | | |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  | **2006** |  |  | **2005** |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  | **(Unaudited)** |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  | **(in millions)** | | | | | | |  |
| **Assets** | | | | | | | | | | | |  |  |  |  |  |  |  |  |  |
| Fixed maturities, available-for-sale | | | | | | | | | | | | **$** | **42,293.4** |  | $ | 42,117.2 | |  |  |  |
| Fixed maturities, trading | | | | | | | | | | | |  | **252.0** |  |  | 113.2 | |  |  |  |
| Equity securities, available-for-sale | | | | | | | | | | | |  | **677.2** |  |  | 724.4 | |  |  |  |
| Equity securities, trading | | | | | | | | | | | |  | **148.3** |  |  | 90.3 | |  |  |  |
| Mortgage loans | | | | | | | | | | | |  | **11,543.9** |  |  | 11,484.3 | |  |  |  |
| Real estate | | | | | | | | | | | |  | **997.2** |  |  | 999.4 | |  |  |  |
| Policy loans | | | | | | | | | | | |  | **843.2** |  |  | 827.7 | |  |  |  |
| Other investments | | | | | | | | | | | |  | **1,368.8** |  |  | 1,113.5 | |  |  |  |
| Total investments | | | | | | | | | | | |  | **58,124.0** |  |  | 57,470.0 | |  |  |  |
| Cash and cash equivalents | | | | | | | | | | | |  | **1,216.9** |  |  | 1,641.3 | |  |  |  |
| Accrued investment income | | | | | | | | | | | |  | **666.0** |  |  | 682.7 | |  |  |  |
| Premiums due and other receivables | | | | | | | | | | | |  | **626.8** |  |  | 592.7 | |  |  |  |
| Deferred policy acquisition costs | | | | | | | | | | | |  | **2,455.6** |  |  | 2,174.1 | |  |  |  |
| Property and equipment | | | | | | | | | | | |  | **420.2** |  |  | 419.8 | |  |  |  |
| Goodwill | | | | | | | | | | | |  | **297.8** |  |  | 282.3 | |  |  |  |
| Other intangibles | | | | | | | | | | | |  | **199.3** |  |  | 202.6 | |  |  |  |
| Separate account assets | | | | | | | | | | | |  | **65,620.2** |  |  | 62,070.0 | |  |  |  |
| Other assets | | | | | | | | | | | |  | **1,802.6** |  |  | 1,499.9 | |  |  |  |
| Total assets | | | | | | | | | | | | **$** | **131,429.4** |  | $ | 127,035.4 | |  |  |  |
| **Liabilities** | | | | | | | | | | | |  |  |  |  |  |  |  |  |  |
| Contractholder funds | | | | | | | | | | | | **$** | **35,512.6** |  | $ | 33,612.1 | |  |  |  |
| Future policy benefits and claims | | | | | | | | | | | |  | **17,006.6** |  |  | 16,825.5 | |  |  |  |
| Other policyholder funds | | | | | | | | | | | |  | **636.3** |  |  | 657.1 | |  |  |  |
| Short-term debt | | | | | | | | | | | |  | **424.4** |  |  | 476.4 | |  |  |  |
| Long-term debt | | | | | | | | | | | |  | **894.2** |  |  | 898.8 | |  |  |  |
| Income taxes currently payable | | | | | | | | | | | |  | **0.5** |  |  | — | | |  |  |
| Deferred income taxes | | | | | | | | | | | |  | **610.9** |  |  | 974.8 | |  |  |  |
| Separate account liabilities | | | | | | | | | | | |  | **65,620.2** |  |  | 62,070.0 | |  |  |  |
| Other liabilities | | | | | | | | | | | |  | **3,879.0** |  |  | 3,713.5 | |  |  |  |
| Total liabilities | | | | | | | | | | | |  | **124,584.7** |  |  | 119,228.2 | |  |  |  |
| **Stockholders’ equity** | | | | | | | | | | | |  |  |  |  |  |  |  |  |  |
| Series A preferred stock, par value $.01 per share with liquidation preference of $100 per share - 3.0 million shares | | | | | | | | | | | |  | **—** | |  |  |  |  |  |  |
| authorized, issued and outstanding in 2006 and 2005 | | | | | | | | | | | |  |  | — | | |  |  |
| Series B preferred stock, par value $.01 per share with liquidation preference of $25 per share - 10.0 million shares | | | | | | | | | | | |  | **0.1** |  |  |  |  |  |  |  |
| authorized, issued and outstanding in 2006 and 2005 | | | | | | | | | | | |  |  |  | 0.1 | |  |  |  |
| Common stock, par value $.01 per share - 2,500.0 million shares authorized, 382.5 million and 381.3 million shares | | | | | | | | | | | |  | **3.8** |  |  |  |  |  |  |  |
| issued, and 269.1 million and 280.6 million shares outstanding in 2006 and 2005, respectively | | | | | | | | | | | |  |  |  | 3.8 | |  |  |  |



|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Additional paid-in capital | **8,068.8** |  | 8,000.0 |  |
| Retained earnings | **2,504.8** |  | 2,008.6 |  |
| Accumulated other comprehensive income | **218.5** |  | 994.8 |  |
| Treasury stock, at cost (113.4 million and 100.7 million shares in 2006 and 2005, respectively) | **(3,951.3)** | | (3,200.1) | |
| Total stockholders’ equity | **6,844.7** |  | 7,807.2 |  |
| Total liabilities and stockholders’ equity | **$ 131,429.4** |  | $ 127,035.4 |  |
|  |  |  |  |  |

*See accompanying notes.*

3



**Principal Financial Group, Inc.**

**Consolidated Statements of Operations**

**(Unaudited)**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  | **For the three months ended** | | | | |  |  | **For the six months ended** | | | | | |  |
|  |  |  |  | **June 30,** | | | |  |  |  | **June 30,** | | | |  |  |  |
|  |  |  |  | **2006** |  |  |  | **2005** |  |  | **2006** |  |  |  | **2005** |  |  |
|  |  |  |  |  |  |  |  | **(in millions, except per share data)** | | | | |  |  |  |  |  |
|  | **Revenues** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Premiums and other considerations | **$** | | **1,104.6** |  | $ | | 948.9 | **$** | | **2,146.4** |  | $ | | 1,883.0 |  |  |
|  | Fees and other revenues |  |  | **451.3** |  |  |  | 405.3 |  |  | **900.1** |  |  |  | 822.5 |  |  |
|  | Net investment income |  |  | **911.6** |  |  |  | 836.0 |  |  | **1,763.8** |  |  |  | 1,629.9 |  |  |
|  | Net realized/unrealized capital gains (losses) |  |  | **(19.1)** | |  |  | 10.2 |  |  | **29.8** |  |  |  | 8.7 |  |  |
|  | Total revenues |  |  | **2,448.4** |  |  |  | 2,200.4 |  |  | **4,840.1** |  |  |  | 4,344.1 |  |  |
|  | **Expenses** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Benefits, claims, and settlement expenses |  |  | **1,459.6** |  |  |  | 1,264.5 |  |  | **2,801.4** |  |  |  | 2,498.8 |  |  |
|  | Dividends to policyholders |  |  | **72.5** |  |  |  | 72.2 |  |  | **144.4** |  |  |  | 145.1 |  |  |
|  | Operating expenses |  |  | **619.8** |  |  |  | 580.8 |  |  | **1,224.2** |  |  |  | 1,137.7 |  |  |
|  | Total expenses |  |  | **2,151.9** |  |  |  | 1,917.5 |  |  | **4,170.0** |  |  |  | 3,781.6 |  |  |
|  | Income from continuing operations before income taxes |  |  | **296.5** |  |  |  | 282.9 |  |  | **670.1** |  |  |  | 562.5 |  |  |
|  | Income taxes |  |  | **77.7** |  |  |  | 59.3 |  |  | **157.4** |  |  |  | 134.0 |  |  |
|  | Income from continuing operations, net of related income taxes |  |  | **218.8** |  |  |  | 223.6 |  |  | **512.7** |  |  |  | 428.5 |  |  |
|  | Income from discontinued operations, net of related income taxes |  |  | **—** | |  |  | 15.3 |  |  | **—** | |  |  | 15.9 |  |  |
|  | Net income |  |  | **218.8** |  |  |  | 238.9 |  |  | **512.7** |  |  |  | 444.4 |  |  |
|  | Preferred stock dividends |  |  | **8.3** |  |  |  | — |  |  | **16.5** |  |  |  | — | |  |
|  | Net income available to common stockholders |  | **$** | **210.5** |  |  | $ | 238.9 |  | **$** | **496.2** |  |  | $ | 444.4 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Earnings per common share** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Basic earnings per common share: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Income from continuing operations, net of related income taxes | **$** | | **0.77** |  | $ | | 0.78 | **$** | | **1.79** |  | $ | | 1.45 |  |  |
|  | Income from discontinued operations, net of related income taxes |  |  | **—** | |  |  | 0.05 |  |  | **¾** |  |  |  | 0.05 |  |  |
|  | Net income |  | **$** | **0.77** |  |  | $ | 0.83 |  | **$** | **1.79** |  |  | $ | 1.50 |  |  |
|  | Diluted earnings per common share: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Income from continuing operations, net of related income taxes | **$** | | **0.76** |  | $ | | 0.77 | **$** | | **1.78** |  | $ | | 1.44 |  |  |
|  | Income from discontinued operations, net of related income taxes |  |  | **—** | |  |  | 0.05 |  |  | **¾** |  |  |  | 0.05 |  |  |
|  | Net income |  | **$** | **0.76** |  |  | $ | 0.82 |  | **$** | **1.78** |  |  | $ | 1.49 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

*See accompanying notes.*

4



**Principal Financial Group, Inc.**

**Consolidated Statements of Stockholders’ Equity**

**(Unaudited)**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  | **Series A** | **Series B** |  |  | **Additional** |  |  | **Accumulated** |  |  | **Total** | |  |
|  |  |  |  | **Common** | **Retained** |  | **other** | **Treasury** |  |  |
|  |  |  | **preferred** | **preferred** |  | **paid-in** |  | **comprehensive** |  | **stockholders’** | |  |
|  |  |  | **stock** | **stock** |  | **stock** | **capital** | **earnings** |  | **income** | **stock** |  | **equity** | |  |
|  |  |  |  |  |  |  | **(in millions)** | |  |  |  |  |  |  |  |
| **Balances at January 1, 2005** | $ | | — $ | — | $ | 3.8 | $ 7,269.4 | $ 1,289.5 | $ | 1,313.3 | $ (2,331.7) | $ | 7,544.3 |  |  |
| Series A preferred stock issued |  |  | — | — |  | — | 296.0 | — |  | — | — |  | 296.0 |  |  |
| Series B preferred stock issued |  |  | — | 0.1 |  | — | 245.9 | — |  | — | — |  | 246.0 |  |  |
| Common stock issued |  |  | — | — |  | — | 25.8 | — |  | — | — |  | 25.8 |  |  |
| Capital transactions of equity |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| method investee, net of related |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| income taxes |  |  | — | — |  | — | 0.4 | — |  | — | — |  | 0.4 |  |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Stock-based compensation, and | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | additional related tax benefits |  |  | — | |  | — |  |  | — | |  | 23.0 |  | — | |  |  | — | | — | |  | 23.0 |  |  |  |
|  | Treasury stock acquired, common |  |  | — | |  | — |  |  | — | |  | — |  | — | |  |  | — | | (868.4) | |  | (868.4) | |  |  |
|  | Comprehensive income: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Net income |  |  | — | |  | — |  |  | — | |  | — | 444.4 | |  |  |  | — | | — | |  | 444.4 |  |  |  |
|  | Net unrealized gains |  |  | — | |  | — |  |  | — | |  | — |  | — | |  |  | 164.7 |  | — | |  | 164.7 |  |  |  |
|  | Provision for deferred income |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | taxes |  |  | — | |  | — |  |  | — | |  | — |  | — | |  |  | (41.0) | | — | |  | (41.0) | |  |  |
|  | Foreign currency translation |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | adjustment, net of related |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | income taxes |  |  | — | |  | — |  |  | — | |  | — |  | — | |  |  | 16.9 |  | — | |  | 16.9 |  |  |  |
|  | Comprehensive income |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | 585.0 |  |  |  |
|  | **Balances at June 30, 2005** |  | $ | — |  | $ | 0.1 |  | $ | 3.8 |  | $ | 7,860.5 |  | $ 1,733.9 |  |  | $ | 1,453.9 |  | $ (3,200.1 | ) | $ | 7,852.1 |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Balances at January 1, 2006** | **$** | | **—** | | **$** | **0.1** | **$** | | **3.8** |  | **$** | **8,000.0** | **$ 2,008.6** | |  | **$** | | **994.8** |  | **$ (3,200.1)** | | **$** | **7,807.2** |  |  |  |
|  | Common stock issued |  |  | **—** | |  | **—** |  |  | **—** | |  | **38.3** |  | **—** | |  |  | **—** | | **—** | |  | **38.3** |  |  |  |
|  | Capital transactions of equity |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | method investee, net of related |  |  | **—** | |  | **—** |  |  | **—** | |  | **0.8** |  | **—** | |  |  | **—** | | **—** | |  | **0.8** |  |  |  |
|  | income taxes |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Stock-based compensation, and |  |  | **—** | |  | **—** |  |  | **—** | |  | **29.7** |  | **—** | |  |  | **—** | | **—** | |  | **29.7** |  |  |  |
|  | additional related tax benefits |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Treasury stock acquired, common |  |  | **—** | |  | **—** |  |  | **—** | |  | **—** |  | **—** | |  |  | **—** | | **(751.2)** | |  | **(751.2)** | |  |  |
|  | Dividends to preferred stockholders |  |  | **—** | |  | **—** |  |  | **—** | |  | **—** | **(16.5)** | | |  |  | **—** | | **—** | |  | **(16.5)** | |  |  |
|  | Comprehensive loss: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Net income |  |  | **—** | |  | **—** |  |  | **—** | |  | **—** | **512.7** | |  |  |  | **—** | | **—** | |  | **512.7** |  |  |  |
|  | Net unrealized losses |  |  | **—** | |  | **—** |  |  | **—** | |  | **—** |  | **—** | |  |  | **(1,113.0)** | | **—** | |  | **(1,113.0)** | |  |  |
|  | Provision for deferred income tax |  |  | **—** | |  | **—** |  |  | **—** | |  | **—** |  | **—** | |  |  | **369.6** |  | **—** | |  | **369.6** |  |  |  |
|  | benefits |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Foreign currency translation |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | adjustment, net of related |  |  | **—** | |  | **—** |  |  | **—** | |  | **—** |  | **—** | |  |  | **(32.9)** | | **—** | |  | **(32.9)** | |  |  |
|  | income taxes |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Comprehensive loss |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | **(263.6)** | |  |  |
|  | **Balances at June 30, 2006** |  | **$** | **—** |  | **$** | **0.1** |  | **$** | **3.8** |  | **$** | **8,068.8** |  | **$ 2,504.8** |  |  | **$** | **218.5** |  | **$ (3,951.3** | **)** | **$** | **6,844.7** |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  | 5 | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Consolidated Statements of Cash Flows**

**(Unaudited)**

**For six months ended**

**June 30,**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  | **2006** |  |  |  | **2005** |  |
|  |  |  |  |  |  |  | **(As Restated -** |  |
|  |  |  |  |  |  |  | **See Note 1)** | |
|  |  |  | **(in millions)** | | | | | |
| **Operating activities** |  |  |  |  |  |  |  |  |
| Net income | **$** | | **512.7** |  | $ | | 444.4 |  |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |  |  |  |  |  |  |  |
| Income from discontinued operations, net of related income taxes |  |  | **—** | |  |  | (15.9) | |
| Amortization of deferred policy acquisition costs |  |  | **136.6** |  |  |  | 126.7 |  |
| Additions to deferred policy acquisition costs |  |  | **(245.0)** | |  |  | (249.4) | |
| Accrued investment income |  |  | **16.7** |  |  |  | 5.3 |  |
| Net cash flows from trading securities |  |  | **(128.5)** | |  |  | 1.6 |  |
| Premiums due and other receivables |  |  | **(22.8)** | |  |  | (20.4) | |
| Contractholder and policyholder liabilities and dividends |  |  | **648.5** |  |  |  | 932.3 |  |
| Current and deferred income taxes |  |  | **(34.9)** | |  |  | (416.0) | |
| Net realized/unrealized capital gains |  |  | **(29.8)** | |  |  | (8.7) | |
| Depreciation and amortization expense |  |  | **49.6** |  |  |  | 47.4 |  |
| Mortgage loans held for sale, acquired or originated |  |  | **(282.4)** | |  |  | (1,077.3) | |
| Mortgage loans held for sale, sold or repaid, net of gain |  |  | **564.6** |  |  |  | 1,108.2 |  |
| Real estate acquired through operating activities |  |  | **(14.7)** | |  |  | (26.7) | |
| Real estate sold through operating activities |  |  | **11.8** |  |  |  | 4.8 |  |
| Stock-based compensation |  |  | **28.9** |  |  |  | 22.9 |  |
| Other |  |  | **(106.5)** | |  |  | (72.8) | |
| Net adjustments |  |  | **592.1** |  |  |  | 362.0 |  |
| Net cash provided by operating activities |  |  | **1,104.8** |  |  |  | 806.4 |  |
| **Investing activities** |  |  |  |  |  |  |  |  |
| Available-for-sale securities: |  |  |  |  |  |  |  |  |
| Purchases |  |  | **(4,384.4)** | |  |  | (4,753.5) | |
| Sales |  |  | **745.3** |  |  |  | 960.1 |  |
| Maturities |  |  | **1,873.0** |  |  |  | 3,046.6 |  |

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Mortgage loans acquired or originated |  |  | **(1,542.5)** | |  |  | (1,272.9) | |  |  |
| Mortgage loans sold or repaid |  |  | **1,192.3** |  |  |  | 1,264.4 |  |  |  |
| Real estate acquired |  |  | **(18.7)** | |  |  | (161.0) | |  |  |
| Real estate sold |  |  | **11.4** |  |  |  | 267.2 |  |  |  |
| Net purchases of property and equipment |  |  | **(23.2)** | |  |  | (18.1) | |  |  |
| Purchases of interest in subsidiaries, net of cash acquired |  |  | **(5.5)** | |  |  | (54.4) | |  |  |
| Net change in other investments |  |  | **84.3** |  |  |  | (41.2) | |  |  |
| Net cash used in investing activities |  |  |  |  |  |  |  |  |  |  |
| **$** | **(2,068.0)** | | $ | (762.8) | |  |  |
|  | 6 |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Consolidated Statements of Cash Flows (continued)**

**(Unaudited)**

**For the six months ended,**

**June 30,**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **2006** |  |  |  | **2005** |  |  |
|  |  |  |  |  |  | **(As Restated -** |  |  |
|  |  |  |  |  |  | **See Note 1)** | |  |
|  |  | **(in millions)** | | | | | |  |
| **Financing activities** |  |  |  |  |  |  |  |  |
| Issuance of preferred stock | **$** | **—** | | $ | | 542.0 |  |  |
| Issuance of common stock |  | **38.3** |  |  |  | 25.8 |  |  |
| Acquisition and sales of treasury stock, net |  | **(751.2)** | |  |  | (868.4) | |  |
| Proceeds from financing element derivatives |  | **81.3** |  |  |  | 83.0 |  |  |
| Payments for financing element derivatives |  | **(69.9)** | |  |  | (55.6) | |  |
| Excess tax benefits from share-based payment arrangements |  | **2.6** |  |  |  | — | |  |
| Dividends to preferred stockholders |  | **(16.5)** | |  |  | — | |  |
| Issuance of long-term debt |  | **8.7** |  |  |  | 12.2 |  |  |
| Principal repayments of long-term debt |  | **(6.3)** | |  |  | (11.5) | |  |
| Net proceeds (repayments) of short-term borrowings |  | **(49.6)** | |  |  | 172.4 |  |  |
| Investment contract deposits |  | **4,835.7** |  |  |  | 4,072.6 |  |  |
| Investment contract withdrawals |  | **(3,609.7)** | |  |  | (3,319.5) | |  |
| Net increase in banking operation deposits |  | **75.4** |  |  |  | 22.7 |  |  |
| Net cash provided by financing activities |  | **538.8** |  |  |  | 675.7 |  |  |
| **Discontinued operations** |  |  |  |  |  |  |  |  |
| Net cash used in operating activities |  | **—** | |  |  | (0.1) | |  |
| Net cash used in investing activities |  | **—** |  |  |  | (0.1) | |  |
| Net cash used in discontinued operations |  |  |  |  |  |  |  |  |
|  | **—** |  |  | (0.2) | |  |
| Net increase (decrease) in cash and cash equivalents |  |  |  |  |  |  |  |  |
|  | **(424.4)** | |  |  | 719.1 |  |  |
| Cash and cash equivalents at beginning of period |  | **1,641.3** |  |  |  | 452.5 |  |  |
| Cash and cash equivalents at end of period | **$** | **1,216.9** |  |  | $ | 1,171.6 |  |  |
| **Cash and cash equivalents of discontinued operations included above** |  |  |  |  |  |  |  |  |
| At beginning of period | **$** | **—** | | $ | | 1.9 |  |  |
| At end of period | **$** | **—** | | $ | | 1.7 |  |  |

*See accompanying notes*

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements**

**June 30, 2006**

**(Unaudited)**

1. **Nature of Operations and Significant Accounting Policies Basis of Presentation**

The accompanying unaudited consolidated financial statements of Principal Financial Group, Inc. (“PFG”), its majority-owned subsidiaries and its consolidated variable interest entities (“VIE”), have been prepared in conformity with accounting principles generally accepted in the U.S. (“U.S. GAAP”) for interim financial statements and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2006, are not necessarily indicative of the results that may be expected for the year ended December 31, 2006. These interim unaudited consolidated financial statements should be read in conjunction with our annual audited financial statements as of December 31, 2005, included in our Form 10-K for the year ended December 31, 2005, filed with the United States Securities and Exchange Commission (“SEC”). The accompanying consolidated statement of

financial position at December 31, 2005, has been derived from the audited consolidated statement of financial position but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

**Restatement**

For the year ended December 31, 2005, we separately disclosed the operating, investing and financing portions of the cash flows attributable to our discontinued operations, which in the prior interim periods were excluded from the statement of cash flows. We have restated the statements of cash flows for the interim periods of 2005 to include and separately disclose the operating, investing, and financing portions of the cash flows attributable to our discontinued operations.

**Recent Accounting Pronouncements**

On July 13, 2006, the Financial Accounting Standards Board (the “FASB”) issued FASB Interpretation (“FIN”) No. 48, *Accounting for Uncertainty* *in Income Taxes* (“FIN 48”). FIN 48, which is an interpretation of Statement of Financial Accounting Standards (“SFAS”) No. 109, *Accounting for Income Taxes*, prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken, orexpected to be taken, in a tax return. FIN 48 requires the affirmative evaluation that it is more likely than not, based on the technical merits of a tax position, that an enterprise is entitled to economic benefits resulting from positions taken in income tax returns. If a tax position does not meet the more-likely-than-not recognition threshold, the benefit of that position is not recognized in the financial statements. FIN 48 also requires companies to disclose additional quantitative and qualitative information in their financial statements about uncertain tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006, and the cumulative effect of applying this Interpretation shall be reported as an adjustment to the opening balance of retained earnings for that fiscal year. FIN 48 is not expected to have a material impact on our consolidated financial statements.

On March 17, 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets* (“SFAS 156”), which amends SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (“SFAS 140”). This Statement (1) requires an entity torecognize a servicing asset or liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in specified situations, (2) requires all separately recognized servicing assets and liabilities to be initially measured at fair value, (3) for subsequent measurement of each class of separately recognized servicing assets and liabilities, an entity can elect either the amortization or fair value measurement method, (4) permits a one-time reclassification of available-for-sale (“AFS”) securities to trading securities by an entity with recognized servicing rights, without calling into question the treatment of other AFS securities, provided the AFS securities are identified in some manner as offsetting the entity’s exposure to changes in fair value of servicing assets or liabilities that a servicer elects to subsequently measure at fair value, and (5) requires separate presentation of servicing assets and liabilities measured at fair value in the statement of financial position and also requires additional disclosures. The initial measurement requirements of this statement should be applied prospectively to all transactions entered into after the fiscal year beginning after September 15, 2006. The election related to the subsequent measurement of servicing assets and liabilities is also effective the first fiscal year beginning after September 15, 2006. SFAS 156 is not expected to have a material impact on our consolidated financial statements.

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**1. Nature of Operations and Significant Accounting Policies (continued)**

On February 16, 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments – an amendment of FASB Statements* *No. 133 and 140* (“SFAS 155”), which amends SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (“SFAS 133”) and SFAS 140.SFAS 155 (1) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (2) clarifies which interest-only and principal-only strips are not subject to the requirements of SFAS 133, (3) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (4) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (5) amends SFAS 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This Statement is effective for all financial instruments acquired or issued after the beginning of an entity’s fiscal year that begins after September 15, 2006. At adoption, the fair value election may also be applied to hybrid financial instruments that have been bifurcated under SFAS 133 prior to adoption of this Statement. Any changes resulting from the adoption of this Statement should be recognized as a cumulative effect adjustment to beginning retained earnings. SFAS 155 is not expected to have a material impact on our consolidated financial statements.

On December 16, 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (“SFAS 123R”). SFAS 123R requires all share-based payments to employees to be recognized at fair value in the financial statements. SFAS 123R replaces SFAS No. 123, *Accounting for Stock-Based* *Compensation* (“SFAS 123”), supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees* (“APB 25”), and SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure - an Amendment of FASB Statement No. 123* and amends SFAS No. 95, *Statement of Cash Flows*. OnApril 14, 2005, the SEC approved a new rule delaying the effective date of SFAS 123R to annual periods that begin after June 15, 2005. Accordingly, we adopted SFAS 123R effective January 1, 2006 using the modified-prospective method.

It is appropriate to recognize compensation cost either immediately for stock awards granted to retirement eligible employees, or over the period from the grant date to the date retirement eligibility is achieved, if retirement eligibility is expected to occur during the nominal vesting period. Our approach was to follow the widespread practice of recognizing compensation cost over the explicit service period (up to the date of actual retirement). For any awards that are granted after our adoption of SFAS 123R on January 1, 2006, we recognize compensation cost through the period that the employee first becomes eligible to retire and is no longer required to provide service to earn the award. If we had applied the nonsubstantive vesting provisions of SFAS 123R to awards granted prior to January 1, 2006, our consolidated financial statements would not have been materially impacted.

SFAS 123R requires that the benefits of tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. While the Company cannot estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options), the amount of financing cash flows recognized for the six months ended June 30, 2006, for such excess tax deductions, was $2.6 million.

Under the modified-prospective method, any excess income tax deduction realized for awards accounted for under SFAS 123R (regardless of the type of award or the jurisdiction in which the tax benefit is generated) is eligible to absorb write-offs of deferred income tax assets for any awards accounted for under SFAS 123R. SFAS 123R does not require separate pools of excess income tax benefits for separate types of awards, rather the excess income tax benefits of employee and nonemployee awards may be combined in a single pool of excess tax benefits. Our policy is to pool the employee and nonemployee awards together in this manner. Deferred income tax asset write-offs resulting from deficient deductions on employee awards may be offset against previous excess income tax benefits arising from nonemployee awards, and vice versa.

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**1. Nature of Operations and Significant Accounting Policies (continued)**

This Statement did not have a material impact on our consolidated financial statements as we began expensing all stock options using a fair-value based method effective for the year beginning January 1, 2002. In addition, any stock options granted prior to January 1, 2002 were fully vested at the time of adoption of SFAS 123R. We use the Black-Scholes formula to estimate the value of stock options granted to employees. We applied the prospective method of transition as prescribed by SFAS 123 when we elected to begin expensing stock-based compensation in 2002. The cumulative effect of the change in accounting principle as a result of adopting this Statement is immaterial. Therefore, the pre-tax cumulative effect of the change in accounting principle is reflected in operating expenses.

See note 9, Stock-Based Compensation Plans, for further details on our stock-based compensation.

**Separate Accounts**

As of June 30, 2006 and December 31, 2005, the separate accounts include a separate account valued at $775.5 million and $726.6 million, respectively, which primarily includes shares of our stock that were allocated and issued to eligible participants of qualified employee benefit plans administered by us as part of the policy credits issued under our 2001 demutualization. These shares are included in both basic and diluted earnings per share calculations. The separate account shares are recorded at fair value and are reported as separate account assets and separate account liabilities in the consolidated statements of financial position. Changes in fair value of the separate account shares are reflected in both the separate account assets and separate account liabilities and do not impact our results of operations.

**2. Significant Unconsolidated Variable Interest Entities**

***Synthetic Collateralized Debt Obligation.*** On June 21, 2006, we invested $285.0 million in a secured limited recourse note issued by a segregatedportfolio company. The note represents Class B notes. Class A notes are senior and Class C through Class F notes are subordinated to Class B notes. The entity entered into a credit default swap with a third party providing credit protection in exchange for a fee. Defaults in an underlying reference portfolio will only affect the note if cumulative losses of a synthetic reference portfolio exceed the loss attachment point on the portfolio. We have determined we are not the primary beneficiary, as we do not hold the majority of the risk of loss. Our maximum exposure to loss as a result of our involvement with this entity is our recorded investment of $285.0 million as of June 30, 2006.

**3. Federal Income Taxes**

The effective income tax rate on income from continuing operations for the three months and six months ended June 30, 2006 is lower than the prevailing corporate federal income tax rate primarily due to income tax deductions allowed for corporate dividends received and interest exclusion from taxable income. The effective income tax rate on income from continuing operations for the six months ended June 30, 2006 is also lower than the prevailing corporate federal income tax rate due to a favorable court ruling on a contested Internal Revenue Service issue for 1991 and later years. The effective income tax rate on income from continuing operations for the three months and six months ended June 30, 2005 is lower than the prevailing corporate federal income tax rate primarily due to income tax deductions allowed for corporate dividends received, tax credits received on our investment in a synthetic fuel facility and interest exclusion from taxable income.

**4. Employee and Agent Benefits**

Effective January 1, 2006, we made changes to our retirement program, including the Principal Select Saving Plan (“401(k)”), the Principal Pension Plan (“Pension Plan”) and the corresponding nonqualified plans. The qualified and nonqualified pension plans’ changes include a reduction to the traditional and cash balance formulas, a change in the early retirement factors, and the removal of the cost of living adjustments for traditional benefits earned after January 1, 2006. The qualified and nonqualified 401(k) plans’ company match increased from 50% of a 6% deferral to 75% of an 8% deferral. The Pension Plan changes reduced the Pension Plan expense in 2006, while the 401(k) changes increased the 401(k) expense.

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

1. **Employee and Agent Benefits (continued) Components of net periodic benefit cost (income):**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **Pension benefits** | | | |  |  |  |  | **Other postretirement** | | | | |  |
|  |  |  |  |  |  | **benefits** | | |  |  |  |
|  | **For the three months ended** | | | | |  |  |  |  | **For the three months ended** | | | |  |  |
|  |  | **June 30,** | | | |  |  |  |  | **June 30,** | | |  |  |  |
|  | **2006** |  |  | **2005** | |  |  |  |  | **2006** |  |  | **2005** |  |  |
|  |  |  |  |  |  | **(in millions)** | | | |  |  |  |  |  |  |
| Service cost | **$** | **11.7** |  | $ | | 12.4 |  | **$** | | **2.4** |  | $ | 2.5 |  |  |
| Interest cost |  | **20.4** |  |  |  | 19.4 |  |  |  | **4.0** |  |  | 4.2 |  |  |
| Expected return on plan assets |  | **(26.3)** | |  |  | (24.1) | |  |  | **(8.1)** | |  | (7.3) | |  |
| Amortization of prior service cost (benefit) |  | **(2.2)** | |  |  | 0.4 |  |  |  | **(0.7)** | |  | (0.6) | |  |
| Recognized net actuarial loss |  | **5.1** |  |  |  | 4.1 |  |  |  | **0.1** |  |  | 0.1 |  |  |
| Net periodic benefit cost (income) | **$** | **8.7** |  |  | $ | 12.2 |  |  | **$** | **(2.3** | **)** | $ | (1.1 | ) |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  | |  |  |
|  |  | **Pension benefits** | | | |  |  |  |  | **Other postretirement** | | | | |  |
|  |  |  |  |  |  | **benefits** | | |  |  |  |
|  | **For the six months ended** | | | | |  |  |  |  | **For the six months ended** | | | |  |  |
|  |  | **June 30,** | | | |  |  |  |  | **June 30,** | | |  |  |  |
|  | **2006** |  |  | **2005** | |  |  |  |  | **2006** |  |  | **2005** |  |  |
|  |  |  |  |  |  | **(in millions)** | | | |  |  |  |  |  |  |
| Service cost | **$** | **23.5** |  | $ | | 24.8 |  | **$** | | **4.7** |  | $ | 5.0 |  |  |
| Interest cost |  | **40.8** |  |  |  | 38.7 |  |  |  | **8.1** |  |  | 8.4 |  |  |
| Expected return on plan assets |  | **(52.7)** | |  |  | (48.1) | |  |  | **(16.2)** | |  | (14.7) | |  |
| Amortization of prior service cost (benefit) |  | **(4.5)** | |  |  | 0.7 |  |  |  | **(1.3)** | |  | (1.3) | |  |
| Recognized net actuarial loss |  | **10.2** |  |  |  | 8.2 |  |  |  | **0.1** |  |  | 0.3 |  |  |
| Net periodic benefit cost (income) | **$** | **17.3** |  |  | $ | 24.3 |  |  | **$** | **(4.6** | **)** | $ | (2.3 | ) |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

**Contributions**

Our funding policy for the Pension Plan is to fund the plan annually in an amount at least equal to the minimum annual contribution required under the Employee Retirement Income Security Act (“ERISA”) and, generally, not greater than the maximum amount that can be deducted for federal income tax purposes. The minimum annual contribution for 2006 will be zero so we will not be required to fund the Pension Plan during 2006. However, it is possible that we may fund the qualified and nonqualified plans in 2006 in the range of $20.0 million to $50.0 million. During the three months and six months ended June 30, 2006, $5.2 million was contributed to the plans.

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

1. **Contingencies, Guarantees and Indemnifications Litigation**

We are regularly involved in litigation, both as a defendant and as a plaintiff, but primarily as a defendant. Litigation naming us as a defendant ordinarily arises out of our business operations as a provider of asset management and accumulation products and services, life, health and disability insurance. Some of the lawsuits are class actions, or purport to be, and some include claims for punitive damages. In addition, regulatory bodies, such as state insurance departments, the SEC, the National Association of Securities Dealers, Inc., the Department of Labor and other regulatory bodies regularly make inquiries and conduct examinations or investigations concerning our compliance with, among other things, insurance laws, securities laws, ERISA and laws governing the activities of broker-dealers.

Several lawsuits have been filed against other insurance companies and insurance brokers alleging improper conduct relating to the payment and non-disclosure of contingent compensation and bid-rigging activity. Several of these suits were filed as purported class actions. Several state attorneys general and insurance regulators have initiated industry-wide inquiries or other actions relating to compensation arrangements between insurance brokers and insurance companies and other industry issues. Beginning in March of 2005, we have received subpoenas and interrogatories from the offices of the Attorneys General of New York and Connecticut seeking information related to compensation agreements with brokers and agents and the sale of retirement products and services. We are cooperating with these inquiries. We have received other requests from regulators and other governmental authorities relating to industry issues and may receive additional such requests, including subpoenas and interrogatories, in the future.

On December 23, 2004, a lawsuit was filed in Iowa state court against us and our wholly owned subsidiaries, Principal Life Insurance Company (“Principal Life”) and Principal Financial Services, Inc., on behalf of a proposed class comprised of the settlement class in the Principal Life sales practices class action settlement, which was approved in April 2001 by the United States District Court for the Southern District of Iowa. This more recent lawsuit

claims that the treatment of the settlement costs of that sales practices litigation in relation to the allocation of demutualization consideration to Principal Life policyholders was inappropriate. Demutualization allocation was done pursuant to the terms of a plan of demutualization approved by the policyholders in July 2001 and Insurance Commissioner of the State of Iowa in August 2001. The lawsuit further claims that such allocation was not accurately described to policyholders during the demutualization process and is a breach of the sales practices settlement. On January 27, 2005, we filed a notice to remove the action from state court to the United States District Court for the Southern District of Iowa. On July 22, 2005, the plaintiff’s motion to remand the action to state court was denied, and our motion to dismiss the lawsuit was granted. On September 21, 2005, the plaintiff’s motion to alter or amend the judgment was denied. On October 4, 2005, the plaintiff filed a notice of appeal to the United States Court of Appeals for the Eighth Circuit.

A lawsuit was filed against us, Principal Life, and Principal Financial Services, Inc. in the United States District Court for the Southern District of Iowa on October 31, 2005, but the plaintiff dismissed the case without prejudice on March 17, 2006. The claims and allegations in the lawsuit were substantially the same as those in the December 23, 2004 lawsuit, but the proposed class was limited to those members of the settlement class in the Principal Life sales practices class action settlement who did not own annuities and who received demutualization consideration in the form of cash under the plan of demutualization.

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**5. Contingencies, Guarantees and Indemnifications (continued)**

While the outcome of any pending or future litigation cannot be predicted, management does not believe that any pending litigation will have a material adverse effect on our business or financial position. The outcome of litigation is always uncertain, and unforeseen results can occur. It is possible that such outcomes could materially affect net income in a particular quarter or annual period.

**Guarantees and Indemnifications**

In the normal course of business, we have provided guarantees to third parties primarily related to a former subsidiary, joint ventures and industrial revenue bonds. These agreements generally expire from 2006 through 2019. The maximum exposure under these agreements as of June 30, 2006, was approximately $166.0 million; however, we believe the likelihood is remote that material payments will be required and therefore have not accrued for a liability on our consolidated statements of financial position. Should we be required to perform under these guarantees, we generally could recover a portion of the loss from third parties through recourse provisions included in agreements with such parties, the sale of assets held as collateral that can be liquidated in the event that performance is required under the guarantees or other recourse generally available to us, therefore, such guarantees would not result in a material adverse effect on our business or financial position. It is possible that such outcomes could materially affect net income in a particular quarter or annual period. The fair value of such guarantees is not material.

In connection with the 2002 sale of BT Financial Group, we agreed to indemnify the purchaser, Westpac Banking Corporation (“Westpac”), for among other things, the costs associated with potential late filings made by BT Financial Group in New Zealand prior to Westpac’s ownership, up to a maximum of A$250.0 million Australian dollars (approximately U.S. $186.0 million as of June 30, 2006). New Zealand securities regulations allow Australian issuers to issue their securities in New Zealand provided that certain documents are appropriately filed with the New Zealand Registrar of Companies. Specifically, the regulations require that any amendments to constitutions and compliance plans be filed in New Zealand. In April 2003, the New Zealand Securities Commission opined that such late filings would result in certain New Zealand investors having a right to return of their investment plus interest at 10% per annum from the date of investment. This technical issue affected many in the industry.

On December 24, 2004, Westpac lodged several warranty and indemnification claims related to the sale of BT Financial Group. The claims aggregated approximately A$50.0 million Australian dollars (approximately U.S. $37.0 million as of June 30, 2006) with the majority of the claims (approximately A$45.0 million Australian dollars, or U.S. $33.0 million as of June 30, 2006) related to fund pricing and accounting issues around a tax asset called future income tax benefit (“FITB”). FITB is an asset used in calculating unit pricing of funds. Westpac claimed that BT Financial Group incorrectly accrued FITB assets in valuing asset portfolios of BT funds in Australia and New Zealand and that, as a result, fund values were overstated.

The claims made by Westpac related to both indemnifications were settled and paid by us in 2006. This settlement did not have a material impact on net income.

We are also subject to various other indemnification obligations issued in conjunction with certain transactions, primarily the sale of Principal Residential Mortgage, Inc. and other divestitures, acquisitions and financing transactions whose terms range in duration and often are not explicitly defined. Certain portions of these indemnifications may be capped, while other portions are not subject to such limitations; therefore, the overall maximum amount of the obligation under the indemnifications cannot be reasonably estimated. While we are unable to estimate with certainty the ultimate legal and financial liability with respect to these indemnifications, we believe the likelihood is remote that material payments would be required under such indemnifications and therefore such indemnifications would not result in a material adverse effect on our business or financial position. It is possible that such outcomes could materially affect net income in a particular quarter or annual period. The fair value of such indemnifications is not material.

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

1. **Stockholders’ Equity Common Stock**

On May 19, 2006, following our Board of Directors’ share repurchase authorization, we entered into an accelerated common stock repurchase agreement with a third party investment bank for an aggregate purchase price of $500.0 million. On this date, we paid $500.0 million and received the initial delivery of 7.7 million common shares, while retaining the right to receive additional common shares depending on the volume weighted average share price of our common stock over the program’s duration. The maximum number of shares eligible for repurchase under this program is 19.5 million common shares. The program will be completed in the fourth quarter 2006, at which time we will receive any remaining common shares owed to us under this agreement.

**Reconciliation of Outstanding Shares**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  | **Series A** | |  |  | **Series B** | |  |  | **Common** | | |  |  |
|  |  |  |  |  |  |  |  | **Preferred** | | |  | **Preferred** | |  |  |  |  |
|  |  |  |  |  |  |  |  | **Stock** | |  |  | **Stock** | |  |  | **Stock** | | |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  | **(in millions)** | |  |  |  |  |  |  |  |
|  | Outstanding shares at January 1, 2005 |  |  |  |  |  |  |  |  | — |  |  | — |  |  | 300.6 |  |  |  |  |
|  | Shares issued |  |  |  |  |  |  |  |  | 3.0 | 10.0 | | |  |  | 1.0 |  |  |  |  |
|  | Treasury stock acquired |  |  |  |  |  |  |  |  | — |  |  | — |  |  | (22.2) | | |  |  |
|  | Outstanding shares at June 30, 2005 |  |  |  |  |  |  |  |  | 3.0 |  | 10.0 | |  |  | 279.4 |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Outstanding shares at January 1, 2006 |  |  |  |  |  |  |  |  | **3.0** | **10.0** | | |  |  | **280.6** |  |  |  |  |
|  | Shares issued |  |  |  |  |  |  |  |  | **—** |  |  | **—** |  |  | **1.3** |  |  |  |  |
|  | Treasury stock acquired |  |  |  |  |  |  |  |  | **—** |  |  | **—** |  |  | **(12.8)** | | |  |  |
|  | Outstanding shares at June 30, 2006 |  |  |  |  |  |  |  |  | **3.0** |  | **10.0** | |  |  | **269.1** |  |  |  |  |
|  |  | 14 | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | |  | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | **Principal Financial Group, Inc.** | | | | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | **Notes to Consolidated Financial Statements (continued)** | | | | | | | | |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **June 30, 2006** | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **(Unaudited)** | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **7. Comprehensive Income (Loss)** | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Comprehensive income (loss) is as follows: | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  | **For the three months ended** | | | | | | |  |  | **For the six months ended** | | | | | | |  |  |
|  |  |  |  | **June 30,** | | |  |  |  |  |  | **June 30,** | | | |  |  |  |  |  |
|  |  |  | **2006** |  |  |  | **2005** |  |  |  | **2006** | |  |  |  | **2005** |  |  |  |  |
|  |  |  |  |  |  |  |  | **(in millions)** | | |  |  |  |  |  |  |  |  |  |  |
|  | **Comprehensive income (loss):** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Net income | **$** | | **218.8** |  | $ | 238.9 | |  | **$** | **512.7** | |  | $ | | 444.4 | |  |  |  |
|  | Net change in unrealized gains and losses on fixed maturities, |  |  | **(625.0)** | |  |  |  |  |  | **(1,368.3)** | | |  |  |  |  |  |  |  |
|  | available-for-sale |  |  |  | 691.0 | |  |  |  |  | 158.5 | |  |  |  |
|  | Net change in unrealized gains and losses on equity securities, |  |  | **(10.9)** | |  |  |  |  |  | **(9.6)** | | |  |  |  |  |  |  |  |
|  | available-for-sale |  |  |  | 10.1 | |  |  |  |  | 3.8 | |  |  |  |
|  | Net change in unrealized gains and losses on equity method |  |  | **(51.2)** | |  |  |  |  |  | **18.3** | |  |  |  |  |  |  |  |  |
|  | subsidiaries and minority interest adjustments |  |  |  | (17.3) | | |  |  |  |  | (17.0) | | |  |  |
|  | Adjustments for assumed changes in amortization patterns: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Deferred policy acquisition costs |  |  | **92.1** |  |  | (36.8) | | |  | **179.8** | |  |  |  | 6.8 | |  |  |  |
|  | Sales inducements |  |  | **4.8** |  |  | (3.8) | | |  | **9.3** | |  |  |  | (0.2) | | |  |  |
|  | Unearned revenue reserves |  |  | **(4.1)** | |  | (9.5) | | |  | **(7.9)** | | |  |  | (2.4) | | |  |  |
|  | Net change in unrealized gains and losses on derivative instruments |  |  | **15.2** |  |  | 0.6 | |  |  | **31.7** | |  |  |  | 25.2 | |  |  |  |
|  | Adjustments to unrealized gains and losses for Closed Block |  |  | **—** | |  |  |  |  |  | **33.7** | |  |  |  |  |  |  |  |  |
|  | policyholder dividend obligation |  |  |  | (62.9) | | |  |  |  |  | (10.0) | | |  |  |
|  | Change in net foreign currency translation adjustment |  |  | **(31.6)** | |  | 24.2 | |  |  | **(30.2)** | | |  |  | 15.2 | |  |  |  |
|  | Provision for deferred income taxes (benefits) |  |  | **189.9** |  |  | (188.1) | | |  | **366.9** | |  |  |  | (39.3) | | |  |  |
|  | Comprehensive income (loss) |  | **$** | **(202.0** | **)** | $ | 646.4 | |  | **$** | **(263.6** | | **)** |  | $ | 585.0 | |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**8. Segment Information**

We provide financial products and services through the following segments: U.S. Asset Management and Accumulation, International Asset Management and Accumulation and Life and Health Insurance. In addition, there is a Corporate and Other segment. The segments are managed and reported separately because they provide different products and services, have different strategies or have different markets and distribution channels.

The U.S. Asset Management and Accumulation segment provides retirement and related financial products and services primarily to businesses, their employees and other individuals and provides asset management services to our asset accumulation business, the life and health insurance operations, the Corporate and Other segment and third-party clients.

The International Asset Management and Accumulation segment consists of Principal International operations in Chile, Mexico, Hong Kong, Brazil, India, China, and Malaysia. We focus on countries with favorable demographics and a trend toward private sector defined contribution pension systems. We entered these countries through acquisitions, start-up operations and joint ventures.

The Life and Health insurance segment provides individual life insurance, group health insurance and specialty benefits, which consists of group dental and vision insurance, individual and group disability insurance and group life insurance, throughout the United States.

The Corporate and Other segment manages the assets representing capital that has not been allocated to any other segment. Financial results of the Corporate and Other segment primarily reflect our financing activities (including interest expense), income on capital not allocated to other segments, inter-segment eliminations, income tax risks and certain income, expenses and other after-tax adjustments not allocated to the segments based on the nature of such items.

Management uses segment operating earnings for goal setting, determining employee compensation and evaluating performance on a basis comparable to that used by securities analysts. We determine segment operating earnings by adjusting U.S. GAAP net income available to common stockholders for net realized/unrealized capital gains and losses, as adjusted, and other after-tax adjustments which management believes are not indicative of overall operating trends. Net realized/unrealized capital gains and losses, as adjusted, are net of income taxes, related changes in the amortization pattern of deferred policy acquisition costs (“DPAC”) and sales inducements, recognition of front-end fee revenues for sales charges on pension products and services, net realized capital gains and losses distributed, minority interest capital gains and losses and certain market value adjustments to fee revenues. Segment operating revenues exclude net realized/unrealized capital gains and their impact on recognition of front-end fee revenues and certain market value adjustments to fee revenues and include operating revenues from real estate properties that qualify for discontinued operations treatment under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (“SFAS 144”). While these items may be significant components in understanding andassessing the consolidated financial performance, management believes the presentation of segment operating earnings enhances the understanding of our results of operations by highlighting earnings attributable to the normal, ongoing operations of the business.

The accounting policies of the segments are consistent with the accounting policies for the consolidated financial statements, with the exception of income tax allocation. The Corporate and Other segment functions to absorb the risk inherent in interpreting and applying tax law. The segments are allocated tax adjustments consistent with our tax position. The Corporate and Other segment results reflect any differences between the tax returns and the estimated resolution of any disputes.

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**8. Segment Information (continued)**

The following tables summarize selected financial information by segment and reconcile segment totals to those reported in the consolidated financial statements:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  | **June 30,** | | **December 31,** | | |
|  |  | **2006** |  |  | **2005** |  |
|  |  | **(in millions)** | | | |  |
| **Assets:** |  |  |  |  |  |  |
| U.S. Asset Management and Accumulation | **$** | **108,160.0** |  | $ | 103,506.1 |  |
| International Asset Management and Accumulation |  | **6,833.2** |  |  | 6,856.2 |  |
| Life and Health Insurance |  | **13,951.7** |  |  | 14,080.2 |  |
| Corporate and Other |  | **2,484.5** |  |  | 2,592.9 |  |
| Total consolidated assets | **$** | **131,429.4** |  | $ | 127,035.4 |  |
|  |  |  |  |  |  |  |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **For the three months ended** | | | **For the six months ended** | |
|  | **June 30,** | |  | **June 30,** |
| **2006** | **2005** |  | **2006** | **2005** |
|  | **(in millions)** | | |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Operating revenues by segment:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Asset Management and Accumulation | **$** | | **1,116.2** |  | $ | | 971.1 |  | **$** | | **2,166.0** |  | $ | 1,928.4 |  |  |
| International Asset Management and Accumulation |  |  | **164.2** |  |  |  | 158.2 |  |  |  | **307.6** |  |  | 291.0 |  |  |
| Life and Health Insurance |  |  | **1,183.1** |  |  |  | 1,089.5 |  |  |  | **2,342.7** |  |  | 2,158.1 |  |  |
| Corporate and Other |  |  | **3.8** |  |  |  | (28.0) | |  |  | **(5.9)** | |  | (38.1) | |  |
| Total segment operating revenues |  |  | **2,467.3** |  |  |  | 2,190.8 |  |  |  | **4,810.4** |  |  | 4,339.4 |  |  |
| Add: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Net realized/unrealized capital gains (losses), |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| including recognition of front-end fee revenues |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| and certain market value adjustments to fee |  |  | **(18.9)** | |  |  |  |  |  |  | **29.7** |  |  |  |  |  |
| revenues |  |  |  |  | 10.6 |  |  |  |  |  | 6.6 |  |  |
| Subtract: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Operating revenues from a discontinued real estate |  |  | **—** |  |  |  |  |  |  |  | **—** |  |  |  |  |  |
| investment |  |  |  |  | 1.0 |  |  |  |  | 1.9 |  |  |
| Total revenues per consolidated statements of | **$** | | **2,448.4** |  | $ | | 2,200.4 |  | **$** | | **4,840.1** |  | $ | 4,344.1 |  |  |
| operations |  |  |  |  |  |
| **Operating earnings (loss) by segment, net of related** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **income taxes:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Asset Management and Accumulation | **$** | | **151.2** |  | $ | | 130.5 |  | **$** | | **309.0** |  | $ | 269.1 |  |  |
| International Asset Management and Accumulation |  |  | **16.1** |  |  |  | 19.1 |  |  |  | **33.7** |  |  | 28.6 |  |  |
| Life and Health Insurance |  |  | **65.2** |  |  |  | 76.3 |  |  |  | **135.6** |  |  | 145.8 |  |  |
| Corporate and Other |  |  | **(7.3)** | |  |  | (4.9) | |  |  | **(12.9)** | |  | (13.3) | |  |
| Total segment operating earnings, net of related |  |  | **225.2** |  |  |  |  |  |  |  | **465.4** |  |  |  |  |  |
| income taxes |  |  |  |  |  | 221.0 |  |  |  |  |  | 430.2 |  |  |
| Net realized/unrealized capital gains (losses), as |  |  | **(12.9)** | |  |  |  |  |  |  | **12.0** |  |  |  |  |  |
| adjusted |  |  |  |  | 3.2 |  |  |  |  |  | (0.5) | |  |
| Other after-tax adjustments (1) |  |  | **(1.8)** | |  |  | 14.7 |  |  |  | **18.8** |  |  | 14.7 |  |  |
| Net income available to common stockholders per |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **$** | | **210.5** |  | $ | | 238.9 |  | **$** | | **496.2** |  | $ | 444.4 |  |  |
| consolidated statements of operations |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



1. For the three months ended June 30, 2006, other after-tax adjustments of $(1.8) million included a change in estimate associated with a favorable court ruling on a contested IRS issue for 1991 and later years.

For the three months ended June 30, 2005, other after-tax adjustments reflect a $14.7 million gain on sale of a real estate property that qualifies for discontinued operations treatment under SFAS 144.

For the six months ended June 30, 2006, other after-tax adjustments of $18.8 million included the positive effect of a favorable court ruling on a contested IRS issue for 1991 and later years.

For the six months ended June 30, 2005, other after-tax adjustments reflect a $14.7 million gain on sale of a real estate property that qualifies for discontinued operations treatment under SFAS 144.

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**9. Stock-Based Compensation Plans**

As of June 30, 2006, we have the 2005 Stock Incentive Plan, the Employee Stock Purchase Plan, the 2005 Directors Stock Plan, the Stock Incentive Plan, the Directors Stock Plan and the Long-Term Performance Plan. As of May 17, 2005, no new grants will be made under the Stock Incentive Plan, the Directors Stock Plan or the Long-Term Performance Plan (“Stock-Based Compensation Plans”). Under the terms of the 2005 Stock Incentive Plan, grants may be nonqualified stock options, incentive stock options qualifying under Section 422 of the Internal Revenue Code, restricted stock, restricted stock units, stock appreciation rights, performance shares, performance units, or other stock based awards. The 2005 Directors Stock Plan provides for the grant of nonqualified stock options, restricted stock, restricted stock units, or other stock-based awards to our nonemployee directors. To date, we have not granted any incentive stock options, restricted stock, or performance units.

As of June 30, 2006, the maximum number of new shares of common stock that were available for grant under the 2005 Stock Incentive Plan and the 2005 Directors Stock Plan was 21.6 million.

For awards with graded vesting, we use an accelerated expense attribution method. The compensation cost that was charged against income for the

Stock-Based Compensation Plans is as follows:

**For the six months ended**

**June 30,**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  | **2006** |  |  | **2005** |  |
|  |  |  | **(in millions)** | |  |  |
| Compensation cost | **$** | | **27.5** | $ | 19.5 |  |
| Related income tax benefit |  |  | **8.5** |  | 6.0 |  |
| Capitalized as part of an asset |  |  | **1.8** |  | 0.7 |  |

**Nonqualified Stock Options**

We issue nonqualified stock options under the 2005 Directors Stock Plan, Directors Stock Plan, 2005 Stock Incentive Plan, and Stock Incentive Plan.

Nonqualified stock options are treated as an equity award.

Non-qualified stock options were granted to certain employees under the 2005 Stock Incentive Plan and the Stock Incentive Plan. Total options granted under the 2005 Stock Incentive Plan and the Stock Incentive Plan were 2.1 million and 2.7 million for the six months ended June 30, 2006 and 2005, respectively. Options outstanding under the 2005 Stock Incentive Plan and the Stock Incentive Plan were granted at an exercise price equal to the market value of our common stock on the date of grant, and expire ten years after the grant date. These options have graded or cliff vesting over a three-year period.

Non-qualified stock options granted under the Directors stock plans have an exercise price equal to the fair market value of the common stock on the date of the grant and a contractual term equal to the earlier of five years from the date the participant ceases to provide service or the tenth anniversary of the date the option was granted. Beginning with the 2003 grant, options become exercisable in four approximately equal installments on the three, six and nine month anniversaries of the grant date, and on the date that the Director’s full term of office expires. There were no options granted during the six months ended June 30, 2006 or 2005.

The fair value of stock options is estimated using the Black-Scholes option pricing model that uses the assumptions noted in the following table. Expected volatilities are based on historical volatility of our stock and other factors. Due to our limited public company history, we use peer data to estimate option exercise and employee termination within the valuation model. Separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. The expected term of options granted is estimated based on peer data and represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury risk free interest rate in effect at the time of grant.

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**9. Stock-Based Compensation Plans (continued)**

Cash received from stock options exercised under these share-based payment arrangements for the six months ended June 30, 2006 was $21.7 million. The actual tax benefits realized for the tax deductions for option exercise of the share-based payment arrangements for the six months ended June 30, 2006 was $5.8 million.

The following is a summary of assumptions for the stock options granted during the period:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **For the six months ended** | | | | |  |
| **Options** |  | **June 30,** | | |  |  |  |
| **2006** |  |  | **2005** |  |  |
| Dividend yield |  | **1.32%** | |  | 1.41% | |  |
| Expected volatility | |  |  |  |  |  |  |
| **16.2%** | |  | 19.1% | |  |
| Risk-free interest rate | |  |  |  |  |  |  |
| **4.6%** | |  | 4.1% | |  |
| Expected life (in years) | |  |  |  |  |  |  |
| **6** |  |  | 6 |  |  |
|  |  |  |  |  |  |  |  |

Using the Black-Scholes option valuation model, the weighted-average estimated fair value of stock options granted was $11.41 and $9.17 per share during the six months ended June 30, 2006 and 2005, respectively.

The following is a summary of the status of all of our stock option plans for six months ended June 30, 2006:

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **Number of options** |  | **Weighted-average** | |  |  | **Intrinsic** | |  |
|  |  |  | **exercise price** |  |  | **Value** | |  |
|  | **(in millions)** |  |  |  |  |  | **(in millions)** |  |  |
| Options outstanding at January 1, 2006 | **7.8** | **$** | | **33.06** |  |  |  |  |  |
| Granted | **2.1** |  |  | **49.27** |  |  |  |  |  |
| Exercised | **0.7** |  |  | **29.07** |  |  |  |  |  |
| Canceled | **0.1** |  |  | **40.06** |  |  |  |  |  |
| Options outstanding at June 30, 2006 | **9.1** | **$** | | **37.07** | **$** | | **168.7** |  |  |
| Vested or expected to vest at June 30, 2006 |  | **$** | | **36.67** | **$** | | **167.5** |  |  |
| **8.8** |  |  |
| Options exercisable at June 30, 2006 | **4.7** | **$** | | **31.21** | **$** | | **114.5** |  |  |
|  |  |  |  |  |  |  |  |  |  |

The total intrinsic value of stock options exercised was $20.3 million and $8.8 million during the six months ended June 30, 2006 and 2005, respectively.

The following is a summary of weighted-average remaining contractual lives for stock options outstanding and the range of exercise prices on the stock options as of June 30, 2006:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  | **Number of** | | **Weighted-average** |  |
| **Range of exercise prices** | | **options** | | **remaining** |  |
| **outstanding** | | **contractual life** |  |
|  |  | **(in millions)** |  |  |  |

|  |  |  |
| --- | --- | --- |
| $22.23 - $22.33 | **0.7** | **5** |
| $24.79 - $29.78 | **1.9** | **6** |
| $30.16 - $36.50 | **2.0** | **7** |
| $38.20 - $44.13 | **2.5** | **9** |
| $46.40 - $54.45 | **2.0** | **10** |
| $22.23 - $54.45 | **9.1** | **8** |
|  |  |  |

The weighted-average remaining contractual lives for stock options exercisable is approximately 8 years as of June 30, 2006.

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

1. **Stock-Based Compensation Plans (continued) Performance Share Awards**

Beginning in 2006, we granted performance share awards to certain employees. The performance share awards are treated as an equity award and are paid in shares. Whether the performance shares are earned depends upon the participant’s continued employment through the performance period and our performance against three-year goals set at the beginning of the performance period. A return on equity objective and an earnings per share objective must be achieved for any of the performance shares to be earned. If the performance requirements are not met, the performance shares will be forfeited and no compensation cost is recognized and any previously recognized compensation cost is reversed. There is no maximum contractual term on these awards. As of June 30, 2006, there were $30.6 million of total unrecognized compensation costs related to nonvested performance share awards granted. The cost is expected to be recognized over a weighted-average service period of approximately 3 years.

The fair value of performance share awards is determined based on the closing stock price of our shares on the grant date. The weighted-average grant-date fair value of performance share awards granted during the six months ended June 30, 2006 was $49.27. Because no performance share awards vested, the intrinsic value is $0.0 million for the six months ended June 30, 2006.

The following is a summary of activity for the nonvested performance share awards for the six months ended June 30, 2006:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **Number of** |  |  | **Weighted-average** | |  |
|  | **performance share** |  |  |  |
|  | **awards** |  | **grant-date fair value** | | |  |
|  | **(in millions)** |  |  |  |  |  |
| Nonvested performance share awards at January 1, 2006 | **¾** | **$** | | **—** | |  |
| Granted | **0.8** |  |  | **49.27** |  |  |
| Vested | **¾** |  |  | **¾** |  |  |
| Forfeited | **¾** |  |  | **¾** |  |  |
| Nonvested performance share awards at June 30, 2006 | **0.8** | **$** | | **49.27** |  |  |
|  |  |  |  |  |  |  |

**Restricted Stock Units**

We issue restricted stock units under the 2005 Directors Stock Plan, Directors Stock Plan, 2005 Stock Incentive Plan, and Stock Incentive Plan. Restricted stock units are treated as an equity award. The fair value of restricted stock units is determined based on the closing stock price of our common shares on the grant date. There is no maximum contractual term on these awards.

Restricted stock units were issued to certain employees and agents pursuant to the Stock Incentive Plan and 2005 Stock Incentive Plan. Under these plans, awards have a graded or cliff vesting over a three-year service period. When service for the Company ceases, all vesting stops and unvested units are forfeited.

Beginning in 2005, pursuant to the 2005 Directors Stock Plan, restricted stock units are now granted to each non-employee director in office immediately following each annual meeting of stockholders and to each person who becomes a member of the Board other than on the date of the annual meeting of stockholders. Prior to this time, awards of restricted stock units were granted pursuant to the Directors Stock Plan on the date of each Board member’s election or re-election date. Under the 2005 Directors Stock Plan, awards are granted on an annual basis and cliff vest over the one-year service period. Non-vested awards under the prior plan have graded vesting over a three-year service period. When service to the Company ceases, all vesting stops and unvested units are forfeited.

For the six months ended June 30, 2006 and 2005, 0.2 million and 0.4 million restricted stock units were granted, respectively. The weighted-average grant-date fair value of restricted stock units granted during the six months ended June 30, 2006 and 2005 was $49.67 and $39.11, respectively.

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**9. Stock-Based Compensation Plans (continued)**

The actual tax benefits realized for the tax deductions for option exercise under these share-based payment arrangements for the six months ended June 30, 2006 was $1.3 million.

As of June 30, 2006, there were $16.6 million of total unrecognized compensation costs related to nonvested restricted stock unit awards granted under these plans. The cost is expected to be recognized over a weighted-average period of approximately 1 year. The total intrinsic value of restricted stock units vested was $4.8 million and $1.1 million, during the six months ended June 30, 2006 and 2005, respectively.

The following is a summary of activity for the nonvested restricted stock units for the six months ended June 30, 2006:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **Number of** |  |  | **Weighted-average** | |  |
|  | **restricted stock** |  |  |  |
|  | **units** |  | **grant-date fair value** | | |  |
|  | **(in millions)** |  |  |  |  |  |
| Nonvested restricted stock units at January 1, 2006 | **0.9** | **$** | | **36.71** |  |  |
| Granted | **0.2** |  |  | **49.67** |  |  |
| Vested | **0.1** |  |  | **37.93** |  |  |
| Forfeited | **—** |  |  | **—** | |  |
| Nonvested restricted stock units at June 30, 2006 | **1.0** | **$** | | **39.29** |  |  |
|  |  |  |  |  |  |  |

**Employee Stock Purchase Plan**

Under our Employee Stock Purchase Plan, participating employees have the opportunity to purchase shares of our common stock on a quarterly basis. Employees may purchase up to $25,000 worth of company stock each year. Employees may purchase shares of our common stock at a price equal to 85% of the shares’ fair market value as of the beginning or end of the quarter, whichever is lower. Under the Employee Stock Purchase Plan, employees purchased 0.4 million shares during the six months ended June 30, 2006 and 2005.

We recognize compensation expense for the fair value of the 15% discount granted to employees participating in the employee stock purchase plan in the quarter of grant. Shares of the Employee Stock Purchase Plan are treated as an equity award. The weighted-average fair value of the discount on the stock purchased was $10.29 and $7.13 during the six months ended June 30, 2006 and 2005, respectively. The total intrinsic value of the Employee Stock Purchase Plan settled was $4.4 million and $2.7 million during the six months ended June 30, 2006 and 2005, respectively.

Cash received from shares issued under these share-based payment arrangements for the six months ended June 30, 2006 was $16.7 million. The actual tax benefits realized for the tax deductions for option exercise of the share-based payment arrangements for the six months ended June 30, 2006 was $0.4 million.

The maximum number of shares of common stock that we may issue under the Employee Stock Purchase Plan is 2% of the number of shares outstanding immediately following the completion of the Initial Public Offering. As of June 30, 2006, a total of 3.6 million of new shares are available to be made issuable by us for this plan.

**Long-Term Performance Plan**

We also maintain the Long-Term Performance Plan, which provides the opportunity for eligible executives to receive additional awards if specified minimum corporate performance objectives are achieved over a three-year period. This plan utilizes stock as an option for payment and is treated as a liability award during vesting and a liability award or equity award subsequent to vesting, based on the participant payment election. Effective with stockholder approval of the 2005 Stock Incentive Plan, no further grants will be made under the Long-Term Performance Plan, and any future awards earned under the Long-Term Performance Plan will be issued under the 2005 Stock Incentive Plan. As of December 31, 2005, all awards under this plan were fully vested and no awards were granted under this plan in 2006 or 2005. There is no maximum contractual term on these awards.

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**9. Stock-Based Compensation Plans (continued)**

The amount of cash used to settle Long-Term Performance Plan units granted was $10.7 million and $6.1 million for the six months ended June 30, 2006 and 2005, respectively. The total intrinsic value of Long-Term Performance Plan units settled was $11.1 million and $6.3 million during the six months ended June 30, 2006 and 2005, respectively.

The fair value of Long-Term Performance Plan liability units is determined as of each reporting period based on the Black-Scholes option pricing model that uses the assumptions noted in the following table:

**Long-Term Performance Plan**



Dividend yield

Expected volatility

Risk-free interest rate



Expected life (in years)

**10. Earnings Per Common Share**

The computations of the basic and diluted per share amounts for our continuing operations were as follows:

**For the six**

**months ended**

**June 30,**

**2006**

**—%**

**11.5%**



**5.2%**

**3**



|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **For three months ended** | | | | |  |  | **For six months ended** | | | |  |  |
|  |  |  | **June 30,** | | |  |  |  | **June 30,** | | |  |  |  |
|  |  | **2006** |  |  |  | **2005** |  |  | **2006** |  |  | **2005** |  |  |
|  |  |  |  |  |  | **(in millions, except per share data)** | | | | |  |  |  |  |
|  | Income from continuing operations, | **$** | **218.8** |  |  |  | **$** | | **512.7** |  |  |  |  |  |
|  | net of related income taxes |  | $ | 223.6 |  | $ | 428.5 |  |  |
|  | Subtract: |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Preferred stock dividends |  | **8.3** |  |  | — |  |  | **16.5** |  |  | — |  |  |
|  | Income from continuing operations |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | available to common stockholders, | **$** | **210.5** |  | $ | 223.6 | **$** | | **496.2** |  | $ | 428.5 |  |  |
|  | net of related income taxes |  |  |  |  |
|  | Weighted-average shares outstanding: |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Basic |  | **273.5** |  |  | 288.9 |  |  | **276.5** |  |  | 295.8 |  |  |
|  | Dilutive effects: |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Stock options |  | **2.1** |  |  | 1.5 |  |  | **1.9** |  |  | 1.5 |  |  |
|  | Restricted stock units |  | **0.6** |  |  | 0.4 |  |  | **0.6** |  |  | 0.3 |  |  |
|  | Long term performance plan |  | **—** | |  | 0.1 |  |  | **—** | |  | 0.1 |  |  |
|  | Accelerated stock repurchase |  | **—** | |  |  |  |  | **—** | |  |  |  |  |
|  | agreement |  |  | 0.5 |  |  |  | 0.5 |  |  |
|  | Diluted |  | **276.2** |  |  | 291.4 |  |  | **279.0** |  |  | 298.2 |  |  |
|  | Income from continuing operations |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | per common share: |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Basic | **$** | **0.77** |  | $ | 0.78 | **$** | | **1.79** |  | $ | 1.45 |  |  |
|  | Diluted | **$** | **0.76** |  | $ | 0.77 |  | **$** | **1.78** |  | $ | 1.44 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  | 22 | |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information**

Principal Life has established special purpose entities to issue secured medium-term notes. Under the program, the payment obligations of principal and interest on the notes are secured by funding agreements issued by Principal Life. Principal Life’s payment obligations on the funding agreements are fully and unconditionally guaranteed by Principal Financial Group, Inc. All of the outstanding stock of Principal Life is indirectly owned by PFG and PFG is the only guarantor of the payment obligations of the funding agreements.

We received a subpoena on March 31, 2005 from the Attorney General of West Virginia for documents and other information relating to funding agreement-backed securities, special purpose vehicles related to funding agreement-backed securities, and related subjects. A response has been sent. We understand that other U.S.-based life insurers that have funding agreement-backed note programs such as our on-going programs have received similar subpoenas from the Attorney General of West Virginia. Other than the subpoena, we have received no notification of any pending or threatened investigation or other proceeding by West Virginia governmental authorities involving funding agreement-backed securities.

The following tables set forth condensed consolidating financial information of Principal Life and PFG as of June 30, 2006 and December 31, 2005, and for the six months ended June 30, 2006 and 2005.

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Financial Position**

**June 30, 2006**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **Principal** | |  | **Principal Life** | |  |  | **Principal Financial** | |  |  |  |  | **Principal** | |  |  |
|  |  | **Financial** | |  | **Insurance** | |  |  | **Services, Inc. and** | |  |  |  |  | **Financial** | |  |  |
|  |  | **Group, Inc.** | |  | **Company** | |  |  | **Other Subsidiaries** | |  | **Eliminations** | |  | **Group, Inc.** | |  |  |
|  |  | **Parent Only** | |  | **Only** | |  |  | **Combined** | |  |  | **Consolidated** | |  |  |
|  |  |  |  |  |  |  |  |  | **(in millions)** | |  |  |  |  |  |  |  |  |
| **Assets** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Fixed maturities, available-for-sale | **$** | **—** | | **$** | **38,847.6** |  | **$** | | **4,213.1** |  | **$** | **(767.3)** | | **$** | **42,293.4** |  |  |  |
| Fixed maturities, trading |  | **—** | |  | **48.8** |  |  |  | **203.2** |  |  | **¾** |  |  | **252.0** |  |  |  |
| Equity securities, available-for-sale |  | **—** | |  | **650.9** |  |  |  | **26.3** |  |  | **¾** |  |  | **677.2** |  |  |  |
| Equity securities, trading |  | **—** | |  | **9.4** |  |  |  | **138.9** |  |  | **¾** |  |  | **148.3** |  |  |  |
| Mortgage loans |  | **—** | |  | **9,734.6** |  |  |  | **2,146.7** |  |  | **(337.4)** | |  | **11,543.9** |  |  |  |
| Real estate |  | **—** | |  | **421.0** |  |  |  | **576.2** |  |  | **—** | |  | **997.2** |  |  |  |
| Policy loans |  | **—** | |  | **843.2** |  |  |  | **—** | |  | **—** | |  | **843.2** |  |  |  |
| Investment in unconsolidated entities |  | **6,664.0** |  |  | **288.8** |  |  |  | **4,023.3** |  |  | **(10,718.4)** | |  | **257.7** |  |  |  |
| Other investments |  | **19.2** |  |  | **2,579.2** |  |  |  | **134.3** |  |  | **(1,621.6)** | |  | **1,111.1** |  |  |  |
| Cash and cash equivalents |  | **166.7** |  |  | **554.3** |  |  |  | **739.1** |  |  | **(243.2)** | |  | **1,216.9** |  |  |  |
| Accrued investment income |  | **—** | |  | **622.9** |  |  |  | **49.0** |  |  | **(5.9)** | |  | **666.0** |  |  |  |
| Premiums due and other receivables |  | **¾** |  |  | **634.4** |  |  |  | **104.3** |  |  | **(111.9)** | |  | **626.8** |  |  |  |
| Deferred policy acquisition costs |  | **—** | |  | **2,329.5** |  |  |  | **126.1** |  |  | **—** | |  | **2,455.6** |  |  |  |
| Property and equipment |  | **—** | |  | **398.8** |  |  |  | **21.4** |  |  | **—** | |  | **420.2** |  |  |  |
| Goodwill |  | **—** | |  | **77.2** |  |  |  | **220.6** |  |  | **—** | |  | **297.8** |  |  |  |
| Other intangibles |  | **—** | |  | **39.7** |  |  |  | **159.6** |  |  | **—** | |  | **199.3** |  |  |  |
| Separate account assets |  | **—** | |  | **62,159.4** |  |  |  | **3,460.8** |  |  | **—** | |  | **65,620.2** |  |  |  |
| Other assets |  | **—** | |  | **1,300.0** |  |  |  | **237.0** |  |  | **265.6** |  |  | **1,802.6** |  |  |  |
| Total assets | **$** | **6,849.9** |  | **$** | **121,539.7** |  |  | **$** | **16,579.9** |  | **$** | **(13,540.1** | **)** | **$** | **131,429.4** |  |  |  |
| **Liabilities** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Contractholder funds | **$** | **—** | | **$** | **35,702.2** |  | **$** | | **14.1** |  | **$** | **(203.7)** | | **$** | **35,512.6** |  |  |  |
| Future policy benefits and claims |  | **—** | |  | **14,818.5** |  |  |  | **2,188.1** |  |  | **—** | |  | **17,006.6** |  |  |  |
| Other policyholder funds |  | **—** | |  | **631.9** |  |  |  | **4.4** |  |  | **—** | |  | **636.3** |  |  |  |
| Short-term debt |  | **—** | |  | **302.1** |  |  |  | **209.7** |  |  | **(87.4)** | |  | **424.4** |  |  |  |
| Long-term debt |  | **—** | |  | **247.5** |  |  |  | **1,303.3** |  |  | **(656.6)** | |  | **894.2** |  |  |  |
| Income taxes currently payable |  | **(2.0)** | |  | **(328.4)** | |  |  | **14.4** |  |  | **316.5** |  |  | **0.5** |  |  |  |
| Deferred income taxes |  | **5.4** |  |  | **395.1** |  |  |  | **209.8** |  |  | **0.6** |  |  | **610.9** |  |  |  |
| Separate account liabilities |  | **—** | |  | **62,159.4** |  |  |  | **3,460.8** |  |  | **¾** |  |  | **65,620.2** |  |  |  |
| Other liabilities |  | **1.8** |  |  | **1,709.4** |  |  |  | **2,511.3** |  |  | **(343.5)** | |  | **3,879.0** |  |  |  |
| Total liabilities |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | **5.2** |  |  | **115,637.7** |  |  |  | **9,915.9** |  |  | **(974.1)** | |  | **124,584.7** |  |  |  |
| **Stockholders’ equity** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Series A preferred stock |  | **—** | |  | **—** | |  |  | **—** | |  | **—** | |  | **—** | |  |  |
| Series B preferred stock |  | **0.1** |  |  | **—** | |  |  | **—** | |  | **—** | |  | **0.1** |  |  |  |
| Common stock |  | **3.8** |  |  | **2.5** |  |  |  | **—** | |  | **(2.5)** | |  | **3.8** |  |  |  |
| Additional paid-in capital |  | **8,068.8** |  |  | **5,380.1** |  |  |  | **7,099.1** |  |  | **(12,479.2)** | |  | **8,068.8** |  |  |  |
| Retained earnings (deficit) |  | **2,504.8** |  |  | **379.4** |  |  |  | **(641.1)** | |  | **261.7** |  |  | **2,504.8** |  |  |  |
| Accumulated other comprehensive income |  | **218.5** |  |  | **140.0** |  |  |  | **206.0** |  |  | **(346.0)** | |  | **218.5** |  |  |  |
| Treasury stock, at cost |  | **(3,951.3)** | |  | **—** | |  |  | **—** | |  | **—** | |  | **(3,951.3)** | |  |  |
| Total stockholders’ equity |  | **6,844.7** |  |  | **5,902.0** |  |  |  | **6,664.0** |  |  | **(12,566.0)** |  |  | **6,844.7** |  |  |  |
| Total liabilities and stockholders’ equity | **$** | **6,849.9** |  | **$** | **121,539.7** |  |  | **$** | **16,579.9** |  | **$** | **(13,540.1** | **)** | **$** | **131,429.4** |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  | 24 |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Financial Position**

**December 31, 2005**

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **Principal** |  |  | **Principal Life** |  | **Principal Financial** |  |  |  | **Principal** | |  |
|  | **Financial** |  |  | **Insurance** |  | **Services, Inc. and** |  |  |  | **Financial** | |  |
|  | **Group, Inc.** |  |  | **Company** |  | **Other Subsidiaries** |  | **Eliminations** |  | **Group, Inc.** | |  |
|  | **Parent Only** |  |  | **Only** |  | **Combined** |  |  | **Consolidated** | |  |
|  |  |  |  |  |  | **(in millions)** |  |  |  |  |  |  |
| **Assets** |  |  |  |  |  |  |  |  |  |  |  |  |
| Fixed maturities, available-for-sale | $ | — | $ | 38,886.6 | $ | 3,896.5 | $ | (665.9) | $ | 42,117.2 |  |  |
| Fixed maturities, trading |  | — |  | 18.9 |  | 94.3 |  | ¾ |  | 113.2 |  |  |
| Equity securities, available-for-sale |  | — |  | 658.8 |  | 65.6 |  | ¾ |  | 724.4 |  |  |
| Equity securities, trading |  | — |  | — |  | 90.3 |  | ¾ |  | 90.3 |  |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Mortgage loans |  | — | |  | 9,448.9 |  |  | 2,365.5 |  |  | (330.1) | |  |  | 11,484.3 |  |  |  |
| Real estate |  | — | |  | 412.8 |  |  | 586.6 |  |  | — | |  |  | 999.4 |  |  |  |
| Policy loans |  | — | |  | 827.7 |  |  | — | |  | — | |  |  | 827.7 |  |  |  |
| Investment in unconsolidated entities |  | 7,784.2 |  |  | 275.6 |  |  | 5,515.1 |  |  | (13,311.0) | |  |  | 263.9 |  |  |  |
| Other investments |  | — | |  | 2,041.8 |  |  | 129.6 |  |  | (1,321.8) | |  |  | 849.6 |  |  |  |
| Cash and cash equivalents |  | 21.6 |  |  | 1,261.9 |  |  | 542.3 |  |  | (184.5) | |  |  | 1,641.3 |  |  |  |
| Accrued investment income |  | — | |  | 638.8 |  |  | 48.5 |  |  | (4.6) | |  |  | 682.7 |  |  |  |
| Premiums due and other receivables |  | — | |  | 589.2 |  |  | 112.7 |  |  | (109.2) | |  |  | 592.7 |  |  |  |
| Deferred policy acquisition costs |  | — | |  | 2,069.9 |  |  | 104.2 |  |  | — | |  |  | 2,174.1 |  |  |  |
| Property and equipment |  | — | |  | 397.2 |  |  | 22.6 |  |  | — | |  |  | 419.8 |  |  |  |
| Goodwill |  | — | |  | 50.4 |  |  | 231.9 |  |  | — | |  |  | 282.3 |  |  |  |
| Other intangibles |  | — | |  | 39.2 |  |  | 163.4 |  |  | — | |  |  | 202.6 |  |  |  |
| Separate account assets |  | — | |  | 58,670.7 |  |  | 3,415.5 |  |  | (16.2) | |  |  | 62,070.0 |  |  |  |
| Other assets |  | 3.5 |  |  | 1,361.4 |  |  | 258.1 |  |  | (123.1) | |  |  | 1,499.9 |  |  |  |
| Total assets |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| $ | 7,809.3 |  | $ | 117,649.8 | $ | 17,642.7 |  | $ | (16,066.4) | | $ | 127,035.4 |  |  |  |
| **Liabilities** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Contractholder funds | $ | — | | $ | 33,797.0 | $ | | 13.5 |  | $ | (198.4) | | $ | | 33,612.1 |  |  |  |
| Future policy benefits and claims |  | — | |  | 14,650.3 |  |  | 2,175.2 |  |  | — | |  |  | 16,825.5 |  |  |  |
| Other policyholder funds |  | — | |  | 654.1 |  |  | 3.0 |  |  | — | |  |  | 657.1 |  |  |  |
| Short-term debt |  | — | |  | — |  |  | 565.6 |  |  | (89.2) | |  |  | 476.4 |  |  |  |
| Long-term debt |  | — | |  | 241.9 |  |  | 1,223.9 |  |  | (567.0) | |  |  | 898.8 |  |  |  |
| Income taxes currently payable |  | — | |  | — |  |  | 0.3 |  |  | (0.3) | |  |  | — | |  |  |
| Deferred income taxes |  | — | |  | 753.1 |  |  | 237.1 |  |  | (15.4) | |  |  | 974.8 |  |  |  |
| Separate account liabilities |  | — | |  | 58,670.7 |  |  | 3,415.5 |  |  | (16.2) | |  |  | 62,070.0 |  |  |  |
| Other liabilities |  | 2.1 |  |  | 1,800.1 |  |  | 2,224.4 |  |  | (313.1) | |  |  | 3,713.5 |  |  |  |
| Total liabilities |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | 2.1 |  |  | 110,567.2 |  |  | 9,858.5 |  |  | (1,199.6) | |  |  | 119,228.2 |  |  |  |
| **Stockholders’ equity** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Series A preferred stock |  | ¾ |  |  | — |  |  | — | |  | — | |  |  | ¾ |  |  |  |
| Serice B preferred stock |  | 0.1 |  |  | — |  |  | — | |  | — | |  |  | 0.1 |  |  |  |
| Common stock |  | 3.8 |  |  | 2.5 |  |  | — | |  | (2.5) | |  |  | 3.8 |  |  |  |
| Additional paid-in capital |  | 8,000.0 |  |  | 5,354.8 |  |  | 7,071.3 |  |  | (12,426.1) | |  |  | 8,000.0 |  |  |  |
| Retained earnings (deficit) |  | 2,008.6 |  |  | 870.4 |  |  | (281.9) | |  | (588.5) | |  |  | 2,008.6 |  |  |  |
| Accumulated other comprehensive income |  | 994.8 |  |  | 854.9 |  |  | 994.8 |  |  | (1,849.7) | |  |  | 994.8 |  |  |  |
| Treasury stock, at cost |  | (3,200.1) | |  | — |  |  | — | |  | — | |  |  | (3,200.1) | |  |  |
| Total stockholders’ equity |  | 7,807.2 |  |  | 7,082.6 |  |  | 7,784.2 |  |  | (14,866.8) |  |  |  | 7,807.2 |  |  |  |
| Total liabilities and stockholders’ equity | $ | 7,809.3 |  | $ | 117,649.8 |  | $ | 17,642.7 |  | $ | (16,066.4 | ) |  | $ | 127,035.4 |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  | 25 |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Operations**

**For the six months ended June 30, 2006**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  | **Principal** | |  |  |  |  |  |  |  |
|  |  |  | **Principal** | |  | **Principal Life** | |  |  | **Financial** | |  |  |  |  | **Principal** | |  |
|  |  |  |  |  |  | **Services, Inc. and** | |  |  |  |  |  |
|  |  |  | **Financial** | |  | **Insurance** | |  |  | **Other** | |  |  |  |  | **Financial** | |  |
|  |  |  | **Group, Inc.** | |  | **Company** | |  |  | **Subsidiaries** | |  | **Eliminations** | |  | **Group, Inc.** | |  |
|  |  |  | **Parent Only** | |  | **Only** | |  |  | **Combined** | |  |  | **Consolidated** | |  |
|  |  |  |  |  |  |  |  |  |  | **(in millions)** | |  |  |  |  |  |  |  |
|  | **Revenues** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Premiums and other considerations | **$** | **—** | | **$** | **2,003.9** |  | **$** | | **142.5** |  | **$** | **—** | | **$** | **2,146.4** |  |  |
|  | Fees and other revenues |  | **—** | |  | **627.7** |  |  |  | **448.4** |  |  | **(176.0)** | |  | **900.1** |  |  |
|  | Net investment income |  | **1.8** |  |  | **1,558.8** |  |  |  | **213.0** |  |  | **(9.8)** | |  | **1,763.8** |  |  |
|  | Net realized/unrealized capital gains |  | **—** |  |  | **(9.9)** | |  |  | **42.5** |  |  | **(2.8)** | |  | **29.8** |  |  |
|  | Total revenues |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **1.8** |  |  | **4,180.5** |  |  |  | **846.4** |  |  | **(188.6)** | |  | **4,840.1** |  |  |
|  | **Expenses** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Benefits, claims, and settlement expenses |  | **—** | |  | **2,596.9** |  |  |  | **211.2** |  |  | **(6.7)** | |  | **2,801.4** |  |  |
|  | Dividends to policyholders |  | **—** | |  | **144.4** |  |  |  | **—** | |  | **—** | |  | **144.4** |  |  |
|  | Operating expenses |  | **6.9** |  |  | **945.0** |  |  |  | **423.9** |  |  | **(151.6)** | |  | **1,224.2** |  |  |
|  | Total expenses |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **6.9** |  |  | **3,686.3** |  |  |  | **635.1** |  |  | **(158.3)** | |  | **4,170.0** |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Income (loss) from continuing operations |  | **(5.1)** | |  | **494.2** |  |  |  | **211.3** |  |  | **(30.3)** | |  | **670.1** |  |  |
|  | before income taxes |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Income taxes (benefits) |  | **(2.0)** | |  | **104.9** |  |  |  | **54.4** |  |  | **0.1** |  |  | **157.4** |  |  |
|  | Equity in the net income of subsidiaries |  | **515.8** |  |  | **94.7** |  |  |  | **358.9** |  |  | **(969.4)** | |  | **—** | |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Net income |  | **512.7** |  |  | **484.0** |  |  | **515.8** |  |  | **(999.8)** | |  | **512.7** |  |  |
| Preferred stock dividends |  | **16.5** |  |  | **—** |  |  | **—** | |  | **—** | | | **16.5** |  |  |
| Net income available to common stockholders | **$** | **496.2** |  | **$** | **484.0** |  | **$** | **515.8** |  | **$** | **(999.8** | **)** | **$** | **496.2** |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  | 26 |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Operations**

**For the six months ended June 30, 2005**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  | **Principal** | |  | **Principal Life** | |  | **Principal Financial** |  |  |  |  |  |  | **Principal** |  |  |
|  |  |  |  |  |  | **Services, Inc. and** |  |  |  |  |  |  |  |  |
|  |  |  |  | **Financial** | |  | **Insurance** | |  | **Other** |  |  |  |  |  |  | **Financial** |  |  |
|  |  |  |  | **Group, Inc.** | |  | **Company** | |  | **Subsidiaries** |  |  | **Eliminations** | |  |  | **Group, Inc.** |  |  |
|  |  |  |  | **Parent Only** | |  | **Only** | |  | **Combined** |  |  |  |  | **Consolidated** |  |  |
|  |  |  |  |  |  |  |  |  |  | **(in millions)** |  |  |  |  |  |  |  |  |  |
|  | **Revenues** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Premiums and other considerations | $ | | — | | $ | 1,726.0 |  | $ | 157.0 | $ | | — | | $ | | 1,883.0 |  |  |
|  | Fees and other revenues |  |  | — | |  | 572.0 |  |  | 376.9 |  |  | (126.4) | |  |  | 822.5 |  |  |
|  | Net investment income |  |  | 1.1 |  |  | 1,493.7 |  |  | 127.6 |  |  | 7.5 |  |  |  | 1,629.9 |  |  |
|  | Net realized/unrealized capital gains |  |  | — |  |  | 2.4 |  |  | 3.5 |  |  | 2.8 |  |  |  | 8.7 |  |  |
|  | Total revenues |  |  | 1.1 |  |  | 3,794.1 |  |  | 665.0 |  |  | (116.1) | |  |  | 4,344.1 |  |  |
|  | **Expenses** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Benefits, claims, and settlement expenses |  |  | — | |  | 2,293.5 |  |  | 210.5 |  |  | (5.2) | |  |  | 2,498.8 |  |  |
|  | Dividends to policyholders |  |  | — | |  | 145.1 |  |  | ¾ |  |  | — | |  |  | 145.1 |  |  |
|  | Operating expenses |  |  | 5.4 |  |  | 877.6 |  |  | 366.1 |  |  | (111.4) | |  |  | 1,137.7 |  |  |
|  | Total expenses |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  | 5.4 |  |  | 3,316.2 |  |  | 576.6 |  |  | (116.6) | |  |  | 3,781.6 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Income (loss) from continuing operations |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | before income taxes |  |  | (4.3) | |  | 477.9 |  |  | 88.4 |  |  | 0.5 |  |  |  | 562.5 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Income taxes (benefits) |  |  | (2.1) | |  | 125.2 |  |  | 10.0 |  |  | 0.9 |  |  |  | 134.0 |  |  |
|  | Equity in the net income of subsidiaries, |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | excluding discontinued operations |  |  | 430.7 |  |  | 50.7 |  |  | 352.3 |  |  | (833.7) | |  |  | — |  |  |
|  | Income (loss) from continuing operations, |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | net of related income taxes |  |  | (2.2) | |  | 352.7 |  |  | 78.4 |  |  | (0.4) | |  |  | 428.5 |  |  |
|  | Income from discontinued operations, net |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | of related income taxes |  |  | 15.9 |  |  | 15.9 |  |  | 15.9 |  |  | (31.8) | |  |  | 15.9 |  |  |
|  | Net income |  | $ | 444.4 |  | $ | 419.3 |  | $ | 446.6 |  | $ | (865.9 | ) |  | $ | 444.4 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  | 27 |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Cash Flows**

**For the six months ended June 30, 2006**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  | **Principal** |  | **Principal Life** |  | **Principal** |  |  |  | **Principal** | |  |
|  |  |  |  |  | **Financial** |  |  |  |  |
|  |  |  | **Financial** |  | **Insurance** |  | **Services, Inc. and** |  |  |  | **Financial** | |  |
|  |  |  | **Group, Inc.** |  | **Company** |  | **Other Subsidiaries** |  | **Eliminations** |  | **Group, Inc.** | |  |
|  |  |  | **Parent Only** |  | **Only** |  | **Combined** |  |  | **Consolidated** | |  |
|  |  |  |  |  |  |  | **(in millions)** |  |  |  |  |  |  |
| **Operating activities** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Net cash provided by (used in) operating | **$** | | **(1.8)** | **$** | **829.6** | **$** | **285.0** | **$** | **(8.0)** | **$** | **1,104.8** |  |  |
| activities |  |  |
| **Investing activities** |  |  |  |  |  |  |  |  |  |  |  |  |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Available-for-sale securities: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Purchases |  |  | **—** |  |  | **(3,827.7)** | |  |  | **(570.9)** | |  | **14.2** |  |  |  | **(4,384.4)** | |  |  |
| Sales |  |  | **—** |  |  | **490.7** |  |  |  | **254.6** |  |  | **—** | |  |  | **745.3** |  |  |  |
| Maturities |  |  | **—** |  |  | **1,777.7** |  |  |  | **95.3** |  |  | **—** | |  |  | **1,873.0** |  |  |  |
| Mortgage loans acquired or originated |  |  | **—** |  |  | **(1,352.5)** | |  |  | **(235.1)** | |  | **45.1** |  |  |  | **(1,542.5)** | |  |  |
| Mortgage loans sold or repaid |  |  | **—** |  |  | **1,066.6** |  |  |  | **163.5** |  |  | **(37.8)** | |  |  | **1,192.3** |  |  |  |
| Real estate acquired |  |  | **—** |  |  | **(11.2)** | |  |  | **(7.5)** | |  | **—** | |  |  | **(18.7)** | |  |  |
| Real estate sold |  |  | **—** |  |  | **0.1** |  |  |  | **11.3** |  |  | **—** | |  |  | **11.4** |  |  |  |
| Net purchases of property and equipment |  |  | **—** |  |  | **(17.8)** | |  |  | **(5.4)** | |  | **—** | |  |  | **(23.2)** | |  |  |
| Purchases of interest in subsidiaries, net of cash |  |  | **—** |  |  | **—** | |  |  | **(5.5)** | |  | **—** | |  |  | **(5.5)** | |  |  |
| acquired |  |  |  |  |  |  |  |  |  |  |  |
| Dividends received from (contributions to) |  |  | **876.3** |  |  | **(240.1)** | |  |  | **975.0** |  |  | **(1,611.2)** | |  |  | **—** | |  |  |
| unconsolidated entities |  |  |  |  |  |  |  |  |  |  |  |  |
| Net change in other investments |  |  | **¾** |  |  | **5.0** |  |  |  | **63.7** |  |  | **15.6** |  |  |  | **84.3** |  |  |  |
| Net cash provided by (used in) investing | **$** | | **876.3** | **$** | | **(2,109.2)** | | **$** | | **739.0** |  | **$** | **(1,574.1)** | | **$** | | **(2,068.0)** | |  |  |
| activities |  |  |  |
|  |  |  |  |  |  | 28 |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Cash Flows (continued)**

**For the six months ended June 30, 2006**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  | **Principal** | |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  | **Financial** | |  |  |  |  |  |  |  |  |
|  |  |  |  | **Principal** | |  |  | **Principal Life** | |  | **Services, Inc.** | |  |  |  |  | **Principal** | |  |  |
|  |  |  |  |  |  |  | **and** | |  |  |  |  |  |  |
|  |  |  |  | **Financial** | |  |  | **Insurance** | |  | **Other** | |  |  |  |  | **Financial** | |  |  |
|  |  |  |  | **Group, Inc.** | |  |  | **Company** | |  | **Subsidiaries** | |  | **Eliminations** | |  | **Group, Inc.** | |  |  |
|  |  |  |  | **Parent Only** | |  |  | **Only** | |  | **Combined** | |  |  | **Consolidated** | |  |  |
|  |  |  |  |  |  |  |  |  |  |  | **(in millions)** | |  |  |  |  |  |  |  |  |
|  | **Financing activities** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Issuance of common stock | **$** | | **38.3** |  | **$** | | **—** | | **$** | **—** | | **$** | **—** | | **$** | **38.3** |  |  |  |
|  | Acquisition of treasury stock, net |  |  | **(751.2)** | |  |  | **—** | |  | **—** | |  | **—** | |  | **(751.2)** | |  |  |
|  | Proceeds from financing element derivatives |  |  | **—** | |  |  | **81.3** |  |  | **—** | |  | **—** | |  | **81.3** |  |  |  |
|  | Payments for financing element derivatives |  |  | **—** | |  |  | **(69.9)** | |  | **—** | |  | **—** | |  | **(69.9)** | |  |  |
|  | Excess tax benefits from share-based payment |  |  | **—** | |  |  | **1.9** |  |  | **0.7** |  |  | **—** | |  | **2.6** |  |  |  |
|  | arrangements |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Dividends to preferred stockholders |  |  | **(16.5)** | |  |  | **—** | |  | **—** | |  | **—** | |  | **(16.5)** | |  |  |
|  | Issuance of long-term debt |  |  | **—** | |  |  | **5.6** |  |  | **92.7** |  |  | **(89.6)** | |  | **8.7** |  |  |  |
|  | Principal repayments of long-term debt |  |  | **—** | |  |  | **¾** |  |  | **(6.3)** | |  | **—** | |  | **(6.3)** | |  |  |
|  | Net proceeds (repayments) of short-term borrowings |  |  | **—** | |  |  | **302.1** |  |  | **(353.5)** | |  | **1.8** |  |  | **(49.6)** | |  |  |
|  | Capital dividends paid to parent |  |  | **—** | |  |  | **(975.0)** | |  | **(636.2)** | |  | **1,611.2** |  |  | **—** | |  |  |
|  | Investment contract deposits |  |  | **—** | |  |  | **4,835.7** |  |  | **—** | |  | **—** | |  | **4,835.7** |  |  |  |
|  | Investment contract withdrawals |  |  | **—** | |  |  | **(3,609.7)** | |  | **—** | |  | **—** | |  | **(3,609.7)** | |  |  |
|  | Net increase in banking operation deposits |  |  | **—** |  |  |  | **—** |  |  | **75.4** |  |  | **—** |  |  | **75.4** |  |  |  |
|  | Net cash provided by (used in) financing activities |  |  | **(729.4)** | |  |  | **572.0** |  |  | **(827.2)** | |  | **1,523.4** |  |  | **538.8** |  |  |  |
|  | Net increase (decrease) in cash and cash equivalents |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  | **145.1** |  |  |  | **(707.6)** | |  | **196.8** |  |  | **(58.7)** | |  | **(424.4)** | |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Cash and cash equivalents at beginning of period |  |  | **21.6** |  |  |  | **1,261.9** |  |  | **542.3** |  |  | **(184.5)** | |  | **1,641.3** |  |  |  |
|  | Cash and cash equivalents at end of period |  | **$** | **166.7** |  |  | **$** | **554.3** |  | **$** | **739.1** |  | **$** | **(243.2** | **)** | **$** | **1,216.9** |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  | 29 | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Cash Flows – (As Restated – See Note 1)**

**For the six months ended June 30, 2005**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  | **Principal** | |  |  | **Principal Life** | |  | **Principal Financial** | |  |  |  |  |  | **Principal** | |  |  |
|  |  |  | **Financial** | |  |  | **Insurance** | |  | **Services, Inc. and** | |  |  |  |  |  | **Financial** | |  |  |
|  |  |  | **Group, Inc.** | |  |  | **Company** | |  | **Other Subsidiaries** | |  |  | **Eliminations** | |  | **Group, Inc.** | |  |  |
|  |  |  | **Parent Only** | |  |  | **Only** | |  | **Combined** | |  |  |  | **Consolidated** | |  |  |
|  |  |  |  |  |  |  |  |  |  | **(in millions)** | |  |  |  |  |  |  |  |  |  |
| **Operating activities** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Net cash provided by (used in) operating |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| activities | $ | | (2.6) | | $ | | 540.0 |  | $ | 327.2 |  | $ | | (58.2) | | $ | 806.4 |  |  |  |
| **Investing activities** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Available-for-sale securities: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Purchases |  |  | — | |  |  | (3,106.3) | |  | (1,760.5) | |  |  | 113.3 |  |  | (4,753.5) | |  |  |
| Sales |  |  | — | |  |  | 878.7 |  |  | 81.4 |  |  |  | — | |  | 960.1 |  |  |  |
| Maturities |  |  | — | |  |  | 1,747.0 |  |  | 1,299.6 |  |  |  | — | |  | 3,046.6 |  |  |  |
| Mortgage loans acquired or originated |  |  | — | |  |  | (1,098.4) | |  | (289.5) | |  |  | 115.0 |  |  | (1,272.9) | |  |  |
| Mortgage loans sold or repaid |  |  | — | |  |  | 1,188.5 |  |  | 180.9 |  |  |  | (105.0) | |  | 1,264.4 |  |  |  |
| Real estate acquired |  |  | — | |  |  | (125.6) | |  | (35.4) | |  |  | — | |  | (161.0) | |  |  |
| Real estate sold |  |  | — | |  |  | 213.7 |  |  | 53.5 |  |  |  | — | |  | 267.2 |  |  |  |
| Net purchases of property and equipment |  |  | — | |  |  | (13.3) | |  | (4.8) | |  |  | — | |  | (18.1) | |  |  |
| Purchases of interest in subsidiaries, net |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| of cash acquired |  |  | — | |  |  | — | |  | (54.4) | |  |  | — | |  | (54.4) | |  |  |
| Dividends received from (paid to) |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| unconsolidated entities |  |  | 251.1 |  |  |  | (226.4) | |  | (35.0) | |  |  | 10.3 |  |  | — | |  |  |
| Net change in other investments |  |  | — | |  |  | (4.6) | |  | (45.0) | |  |  | 8.4 |  |  | (41.2) | |  |  |
| Net cash provided by (used in) investing |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| activities | $ | | 251.1 |  | $ | | (546.7) | | $ | (609.2) | | $ | | 142.0 |  | $ | (762.8) | |  |  |
|  |  |  |  |  |  |  | 30 |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Cash Flows – (As Restated – See Note 1) (continued)**

**For the six months ended June 30, 2005**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  | **Principal** | |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  | **Financial** | |  |  |  |  |  |  |  |
|  |  |  |  | **Principal** | |  | **Principal Life** | |  | **Services, Inc.** | |  |  |  |  | **Principal** | |  |
|  |  |  |  |  |  | **and** | |  |  |  |  |  |
|  |  |  |  | **Financial** | |  | **Insurance** | |  | **Other** | |  |  |  |  | **Financial** | |  |
|  |  |  |  | **Group, Inc.** | |  | **Company** | |  | **Subsidiaries** | |  | **Eliminations** | |  | **Group, Inc.** | |  |
|  |  |  |  | **Parent Only** | |  | **Only** | |  | **Combined** | |  |  | **Consolidated** | |  |
|  |  |  |  |  |  |  |  |  |  | **(in millions)** | |  |  |  |  |  |  |  |
|  | **Financing activities** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Issuance of common stock | $ | | 25.8 |  | $ | — | | $ | — | | $ | — | | $ | 25.8 |  |  |
|  | Issuance of preferred stock |  |  | 542.0 |  |  | — | |  | — | |  | — | |  | 542.0 |  |  |
|  | Acquisition and sales of treasury stock, net |  |  | (868.4) | |  | — | |  | — | |  | — | |  | (868.4) | |  |
|  | Proceeds from financing element derivatives |  |  | — | |  | 83.0 |  |  | — | |  | — | |  | 83.0 |  |  |
|  | Payments for financing element derivatives |  |  | — | |  | (55.6) | |  | — | |  | — | |  | (55.6) | |  |
|  | Issuance of long-term debt |  |  | — | |  | 68.6 |  |  | 83.6 |  |  | (140.0) | |  | 12.2 |  |  |
|  | Principal repayments of long-term debt |  |  | — | |  | (7.8) | |  | (3.8) | |  | 0.1 |  |  | (11.5) | |  |
|  | Net proceeds of short-term borrowings |  |  | — | |  | 1.1 |  |  | 168.3 |  |  | 3.0 |  |  | 172.4 |  |  |
|  | Capital received from (dividends paid to) parent |  |  | — | |  | 35.0 |  |  | (24.7) | |  | (10.3) | |  | — | |  |
|  | Investment contract deposits |  |  | — | |  | 4,072.6 |  |  | — | |  | — | |  | 4,072.6 |  |  |
|  | Investment contract withdrawals |  |  | — | |  | (3,319.5) | |  | — | |  | — | |  | (3,319.5) | |  |
|  | Net increase in banking operation deposits |  |  | — |  |  | — |  |  | 22.7 |  |  | — |  |  | 22.7 |  |  |
|  | Net cash provided by (used in) financing activities |  |  | (300.6) | |  | 877.4 |  |  | 246.1 |  |  | (147.2) | |  | 675.7 |  |  |
|  | **Discontinued operations** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Net cash used in operating activities |  |  | — | |  | (0.1) | |  | — | |  | — | |  | (0.1) | |  |
|  | Net cash used in investing activites |  |  | ¾ |  |  | (0.1) | |  | — | |  | — | |  | (0.1) | |  |
|  | Net cash used in discontinued operations |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  | — |  | (0.2) | |  | — |  | — |  | (0.2) | |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Net increase (decrease) in cash and cash equivalents |  |  | (52.1) | |  | 870.5 |  |  | (35.9) | |  | (63.4) | |  | 719.1 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Cash and cash equivalents at beginning of period |  |  | 75.4 |  |  | 31.9 |  |  | 410.0 |  |  | (64.8) | |  | 452.5 |  |  |
|  | Cash and cash equivalents at end of period |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | $ | 23.3 |  | $ | 902.4 |  | $ | 374.1 |  | $ | (128.2) | | $ | 1,171.6 |  |  |
|  | **Cash and cash equivalents of discontinued operations** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | **included above** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | At beginning of period | $ | | — | | $ | 1.9 |  | $ | — | | $ | — | | $ | 1.9 |  |  |

At end of period $ — $ 1.7 $ — $ — $ 1.7

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**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

On June 30, 2004, our shelf registration statement with the SEC was declared effective. Following our June 2005 issuance of perpetual preferred stock under the shelf registration, we now have the ability to issue up to $2.45 billion of debt securities, preferred stock, common stock, warrants, stock purchase contracts and stock purchase units of PFG and trust preferred securities of three subsidiary trusts. If we issue additional securities, we intend to use the proceeds from the sale of the securities for general corporate purposes, including working capital, capital expenditures, investments in subsidiaries, share repurchase, acquisitions and refinancing of debt, including commercial paper and other short-term indebtedness. Principal Financial Services, Inc. unconditionally guarantees our obligations with respect to one or more series of debt securities described in the shelf registration statement.

The following tables set forth condensed consolidating financial information of Principal Financial Services, Inc. and PFG as of June 30, 2006 and December 31, 2005, and for the six months ended June 30, 2006 and 2005.

**Condensed Consolidating Statements of Financial Position**

**June 30, 2006**

**(Unaudited)**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  | **Principal Life** |  |  |  |  |  |  |  |  |  |  |
|  |  | **Principal** | |  | **Principal** |  |  | **Insurance** |  |  |  |  |  |  | **Principal** | |  |  |
|  |  |  |  |  | **Company and** |  |  |  |  |  |  |  |  |
|  |  | **Financial** | |  | **Financial** |  |  | **Other** |  |  |  |  |  |  | **Financial** | |  |  |
|  |  | **Group, Inc.** | |  | **Services, Inc.** |  |  | **Subsidiaries** |  |  | **Eliminations** | |  |  | **Group, Inc.** | |  |  |
|  |  | **Parent Only** | |  | **Only** |  |  | **Combined** |  |  |  |  | **Consolidated** | |  |  |
|  |  |  |  |  |  |  |  | **(in millions)** |  |  |  |  |  |  |  |  |  |  |
| **Assets** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Fixed maturities, available-for-sale | **$** | **—** | | **$** | **14.9** | **$** | | **42,278.5** | **$** | | **—** | | **$** | | **42,293.4** |  |  |  |
| Fixed maturities, trading |  | **—** | |  | **—** |  |  | **252.0** |  |  | **—** | |  |  | **252.0** |  |  |  |
| Equity securities, available-for-sale |  | **—** | |  | **1.1** |  |  | **676.1** |  |  | **—** | |  |  | **677.2** |  |  |  |
| Equity securities, trading |  | **—** | |  | **—** |  |  | **148.3** |  |  | **—** | |  |  | **148.3** |  |  |  |
| Mortgage loans |  | **—** | |  | **—** |  |  | **11,543.9** |  |  | **—** | |  |  | **11,543.9** |  |  |  |
| Real estate |  | **—** | |  | **—** |  |  | **997.2** |  |  | **—** | |  |  | **997.2** |  |  |  |
| Policy loans |  | **—** | |  | **—** |  |  | **843.2** |  |  | **—** | |  |  | **843.2** |  |  |  |
| Investment in unconsolidated entities |  | **6,664.0** |  |  | **6,935.8** |  |  | **257.6** |  |  | **(13,599.7)** | |  |  | **257.7** |  |  |  |
| Other investments |  | **19.2** |  |  | **19.0** |  |  | **1,092.3** |  |  | **(19.4)** | |  |  | **1,111.1** |  |  |  |
| Cash and cash equivalents |  | **166.7** |  |  | **774.1** |  |  | **1,113.1** |  |  | **(837.0)** | |  |  | **1,216.9** |  |  |  |
| Accrued investment income |  | **—** | |  | **0.2** |  |  | **665.8** |  |  | **—** | |  |  | **666.0** |  |  |  |
| Premiums due and other receivables |  | **¾** |  |  | **1.8** |  |  | **625.0** |  |  | **¾** |  |  |  | **626.8** |  |  |  |
| Deferred policy acquisition cost |  | **—** | |  | **—** |  |  | **2,455.6** |  |  | **—** | |  |  | **2,455.6** |  |  |  |
| Property and equipment |  | **—** | |  | **—** |  |  | **420.2** |  |  | **—** | |  |  | **420.2** |  |  |  |
| Goodwill |  | **—** | |  | **—** |  |  | **297.8** |  |  | **—** | |  |  | **297.8** |  |  |  |
| Other intangibles |  | **—** | |  | **—** |  |  | **199.3** |  |  | **—** | |  |  | **199.3** |  |  |  |
| Separate account assets |  | **—** | |  | **—** |  |  | **65,620.2** |  |  | **—** | |  |  | **65,620.2** |  |  |  |
| Other assets |  | **—** | |  | **1.2** |  |  | **1,803.4** |  |  | **(2.0)** | |  |  | **1,802.6** |  |  |  |
| Total assets | **$** | **6,849.9** |  | **$** | **7,748.1** |  | **$** | **131,289.5** |  | **$** | **(14,458.1** | **)** |  | **$** | **131,429.4** |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | 32 | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Financial Position (continued)**

**June 30, 2006**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  | **Principal Life** | |  |  |  |  |  |  |  |  |  |
|  |  | **Principal** | |  | **Principal** | |  |  | **Insurance** | |  |  |  |  |  | **Principal** | |  |  |
|  |  |  |  |  | **Company and** | |  |  |  |  |  |  |  |
|  |  | **Financial** | |  | **Financial** | |  |  | **Other** | |  |  |  |  |  | **Financial** | |  |  |
|  |  | **Group, Inc.** | |  | **Services, Inc.** | |  |  | **Subsidiaries** | |  | **Eliminations** | |  |  | **Group, Inc.** | |  |  |
|  |  | **Parent Only** | |  | **Only** | |  |  | **Combined** | |  |  |  | **Consolidated** | |  |  |
|  |  |  |  |  |  |  |  |  | **(in millions)** | |  |  |  |  |  |  |  |  |  |
| **Liabilities** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Contractholder funds | **$** | **—** | | **$** | **—** | | **$** | | **35,512.6** |  | **$** | **—** | | **$** | | **35,512.6** |  |  |  |
| Future policy benefits and claims |  | **—** | |  | **—** | |  |  | **17,006.6** |  |  | **—** | |  |  | **17,006.6** |  |  |  |
| Other policyholder funds |  | **—** | |  | **—** | |  |  | **636.3** |  |  | **—** | |  |  | **636.3** |  |  |  |
| Short-term debt |  | **—** | |  | **¾** |  |  |  | **777.1** |  |  | **(352.7)** | |  |  | **424.4** |  |  |  |
| Long-term debt |  | **—** | |  | **464.4** |  |  |  | **429.8** |  |  | **—** | |  |  | **894.2** |  |  |  |
| Income taxes currently payable |  | **(2.0)** | |  | **(3.3)** | |  |  | **2.5** |  |  | **3.3** |  |  |  | **0.5** |  |  |  |
| Deferred income taxes |  | **5.4** |  |  | **5.2** |  |  |  | **600.3** |  |  | **¾** |  |  |  | **610.9** |  |  |  |
| Separate account liabilities |  | **—** | |  | **—** | |  |  | **65,620.2** |  |  | **—** | |  |  | **65,620.2** |  |  |  |
| Other liabilities |  | **1.8** |  |  | **617.8** |  |  |  | **3,768.3** |  |  | **(508.9)** | |  |  | **3,879.0** |  |  |  |
| Total liabilities |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | **5.2** |  |  | **1,084.1** |  |  |  | **124,353.7** |  |  | **(858.3)** | |  |  | **124,584.7** |  |  |  |
| **Stockholders’ equity** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Series A preferred stock |  | **—** | |  | **—** | |  |  | **—** | |  | **—** | |  |  | **—** | |  |  |
| Series B preferred stock |  | **0.1** |  |  | **—** | |  |  | **—** | |  | **—** | |  |  | **0.1** |  |  |  |
| Common stock |  | **3.8** |  |  | **—** | |  |  | **16.8** |  |  | **(16.8)** | |  |  | **3.8** |  |  |  |
| Additional paid-in capital |  | **8,068.8** |  |  | **7,099.1** |  |  |  | **6,142.9** |  |  | **(13,242.0)** | |  |  | **8,068.8** |  |  |  |
| Retained earnings (deficit) |  | **2,504.8** |  |  | **(641.1)** | |  |  | **571.4** |  |  | **69.7** |  |  |  | **2,504.8** |  |  |  |
| Accumulated other comprehensive income |  | **218.5** |  |  | **206.0** |  |  |  | **206.7** |  |  | **(412.7)** | |  |  | **218.5** |  |  |  |
| Treasury stock, at cost |  | **(3,951.3)** | |  | **—** | |  |  | **(2.0)** | |  | **2.0** |  |  |  | **(3,951.3)** | |  |  |
| Total stockholders’ equity |  | **6,844.7** |  |  | **6,664.0** |  |  |  | **6,935.8** |  |  | **(13,599.8)** |  |  |  | **6,844.7** |  |  |  |
| Total liabilities and stockholders’ equity | **$** | **6,849.9** |  | **$** | **7,748.1** |  |  | **$** | **131,289.5** |  | **$** | **(14,458.1** | **)** |  | **$** | **131,429.4** |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | 33 |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Financial Position**

**December 31, 2005**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  | **Principal Life** | |  |  |  |  |  |  |  |  |
|  |  | **Principal** | |  | **Principal** | |  | **Insurance** | |  |  |  |  |  | **Principal** | |  |
|  |  |  |  | **Company and** | |  |  |  |  |  |  |
|  |  | **Financial** | |  | **Financial** | |  | **Other** | |  |  |  |  |  | **Financial** | |  |
|  |  | **Group, Inc.** | |  | **Services, Inc.** | |  | **Subsidiaries** | |  | **Eliminations** | |  |  | **Group, Inc.** | |  |
|  |  | **Parent Only** | |  | **Only** | |  | **Combined** | |  |  |  | **Consolidated** | |  |
|  |  |  |  |  |  |  |  | **(in millions)** | |  |  |  |  |  |  |  |  |
| **Assets** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Fixed maturities, available-for-sale | $ | — | | $ | 14.7 |  | $ | 42,102.5 |  | $ | — | | $ | | 42,117.2 |  |  |
| Fixed maturities, trading |  | — | |  | — | |  | 113.2 |  |  | — | |  |  | 113.2 |  |  |
| Equity securities, available-for-sale |  | — | |  | 1.0 |  |  | 723.4 |  |  | — | |  |  | 724.4 |  |  |
| Equity securities, trading |  | — | |  | — | |  | 90.3 |  |  | — | |  |  | 90.3 |  |  |
| Mortgage loans |  | — | |  | — | |  | 11,484.3 |  |  | — | |  |  | 11,484.3 |  |  |
| Real estate |  | — | |  | — | |  | 999.4 |  |  | — | |  |  | 999.4 |  |  |
| Policy loans |  | — | |  | — | |  | 827.7 |  |  | — | |  |  | 827.7 |  |  |
| Investment in unconsolidated entities |  | 7,784.2 |  |  | 8,168.9 |  |  | 263.8 |  |  | (15,953.0) | |  |  | 263.9 |  |  |
| Other investments |  | — | |  | 8.4 |  |  | 841.2 |  |  | — | |  |  | 849.6 |  |  |
| Cash and cash equivalents |  | 21.6 |  |  | 701.3 |  |  | 1,822.4 |  |  | (904.0) | |  |  | 1,641.3 |  |  |
| Accrued investment income |  | — | |  | 0.2 |  |  | 682.5 |  |  | — | |  |  | 682.7 |  |  |
| Premiums due and other receivables |  | — | |  | 2.3 |  |  | 590.4 |  |  | — | |  |  | 592.7 |  |  |
| Deferred policy acquisition cost |  | — | |  | — | |  | 2,174.1 |  |  | — | |  |  | 2,174.1 |  |  |
| Property and equipment |  | — | |  | — | |  | 419.8 |  |  | — | |  |  | 419.8 |  |  |
| Goodwill |  | — | |  | — | |  | 282.3 |  |  | — | |  |  | 282.3 |  |  |
| Other intangibles |  | — | |  | — | |  | 202.6 |  |  | — | |  |  | 202.6 |  |  |
| Separate account assets |  | — | |  | — | |  | 62,070.0 |  |  | — | |  |  | 62,070.0 |  |  |
| Other assets |  | 3.5 |  |  | 15.0 |  |  | 1,499.9 |  |  | (18.5) | |  |  | 1,499.9 |  |  |
| Total assets | $ | 7,809.3 |  | $ | 8,911.8 |  | $ | 127,189.8 |  | $ | (16,875.5 | ) |  | $ | 127,035.4 |  |  |
| **Liabilities** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Contractholder funds | $ | — | | $ | — | | $ | 33,612.1 |  | $ | — | | $ | | 33,612.1 |  |  |
| Future policy benefits and claims |  | — | |  | — | |  | 16,825.5 |  |  | — | |  |  | 16,825.5 |  |  |
| Other policyholder funds |  | — | |  | — | |  | 657.1 |  |  | — | |  |  | 657.1 |  |  |
| Short-term debt |  | — | |  | 349.9 |  |  | 774.1 |  |  | (647.6) | |  |  | 476.4 |  |  |
| Long-term debt |  | — | |  | 464.3 |  |  | 434.5 |  |  | — | |  |  | 898.8 |  |  |
| Deferred income taxes |  | — | |  | 7.0 |  |  | 983.8 |  |  | (16.0) | |  |  | 974.8 |  |  |
| Separate account liabilities |  | — | |  | — | |  | 62,070.0 |  |  | — | |  |  | 62,070.0 |  |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Other liabilities |  | 2.1 |  |  | 306.4 |  |  | 3,663.8 |  |  | (258.8) | |  | 3,713.5 |  |  |  |
| Total liabilities |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | 2.1 |  |  | 1,127.6 |  |  | 119,020.9 |  |  | (922.4) | |  | 119,228.2 |  |  |  |
| **Stockholders’ equity** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Series A preferred stock |  | ¾ |  |  | — | |  | — | |  | — | | | — | |  |  |
| Series B preferred stock |  | 0.1 |  |  | — | |  | — | |  | — | | | 0.1 |  |  |  |
| Common stock |  | 3.8 |  |  | — | |  | 16.8 |  |  | (16.8) | |  | 3.8 |  |  |  |
| Additional paid-in capital |  | 8,000.0 |  |  | 7,071.3 |  |  | 6,108.7 |  |  | (13,180.0) | |  | 8,000.0 |  |  |  |
| Retained earnings (deficit) |  | 2,008.6 |  |  | (281.9) | |  | 1,050.1 |  |  | (768.2) | |  | 2,008.6 |  |  |  |
| Accumulated other comprehensive income |  | 994.8 |  |  | 994.8 |  |  | 995.3 |  |  | (1,990.1) | |  | 994.8 |  |  |  |
| Treasury stock, at cost |  | (3,200.1) | |  | — | |  | (2.0) | |  | 2.0 |  |  | (3,200.1) | |  |  |
| Total stockholders’ equity |  | 7,807.2 |  |  | 7,784.2 |  |  | 8,168.9 |  |  | (15,953.1) |  |  | 7,807.2 |  |  |  |
| Total liabilities and stockholders’ equity | $ | 7,809.3 |  | $ | 8,911.8 |  | $ | 127,189.8 |  | $ | (16,875.5 | ) | $ | 127,035.4 |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | 34 |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Operations**

**For the six months ended June 30, 2006**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  | **Principal Life** |  |  |  |  |  |  |  |  |
|  |  |  |  | **Principal** | |  |  | **Principal** | |  |  | **Insurance** |  |  |  |  |  | **Principal** |  |  |
|  |  |  |  |  |  |  |  | **Company and** |  |  |  |  |  |  |  |
|  |  |  |  | **Financial** | |  |  | **Financial** | |  |  | **Other** |  |  |  |  |  | **Financial** |  |  |
|  |  |  |  | **Group, Inc.** | |  |  | **Services, Inc.** | |  |  | **Subsidiaries** |  |  | **Eliminations** | |  | **Group, Inc.** |  |  |
|  |  |  |  | **Parent Only** | |  |  | **Only** | |  |  | **Combined** |  |  |  | **Consolidated** |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  | **(in millions)** |  |  |  |  |  |  |  |  |
|  | **Revenues** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Premiums and other considerations | **$** | | **—** | | **$** | | **—** | | **$** | | **2,146.4** | **$** | | **—** | | **$** | **2,146.4** |  |  |
|  | Fees and other revenues |  |  | **—** | |  |  | **—** | |  |  | **900.3** |  |  | **(0.2)** | |  | **900.1** |  |  |
|  | Net investment income |  |  | **1.8** |  |  |  | **6.4** |  |  |  | **1,755.6** |  |  | **—** | |  | **1,763.8** |  |  |
|  | Net realized/unrealized capital gains (losses) |  |  | **—** |  |  |  | **(0.5)** | |  |  | **30.3** |  |  | **—** | |  | **29.8** |  |  |
|  | Total revenues |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  | **1.8** |  |  |  | **5.9** |  |  |  | **4,832.6** |  |  | **(0.2)** | |  | **4,840.1** |  |  |
|  | **Expenses** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Benefits, claims, and settlement expenses |  |  | **—** | |  |  | **—** | |  |  | **2,801.4** |  |  | **—** | |  | **2,801.4** |  |  |
|  | Dividends to policyholders |  |  | **—** | |  |  | **—** | |  |  | **144.4** |  |  | **—** | |  | **144.4** |  |  |
|  | Operating expenses |  |  | **6.9** |  |  |  | **22.8** |  |  |  | **1,194.7** |  |  | **(0.2)** | |  | **1,224.2** |  |  |
|  | Total expenses |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  | **6.9** |  |  |  | **22.8** |  |  |  | **4,140.5** |  |  | **(0.2)** | |  | **4,170.0** |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Income (loss) from continuing operations before income |  |  | **(5.1)** | |  |  | **(16.9)** | |  |  | **692.1** |  |  | **—** | |  | **670.1** |  |  |
|  | taxes |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Income taxes (benefits) |  |  | **(2.0)** | |  |  | **(5.5)** | |  |  | **164.9** |  |  | **—** | |  | **157.4** |  |  |
|  | Equity in the net income of subsidiaries |  |  | **515.8** |  |  |  | **527.2** |  |  |  | **—** |  |  | **(1,043.0)** | |  | **—** |  |  |
|  | Net income |  |  | **512.7** |  |  |  | **515.8** |  |  |  | **527.2** |  |  | **(1,043.0)** |  |  | **512.7** |  |  |
|  | Preferred stock dividends |  |  | **16.5** |  |  |  | **—** | |  |  | **—** |  |  | **—** | |  | **16.5** |  |  |
|  | Net income available to common stockholders |  | **$** | **496.2** |  |  | **$** | **515.8** |  |  | **$** | **527.2** |  | **$** | **(1,043.0** | **)** | **$** | **496.2** |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  | 35 |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Operations**

**For the six months ended June 30, 2005**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  |  | **Principal Life** |  |  |  |  |  |  |  |  |
|  |  |  |  | **Principal** | |  |  | **Principal** | |  |  | **Insurance** |  |  |  |  |  | **Principal** |  |  |
|  |  |  |  |  |  |  |  | **Company and** |  |  |  |  |  |  |  |
|  |  |  |  | **Financial** | |  |  | **Financial** | |  |  | **Other** |  |  |  |  |  | **Financial** |  |  |
|  |  |  |  | **Group, Inc.** | |  |  | **Services, Inc.** | |  |  | **Subsidiaries** |  |  | **Eliminations** | |  | **Group, Inc.** |  |  |
|  |  |  |  | **Parent Only** | |  |  | **Only** | |  |  | **Combined** |  |  |  | **Consolidated** |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  | **(in millions)** |  |  |  |  |  |  |  |  |
|  | **Revenues** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Premiums and other considerations | $ | | — | | $ | | — | | $ | | 1,883.0 | $ | | — | | $ | 1,883.0 |  |  |
|  | Fees and other revenues |  |  | — | |  |  | — | |  |  | 822.6 |  |  | (0.1) | |  | 822.5 |  |  |
|  | Net investment income |  |  | 1.1 |  |  |  | 4.5 |  |  |  | 1,624.3 |  |  | — | |  | 1,629.9 |  |  |
|  | Net realized/unrealized capital gains |  |  | — |  |  |  | 0.2 |  |  |  | 8.5 |  |  | — |  |  | 8.7 |  |  |
|  | Total revenues |  |  | 1.1 |  |  |  | 4.7 |  |  |  | 4,338.4 |  |  | (0.1) | |  | 4,344.1 |  |  |
|  | **Expenses** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Benefits, claims, and settlement expenses |  |  | — | |  |  | — | |  |  | 2,498.8 |  |  | — | |  | 2,498.8 |  |  |
|  | Dividends to policyholders |  |  | — | |  |  | — | |  |  | 145.1 |  |  | — | |  | 145.1 |  |  |
|  | Operating expenses |  |  | 5.4 |  |  |  | 23.2 |  |  |  | 1,109.2 |  |  | (0.1) | |  | 1,137.7 |  |  |
|  | Total expenses |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  | 5.4 |  |  |  | 23.2 |  |  |  | 3,753.1 |  |  | (0.1) | |  | 3,781.6 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Income (loss) from continuing operations before income |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | taxes |  |  | (4.3) | |  |  | (18.5) | |  |  | 585.3 |  |  | — | |  | 562.5 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Income taxes (benefits) |  |  | (2.1) | |  |  | (2.1) | |  |  | 138.2 |  |  | — | |  | 134.0 |  |  |
|  | Equity in the net income of subsidiaries, excluding |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | discontinued operations |  |  | 430.7 |  |  |  | 447.1 |  |  |  | ¾ |  |  | (877.8) | |  | — |  |  |
|  | Income (loss) from continuing operations, net of related |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | income taxes |  |  | 428.5 |  |  |  | 430.7 |  |  |  | 447.1 |  |  | (877.8) | |  | 428.5 |  |  |
|  | Income from discontinued operations, net of related income |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | taxes |  |  | 15.9 |  |  |  | 15.9 |  |  |  | 15.9 |  |  | (31.8) | |  | 15.9 |  |  |
|  | Net income |  | $ | 444.4 |  |  | $ | 446.6 |  |  | $ | 463.0 |  | $ | (909.6 | ) | $ | 444.4 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  | 36 |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Cash Flows**

**For the six months ended June 30, 2006**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **Principal** | |  | **Principal** |  |  | **Principal Life** | |  |  |  |  |  |  | **Principal** | |  |  |
|  |  |  |  |  | **Insurance** | |  |  |  |  |  |  |  |  |
|  |  | **Financial** | |  | **Financial** |  |  | **Company and** | |  |  |  |  |  |  | **Financial** | |  |  |
|  |  | **Group, Inc.** | |  | **Services, Inc.** |  |  | **Other Subsidiaries** | |  |  | **Eliminations** | |  |  | **Group, Inc.** | |  |  |
|  |  | **Parent Only** | |  | **Only** |  |  | **Combined** | |  |  |  |  | **Consolidated** | |  |  |
|  |  |  |  |  |  |  |  | **(in millions)** | |  |  |  |  |  |  |  |  |  |  |
| **Operating activities** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Net cash provided by (used in) operating activities | **$** | **(1.8)** | | **$** | **220.6** | **$** | | **1,101.0** |  | **$** | | **(215.0)** | | **$** | | **1,104.8** |  |  |  |
| **Investing activities** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Available-for-sale securities: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Purchases |  | **—** | |  | **68.9** |  |  | **(4,453.3)** | |  |  | **—** | |  |  | **(4,384.4)** | |  |  |
| Sales |  | **—** | |  | **2.0** |  |  | **743.3** |  |  |  | **—** | |  |  | **745.3** |  |  |  |
| Maturities |  | **—** | |  | **—** |  |  | **1,873.0** |  |  |  | **—** | |  |  | **1,873.0** |  |  |  |
| Mortgage loans acquired or originated |  | **—** | |  | **—** |  |  | **(1,542.5)** | |  |  | **—** | |  |  | **(1,542.5)** | |  |  |
| Mortgage loans sold or repaid |  | **—** | |  | **—** |  |  | **1,192.3** |  |  |  | **—** | |  |  | **1,192.3** |  |  |  |
| Real estate acquired |  | **—** | |  | **—** |  |  | **(18.7)** | |  |  | **—** | |  |  | **(18.7)** | |  |  |
| Real estate sold |  | **—** | |  | **—** |  |  | **11.4** |  |  |  | **—** | |  |  | **11.4** |  |  |  |
| Net purchases of property and equipment |  | **—** | |  | **—** |  |  | **(23.2)** | |  |  | **—** | |  |  | **(23.2)** | |  |  |
| Purchases of interest in subsidiaries, net of cash acquired |  | **—** | |  | **—** |  |  | **(5.5)** | |  |  | **—** | |  |  | **(5.5)** | |  |  |
| Dividends received from unconsolidated entities |  | **876.3** |  |  | **984.7** |  |  | **—** | |  |  | **(1,861.0)** | |  |  | **—** | |  |  |
| Net change in other investments |  | **¾** |  |  | **22.9** |  |  | **74.4** |  |  |  | **(13.0)** | |  |  | **84.3** |  |  |  |
| Net cash provided by (used in) investing activities |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **$** | **876.3** | **$** | **1,078.5** | **$** | **(2,148.8)** | | **$** | **(1,874.0)** | | **$** | **(2,068.0)** | |  |  |
|  |  | 37 | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Cash Flows (continued)**

**For the six months ended June 30, 2006**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  | **Principal Life** | |  |  |  |  |  |  |  |  |  |
|  |  |  |  | **Principal** | |  |  | **Principal** | |  | **Insurance** | |  |  |  |  |  | **Principal** | |  |  |
|  |  |  |  |  |  |  | **Company and** | |  |  |  |  |  |  |  |
|  |  |  |  | **Financial** | |  |  | **Financial** | |  | **Other** | |  |  |  |  |  | **Financial** | |  |  |
|  |  |  |  | **Group, Inc.** | |  |  | **Services, Inc.** | |  | **Subsidiaries** | |  | **Eliminations** | |  |  | **Group, Inc.** | |  |  |
|  |  |  |  | **Parent Only** | |  |  | **Only** | |  | **Combined** | |  |  |  | **Consolidated** | |  |  |
|  |  |  |  |  |  |  |  |  |  |  | **(in millions)** | |  |  |  |  |  |  |  |  |  |
|  | **Financing activities** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Issuance of common stock | **$** | | **38.3** |  | **$** | | **—** | | **$** | **—** | | **$** | **—** | | **$** | | **38.3** |  |  |  |
|  | Acquisition of treasury stock, net |  |  | **(751.2)** | |  |  | **—** | |  | **—** | |  | **—** | |  |  | **(751.2)** | |  |  |
|  | Proceeds from financing element derivatives |  |  | **—** | |  |  | **—** | |  | **81.3** |  |  | **—** | |  |  | **81.3** |  |  |  |
|  | Payments for financing element derivatives |  |  | **—** | |  |  | **—** | |  | **(69.9)** | |  | **—** | |  |  | **(69.9)** | |  |  |
|  | Excess tax benefits from share-based payment arrangements |  |  | **—** | |  |  | **—** | |  | **2.6** |  |  | **—** | |  |  | **2.6** |  |  |  |
|  | Dividends to preferred stockholders |  |  | **(16.5)** | |  |  | **—** | |  | **—** | |  | **—** | |  |  | **(16.5)** | |  |  |
|  | Issuance of long-term debt |  |  | **—** | |  |  | **—** | |  | **8.7** |  |  | **—** | |  |  | **8.7** |  |  |  |
|  | Principal repayments of long-term debt |  |  | **—** | |  |  | **—** | |  | **(6.3)** | |  | **—** | |  |  | **(6.3)** | |  |  |
|  | Net proceeds (repayments) of short-term borrowings |  |  | **—** | |  |  | **(350.0)** | |  | **5.4** |  |  | **295.0** |  |  |  | **(49.6)** | |  |  |
|  | Dividends paid to parent |  |  | **—** | |  |  | **(876.3)** | |  | **(984.7)** | |  | **1,861.0** |  |  |  | **—** | |  |  |
|  | Investment contract deposits |  |  | **—** | |  |  | **—** | |  | **4,835.7** |  |  | **—** | |  |  | **4,835.7** |  |  |  |
|  | Investment contract withdrawals |  |  | **—** | |  |  | **—** | |  | **(3,609.7)** | |  | **—** | |  |  | **(3,609.7)** | |  |  |
|  | Net increase in banking operation deposits |  |  | **—** |  |  |  | **—** |  |  | **75.4** |  |  | **—** |  |  |  | **75.4** |  |  |  |
|  | Net cash provided by (used in) financing activities |  |  | **(729.4)** | |  |  | **(1,226.3)** | |  | **338.5** |  |  | **2,156.0** |  |  |  | **538.8** |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Net increase (decrease) in cash and cash equivalents |  |  | **145.1** |  |  |  | **72.8** |  |  | **(709.3)** | |  | **67.0** |  |  |  | **(424.4)** | |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Cash and cash equivalents at beginning of period |  |  | **21.6** |  |  |  | **701.3** |  |  | **1,822.4** |  |  | **(904.0)** | |  |  | **1,641.3** |  |  |  |
|  | Cash and cash equivalents at end of period |  | **$** | **166.7** |  |  | **$** | **774.1** |  | **$** | **1,113.1** |  | **$** | **(837.0** | **)** |  | **$** | **1,216.9** |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  | 38 |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Cash Flows – (As Restated – See Note 1)**

**For the six months ended June 30, 2005**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  | **Principal Life** | |  |  |  |  |  |  |  |
|  |  |  | **Principal** | |  | **Principal** | |  | **Insurance** | |  |  |  |  | **Principal** | |  |
|  |  |  |  |  | **Company and** | |  |  |  |  |  |
|  |  |  | **Financial** | |  | **Financial** | |  | **Other** | |  |  |  |  | **Financial** | |  |
|  |  |  | **Group, Inc.** | |  | **Services, Inc.** | |  | **Subsidiaries** | |  | **Eliminations** | |  | **Group, Inc.** | |  |
|  |  |  | **Parent Only** | |  | **Only** | |  | **Combined** | |  |  | **Consolidated** | |  |
|  |  |  |  |  |  |  |  |  | **(in millions)** | |  |  |  |  |  |  |  |
| **Operating activities** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Net cash provided by (used in) operating activities | $ | | (2.6) | | $ | 53.4 |  | $ | 813.7 |  | $ | (58.1) | | $ | 806.4 |  |  |
| **Investing activities** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Available-for-sale securities: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Purchases |  |  | — | |  | 139.2 |  |  | (4,892.7) | |  | — | |  | (4,753.5) | |  |
| Sales |  |  | — | |  | (141.2) | |  | 1,101.3 |  |  | — | |  | 960.1 |  |  |
| Maturities |  |  | — | |  | — | |  | 3,046.6 |  |  | — | |  | 3,046.6 |  |  |
| Mortgage loans acquired or originated |  |  | — | |  | — | |  | (1,272.9) | |  | — | |  | (1,272.9) | |  |
| Mortgage loans sold or repaid |  |  | — | |  | — | |  | 1,264.4 |  |  | — | |  | 1,264.4 |  |  |
| Real estate acquired |  |  | — | |  | — | |  | (161.0) | |  | — | |  | (161.0) | |  |
| Real estate sold |  |  | — | |  | — | |  | 267.2 |  |  | — | |  | 267.2 |  |  |
| Net purchases of property and equipment |  |  | — | |  | — | |  | (18.1) | |  | — | |  | (18.1) | |  |
| Purchases of interest in subsidiaries, net of cash acquired |  |  | — | |  | — | |  | (54.4) | |  | — | |  | (54.4) | |  |
| Dividends received from unconsolidated entities |  |  | 251.1 |  |  | 19.9 |  |  | 4.1 |  |  | (275.1) | |  | — | |  |
| Net change in other investments |  |  | — |  |  | 9.5 |  |  | (52.2) | |  | 1.5 |  |  | (41.2) | |  |
| Net cash provided by (used in) investing activities |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | 251.1 |  | 27.4 |  | (767.7) | |  | (273.6) | |  | (762.8) | |  |
| **Financing activities** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Issuance of common stock |  |  | 25.8 |  |  | — | |  | — | |  | — | |  | 25.8 |  |  |
| Issuance of preferred stock |  |  | 542.0 |  |  |  |  |  |  |  |  |  |  |  | 542.0 |  |  |
| Acquisition and sales of treasury stock, net |  |  | (868.4) | |  | — | |  | — | |  | — | |  | (868.4) | |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Proceeds from financing element derivatives |  | — | |  | — | |  | 83.0 |  |  | — | |  | 83.0 |  |  |
| Payments for financing element derivatives |  | — | |  | — | |  | (55.6) | |  | — | |  | (55.6) | |  |
| Issuance of long-term debt |  | — | |  | — | |  | 12.2 |  |  | — | |  | 12.2 |  |  |
| Principal repayments of long-term debt |  | — | |  | — | |  | (11.5) | |  | — | |  | (11.5) | |  |
| Net proceeds of short-term borrowings |  | — | |  | 200.0 |  |  | 3.5 |  |  | (31.1) | |  | 172.4 |  |  |
| Dividends paid to parent |  | — | |  | (251.2) | |  | (23.9) | |  | 275.1 |  |  | — | |  |
| Investment contract deposits |  | — | |  | — | |  | 4,072.6 |  |  | — | |  | 4,072.6 |  |  |
| Investment contract withdrawals |  | — | |  | — | |  | (3,319.5) | |  | — | |  | (3,319.5) | |  |
| Net increase in banking operation deposits |  | — |  |  | — |  |  | 22.7 |  |  | — |  |  | 22.7 |  |  |
| Net cash provided by (used in) financing activities | $ | (300.6) | | $ | (51.2) | | $ | 783.5 |  | $ | 244.0 |  | $ | 675.7 |  |  |
|  |  | 39 | |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Principal Financial Group, Inc.**

**Notes to Consolidated Financial Statements (continued)**

**June 30, 2006**

**(Unaudited)**

**11. Condensed Consolidating Financial Information (continued)**

**Condensed Consolidating Statements of Cash Flows** – **(As Restated** – **See Note 1) (continued)**

**For the six months ended June 30, 2005**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  | **Principal Life** | |  |  |  |  |  |  |  |
|  |  |  |  | **Principal** | |  |  | **Principal** |  |  | **Insurance** | |  |  |  |  | **Principal** | |  |
|  |  |  |  |  |  |  |  | **Company and** | |  |  |  |  |  |
|  |  |  |  | **Financial** | |  |  | **Financial** |  |  | **Other** | |  |  |  |  | **Financial** | |  |
|  |  |  |  | **Group, Inc.** | |  |  | **Services, Inc.** |  |  | **Subsidiaries** | |  | **Eliminations** | |  | **Group, Inc.** | |  |
|  |  |  |  | **Parent Only** | |  |  | **Only** |  |  | **Combined** | |  |  | **Consolidated** | |  |
|  |  |  |  |  |  |  |  |  |  |  | **(in millions)** | |  |  |  |  |  |  |  |
|  | **Discontinued operations** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Net cash used in operating activities | $ | | — | | $ | | — | $ | | (0.1) | | $ | — | | $ | (0.1) | |  |
|  | Net cash used in investing activities |  |  | — |  |  |  | — |  |  | (0.1) | |  | — | |  | (0.1) | |  |
|  | Net cash used in discontinued operations |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  | — |  |  | — |  |  | (0.2) | |  | — |  | (0.2) | |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Net increase (decrease) in cash and cash equivalents |  |  | (52.1) | |  |  | 29.6 |  |  | 829.3 |  |  | (87.7) | |  | 719.1 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Cash and cash equivalents at beginning of period |  |  | 75.4 |  |  |  | 551.9 |  |  | 521.0 |  |  | (695.8) | |  | 452.5 |  |  |
|  | Cash and cash equivalents at end of period |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | $ | 23.3 |  | $ | 581.5 | $ | 1,350.3 |  | $ | (783.5) | | $ | 1,171.6 |  |  |
|  | **Cash and cash equivalents of discontinued operations** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | **included above** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | At beginning of period | $ | | — | | $ | | — | $ | | 1.9 |  | $ | — | | $ | 1.9 |  |  |
|  | At end of period | $ | | — | | $ | | — | $ | | 1.7 |  | $ | — | | $ | 1.7 |  |  |

**12. Subsequent Event**

On July 25, 2006, we announced a definitive agreement to acquire WM Advisors, Inc., and its subsidiaries from Washington Mutual, Inc., for $740.0 million in cash, subject to closing adjustments. We expect the transaction to close in the fourth quarter 2006 or early 2007.

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

The following analysis discusses our financial condition as of June 30, 2006, compared with December 31, 2005, and our consolidated results of operations for the three and six months ended June 30, 2006 and 2005, prepared in conformity with accounting principles generally accepted in the U.S. (“U.S. GAAP”). The discussion and analysis includes, where appropriate, factors that may affect our future financial performance. The discussion should be read in conjunction with our Form 10-K, for the year ended December 31, 2005, filed with the United States Securities and Exchange Commission (“SEC”) and the unaudited consolidated financial statements and the related notes to the financial statements and the other financial information included elsewhere in this Form 10-Q.

**Forward-Looking Information**

Our narrative analysis below contains forward-looking statements intended to enhance the reader’s ability to assess our future financial performance. Forward-looking statements include, but are not limited to, statements that represent our beliefs concerning future operations, strategies, financial results or other developments, and contain words and phrases such as “anticipate,” “believe,” “plan,” “estimate,” “expect,” “intend,” and similar expressions. Forward-looking statements are made based upon management’s current expectations and beliefs concerning future developments and their potential effects on us. Such forward-looking statements are not guarantees of future performance.

Actual results may differ materially from those included in the forward-looking statements as a result of risks and uncertainties including, but not limited to the following: (1) a decline or increased volatility in the securities markets could result in investors withdrawing from the markets or decreasing their rates of investment, either of which could reduce our net income, revenues and assets under management; (2) our investment portfolio is subject to several risks which may diminish the value of our invested assets and affect our sales, profitability and the investment returns credited to our customers; (3) competition from companies that may have greater financial resources, broader arrays of products, higher ratings and stronger financial performance may impair our ability to retain existing customers, attract new customers and maintain our profitability; (4) a downgrade in any of our ratings may increase policy surrenders and withdrawals, reduce new sales and terminate relationships with distributors and cause some of our existing liabilities to be subject to acceleration, additional collateral support, changes in terms, or creation of additional financial obligations; (5) our efforts to reduce the impact of interest rate changes on our profitability and surplus may not be effective; (6) if we are unable to attract and retain sales representatives and develop new distribution sources, sales of our products and services may be reduced; (7) our international businesses face political, legal, operational and other risks that could reduce our profitability in those businesses; (8) our reserves established for future policy benefits and claims may prove inadequate, requiring us to increase liabilities; (9) our ability to pay stockholder dividends and meet our obligations may be constrained by the limitations on dividends Iowa insurance laws impose on Principal Life Insurance Company (“Principal Life”); (10) the pattern of amortizing our deferred policy acquisition costs on our Statement of Financial Accounting Standard (“SFAS”) No. 97 *Accounting and Reporting by* *Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* products may change, impactingboth the level of the asset and the emergence of our operating earnings; (11) we may need to fund deficiencies in our closed block (“Closed Block”) assets;

1. changes in laws, regulations or accounting standards may reduce our profitability; (13) litigation and regulatory investigations may affect our financial strength or reduce our profitability; (14) fluctuations in foreign currency exchange rates could reduce our profitability; and (15) applicable laws and our stockholder rights plan, certificate of incorporation and by-laws may discourage takeovers and business combinations that our stockholders might consider in their best interests. For a more comprehensive discussion of these risks and uncertainties, please see Item 1A, Risk Factors, in our Annual Report on Form 10-K for the year ended December 31, 2005.

**Overview**

We provide financial products and services through the following segments:

* U.S. Asset Management and Accumulation, which consists of our asset accumulation operations, which provide retirement savings and related investment products and services, and our asset management operations conducted through Principal Global Investors. We provide a comprehensive portfolio of asset accumulation products and services to businesses and individuals in the U.S., with a concentration on small and medium-sized businesses, which we define as businesses with fewer than 1,000 employees. We offer to businesses products and services for defined contribution pension plans, including 401(k) and 403(b) plans, defined benefit pension plans, non-qualified executive benefit plans, and employee stock ownership plan consulting services. We also offer annuities, mutual funds and bank products and services to the employees of our business customers and other individuals. Principal Global Investors offers an extensive range of equity, fixed income and real estate investments as well as specialized overlay and advisory services to institutional investors.

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* International Asset Management and Accumulation, which consists of Principal International, offers retirement products and services, annuities, long-term mutual funds and life insurance through operations in Chile, Mexico, Hong Kong, Brazil, India, China, and Malaysia.
* Life and Health Insurance, which provides individual life insurance, group health insurance as well as specialty benefits in the U.S. Our individual life insurance products include universal and variable universal life insurance and traditional life insurance. Our health insurance products include group medical insurance and fee-for-service claims administration and wellness services. Our specialty benefit products include group dental and vision insurance, individual and group disability insurance, and group life insurance.
* Corporate and Other, which manages the assets representing capital that has not been allocated to any other segment. Financial results of the Corporate and Other segment primarily reflect our financing activities (including interest expense), income on capital not allocated to other segments, inter-segment eliminations, income tax risks and certain income, expenses and other after-tax adjustments not allocated to the segments based on the nature of such items.

**Transactions Affecting Comparability of Results of Operations**

***Acquisitions***

We acquired the following businesses, among others, during 2006 and 2005:

***WM Advisors, Inc.*** On July 25, 2006, we announced a definitive agreement to acquire WM Advisors, Inc. (“WM Advisors”) and its subsidiariesfrom Washington Mutual, Inc., for $740.0 million in cash, subject to closing adjustments. WM Advisors, with more than $26.0 billion in assets under management, provides investment advisory services to mutual funds, variable trust funds and asset allocation portfolios to approximately 800,000 shareholder accounts nationwide. We expect the transaction to close in the fourth quarter 2006 or early 2007. The operations of WM Advisors, Inc. will be reported and consolidated in our U.S. Asset Management and Accumulation segment.

***Principal Global Services Private Limited.*** In December 2005, we formed Principal Global Services Private Limited (“PGS”), which will operate inPune, India, starting in the second half of 2006. PGS employees will perform services for our U.S. operations including claims data entry, 401(k) processing, IT coding/application development, and IT quality assurance. PGS start up costs are reported in our Corporate and Other segment. Once operating, expenses will be allocated to the segments for which services are performed.

***Principal Commercial Funding II.*** On October 24, 2005, Principal Real Estate Investors and U.S. Bank National Association announced that theyagreed to create Principal Commercial Funding II, a jointly-owned business that will compete in the commercial mortgage-backed securities (“CMBS”) market. Principal Real Estate Investors is the real estate investment arm of Principal Global Investors. U.S. Bank National Association is the principal banking subsidiary of U.S. Bancorp. The new company is the CMBS platform for both Principal Real Estate Investors and U.S. Bank National Association and focuses on securitizing commercial mortgages originated by both Principal Real Estate Investors and U.S. Bank National Association on its behalf. Principal Commercial Funding II began operations immediately, and began contributing collateral to securitizations during the first quarter of 2006. The operations of Principal Commercial Funding II are reported in our U.S. Asset Management and Accumulation segment using the equity method of accounting.

***CCB-Principal Asset Management Company, Ltd.*** On August 7, 2005, we announced that we entered into a joint venture agreement with ChinaConstruction Bank (“CCB”) to market mutual funds in the People’s Republic of China. We closed the transaction on September 19, 2005 with a 25% ownership in CCB-Principal Asset Management Company, Ltd. The operations of CCB-Principal Asset Management Company, Ltd are reported in our International Asset Management and Accumulation segment using the equity method of accounting.

***PNB Principal Insurance Advisory Company Pvt. Ltd.*** On February 21, 2005, Principal Financial Group (Mauritius) Ltd. (“PFGM”) acquired a 26%stake and management control of PNB Principal Insurance Advisory Company Pvt. Ltd. (“PPIAC”), an insurance brokerage company in India. The operations of PPIAC are reported and consolidated in our International Asset Management and Accumulation segment.

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***Dispositions***

We entered into disposition agreements or disposed of the following business, among others, during 2006 and 2005:

***ING/Principal Pensions Company Ltd.*** On May 26, 2005, we announced jointly with our partner, ING, the intent to liquidate the ING/PrincipalPensions Company, Ltd. operation in Japan. On December 20, 2005, the liquidation process was completed with a formal liquidation filing to the Japanese corporate registry. The results of ING/Principal Pensions Company Ltd. were reported in our International Asset Management and Accumulation segment.

***Real Estate Investment.*** On May 25, 2005, we entered into a definitive agreement for the sale of a real estate property previously held forinvestment purposes. This property qualifies for discontinued operations treatment under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (“SFAS 144”). Therefore, the results of operations have been removed from our results of continuing operations and cash flows for all periodspresented. The gain on disposal is reported as an other after-tax adjustment in our Corporate and Other segment.

Selected financial information for the discontinued operation is as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  | **For the three months** | | | |  |  |  | **For the six months** | | | | |  |
|  |  |  | **ended June 30,** | | | |  |  |  | **ended June 30,** | | | | |  |
|  |  |  | **2006** |  |  | **2005** | |  |  | **2006** |  |  | **2005** |  |  |
|  |  |  |  |  |  |  | **(in millions)** | | |  |  |  |  |  |  |
|  | Total revenues | $ | | — | | $ | 0.7 |  | $ | — | | $ | 1.4 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Income from discontinued operations: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Income before income taxes | $ | | — | | $ | 0.7 |  | $ | — | | $ | 1.4 |  |  |
|  | Income taxes |  |  | — | |  | 0.3 |  |  | — | |  | 0.5 |  |  |
|  | Income from discontinued operations, net of related income taxes |  |  | — |  |  | 0.4 |  |  | — |  |  | 0.9 |  |  |
|  | Gain on disposal of discontinued operations, net of related income taxes |  |  | — | |  | 14.7 |  |  | — | |  | 14.7 |  |  |
|  | Net income |  | $ | — |  | $ | 15.1 |  | $ | — |  | $ | 15.6 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

**Fluctuations in Foreign Currency to U.S. Dollar Exchange Rates**

Fluctuations in foreign currency to U.S. dollar exchange rates for countries in which we have operations can affect reported financial results. In years when foreign currencies weaken against the U.S. dollar, translating foreign currencies into U.S. dollars results in fewer U.S. dollars to be reported. When foreign currencies strengthen, translating foreign currencies into U.S. dollars results in more U.S. dollars to be reported.

Foreign currency exchange rate fluctuations create variances in our financial statement line items but have not had a material impact on our consolidated income from continuing operations. Our consolidated income from continuing operations was positively impacted by $1.0 million and $1.1 million for the three months ended June 30, 2006 and 2005, respectively, and positively impacted $3.4 million and $1.4 million for the six months ended June 30, 2006 and 2005, respectively, as a result of fluctuations in foreign currency to U.S. dollar exchange rates. For a discussion of our approaches to foreign currency exchange rate risk, see Item 3. “Quantitative and Qualitative Disclosures about Market Risk.”

**Stock-Based Compensation Plans**

As of June 30, 2006, we have the 2005 Stock Incentive Plan, the Employee Stock Purchase Plan, the 2005 Directors Stock Plan, the Stock Incentive Plan, the Directors Stock Plan and the Long-Term Performance Plan. As of May 17, 2005, no new grants will be made under the Stock Incentive Plan, the Directors Stock Plan or the Long-Term Performance Plan (“Stock-Based Compensation Plans”). Under the terms of the 2005 Stock Incentive Plan, grants may be nonqualified stock options, incentive stock options qualifying under Section 422 of the Internal Revenue Code, restricted stock, restricted stock units, stock appreciation rights, performance shares, performance units, or other stock based awards. The 2005 Directors Stock Plan provides for the grant of nonqualified stock options, restricted stock, restricted stock units, or other stock-based awards to our nonemployee directors. To date, we have not granted any incentive stock options, restricted stock or performance units.

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The compensation cost that was charged against income for the Stock-Based Compensation Plans was $15.9 million and $12.2 million, and the related income tax benefit recognized in the income statement was $5.2 million and $3.9 million for the three months ended June 30, 2006 and 2005, respectively. The compensation cost that was charged against income for the Stock-Based Compensation Plans was $27.5 million and $19.5 million, and the related income tax benefit recognized in the income statement was $8.5 million and $6.0 million for the six months ended June 30, 2006 and 2005, respectively. For awards with

graded vesting, we use an accelerated expense attribution method. The total compensation cost capitalized as part of the cost of an asset was $0.9 million and $0.5 million for the three months ended June 30, 2006 and 2005 and $1.8 million and $0.7 million for the six months ended June 30, 2006 and 2005, respectively.

Beginning in 2006, we granted performance share awards to certain employees. The performance share awards are treated as an equity award and are paid in shares. Whether the performance shares are earned depends upon the participant’s continued employment through the performance period and our performance against three-year goals set at the beginning of the performance period. A return on equity objective and an earnings per share objective must be achieved for any of the performance shares to be earned. If the performance requirements are not met, the performance shares will be forfeited and no compensation cost is recognized and any previously recognized compensation cost is reversed. There is no maximum contractual term on these awards.

The total compensation cost related to nonvested awards not yet recognized is $47.2 million. This compensation cost is expected to be recognized over a weighted average period of approximately 2 years.

**Pension and 401(k) Benefit Expense**

Effective January 1, 2006, we made changes to our retirement program, including the Principal Select Savings Plan (“401(k) Plan”) and the Principal Pension Plan (“Pension Plan”) and the corresponding nonqualified plans. The qualified and nonqualified Pension Plans’ changes include a reduction to the traditional and cash balance formulas, a change in the early retirement factors, and the removal of the cost of living adjustments for traditional benefits earned after January 1, 2006. The qualified and nonqualified 401(k) Plans’ company match increased from 50 percent of a 6 percent deferral to 75 percent of an 8 percent deferral. The Pension Plan changes reduced the Pension Plan expense in 2006, while the 401(k) changes increased the 401(k) expense.

The 2006 pension expense for substantially all of our employees and certain agents is expected to be approximately $34.6 million. This is a decrease of $14.0 million over the 2005 pension expense. This decrease is due to the reduction in the Pension Plan formulas and asset performance in excess of our 8.5% long-term assumption. Partially offsetting this was an increase attributable to the use of a lower discount rate and lower long-term asset return assumption. Approximately $8.7 million and $17.3 million of pre-tax pension expense was reflected in the determination of net income for the three and six months ended June 30, 2006, respectively. In addition, approximately $8.6 million of pre-tax pension expense will be reflected in each of the following two quarters for 2006. The discount rate used to develop the 2006 expense was lowered to 5.75%, from the 6.0% discount rate used to develop the 2005 expense. The long-term asset assumption was also lowered to 8.25%, from the 8.50% assumption used to develop the 2005 expense. The 2006 decrease in pension expense is expected to be offset by a $19.7 million increase in the qualified and nonqualified 401(k) Plans’ company matching expense resulting from the January 1, 2006 changes.

**Recent Accounting Pronouncements**

On July 13, 2006, the Financial Accounting Standards Board (the “FASB”) issued FASB Interpretation (“FIN”) No. 48, *Accounting for Uncertainty* *in Income Taxes* (“FIN 48”). FIN 48, which is an interpretation of Statement of Financial Accounting Standards (“SFAS”) No. 109, *Accounting for Income Taxes*, prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken, orexpected to be taken, in a tax return. FIN 48 requires the affirmative evaluation that it is more likely than not, based on the technical merits of a tax position, that an enterprise is entitled to economic benefits resulting from positions taken in income tax returns. If a tax position does not meet the more-likely-than-not recognition threshold, the benefit of that position is not recognized in the financial statements. FIN 48 also requires companies to disclose additional quantitative and qualitative information in their financial statements about uncertain tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006, and the cumulative effect of applying this Interpretation shall be reported as an adjustment to the opening balance of retained earnings for that fiscal year. FIN 48 is not expected to have a material impact on our consolidated financial statements.

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On March 17, 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets* (“SFAS 156”), which amends SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (“SFAS 140”). This Statement (1) requires an entity torecognize a servicing asset or liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in specified situations, (2) requires all separately recognized servicing assets and liabilities to be initially measured at fair value, (3) for subsequent measurement of each class of separately recognized servicing assets and liabilities, an entity can elect either the amortization or fair value measurement method, (4) permits a one-time reclassification of available-for-sale (“AFS”) securities to trading securities by an entity with recognized servicing rights, without calling into question the treatment of other AFS securities, provided the AFS securities are identified in some manner as offsetting the entity’s exposure to changes in fair value of servicing assets or liabilities that a servicer elects to subsequently measure at fair value, and (5) requires separate presentation of servicing assets and liabilities measured at fair value in the statement of financial position and also requires additional disclosures. The initial measurement requirements of this statement should be applied prospectively to all transactions entered into after the fiscal year beginning after September 15, 2006. The election related to the subsequent measurement of servicing assets and liabilities is also effective the first fiscal year beginning after September 15, 2006. SFAS 156 is not expected to have a material impact on our consolidated financial statements.

On February 16, 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments – an amendment of FASB Statements* *No. 133 and 140* (“SFAS 155”), which amends SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (“SFAS 133”) and SFAS 140.SFAS 155 (1) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (2) clarifies which interest-only and principal-only strips are not subject to the requirements of SFAS 133, (3) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (4) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (5) amends SFAS 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This Statement is effective for all financial instruments acquired or issued after the beginning of an entity’s fiscal year that begins after September 15, 2006. At adoption, the fair value election may also be applied to hybrid financial instruments that have been bifurcated under SFAS 133 prior to adoption of this Statement. Any changes resulting from the adoption of this Statement should be recognized as a cumulative effect adjustment to beginning retained earnings. SFAS 155 is not expected to have a material impact on our consolidated financial statements.

On December 16, 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (“SFAS 123R”). SFAS 123R requires all share-based payments to employees to be recognized at fair value in the financial statements. SFAS 123R replaces SFAS No. 123, *Accounting for Stock-Based* *Compensation* (“SFAS 123”), supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees* (“APB 25”), and SFAS No. 148, *Accounting for*

*Stock-Based Compensation-Transition and Disclosure - an Amendment of FASB Statement No. 123* and amends SFAS No. 95, *Statement of Cash Flows*. OnApril 14, 2005, the SEC approved a new rule delaying the effective date of SFAS 123R to annual periods that begin after June 15, 2005. Accordingly, we adopted SFAS 123R effective January 1, 2006 using the modified-prospective method.

It is appropriate to recognize compensation cost either immediately for stock awards granted to retirement eligible employees, or over the period from the grant date to the date retirement eligibility is achieved, if retirement eligibility is expected to occur during the nominal vesting period. Our approach was to follow the widespread practice of recognizing compensation cost over the explicit service period (up to the date of actual retirement). For any awards that are granted after our adoption of SFAS 123R on January 1, 2006, we recognize compensation cost through the period that the employee first becomes eligible to retire and is no longer required to provide service to earn the award. If we had applied the nonsubstantive vesting provisions of SFAS 123R to awards granted prior to January 1, 2006, our consolidated financial statements would not have been materially impacted.

SFAS 123R requires that the benefits of tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. While the Company cannot estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options), the amount of financing cash flows recognized for the six months ended June 30, 2006, for such excess tax deductions, was $2.6 million.

Under the modified-prospective method, any excess income tax deduction realized for awards accounted for under SFAS 123R (regardless of the type of award or the jurisdiction in which the tax benefit is generated) is eligible to absorb write-offs of deferred income tax assets for any awards accounted for under SFAS 123R. SFAS 123R does not require separate pools of excess income tax benefits for separate types of awards, rather the excess income tax benefits of employee and nonemployee awards may be combined in a single pool of excess tax benefits. Our policy is to pool the employee and

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nonemployee awards together in this manner. Deferred income tax asset write-offs resulting from deficient deductions on employee awards may be offset against previous excess income tax benefits arising from nonemployee awards, and vice versa.

This Statement did not have a material impact on our consolidated financial statements as we began expensing all stock options using a fair-value based method effective for the year beginning January 1, 2002. In addition, any stock options granted prior to January 1, 2002 were fully vested at the time of adoption of SFAS 123R. We use the Black-Scholes formula to estimate the value of stock options granted to employees. We applied the prospective method of transition as prescribed by SFAS 123 when we elected to begin expensing stock-based compensation in 2002. The cumulative effect of the change in accounting principle as a result of adopting this Statement is immaterial. Therefore, the pre-tax cumulative effect of the change in accounting principle is reflected in operating expenses.

**Results of Operations**

The following table presents summary consolidated financial information for the periods indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  | **For the three months** | | | | |  |  | **For the six months** | | | | |
|  |  |  | **ended June 30,** | | | | |  |  | **ended June 30,** | | | | |
|  |  |  | **2006** |  |  |  | **2005** |  |  | **2006** |  |  | **2005** |  |
|  |  |  |  |  |  |  | **(in millions)** | | |  |  |  |  |  |
| Revenues: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Premiums and other considerations | **$** | | **1,104.6** |  | $ | | 948.9 | **$** | | **2,146.4** |  | $ | 1,883.0 |  |
| Fees and other revenues |  |  | **451.3** |  |  |  | 405.3 |  |  | **900.1** |  |  | 822.5 |  |
| Net investment income |  |  | **911.6** |  |  |  | 836.0 |  |  | **1,763.8** |  |  | 1,629.9 |  |
| Net realized/unrealized capital gains (losses) |  |  | **(19.1)** | |  |  | 10.2 |  |  | **29.8** |  |  | 8.7 |  |
| Total revenues |  |  | **2,448.4** |  |  |  | 2,200.4 |  |  | **4,840.1** |  |  | 4,344.1 |  |
| Expenses: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Benefits, claims and settlement expenses |  |  | **1,459.6** |  |  |  | 1,264.5 |  |  | **2,801.4** |  |  | 2,498.8 |  |
| Dividends to policyholders |  |  | **72.5** |  |  |  | 72.2 |  |  | **144.4** |  |  | 145.1 |  |
| Operating expenses |  |  | **619.8** |  |  |  | 580.8 |  |  | **1,224.2** |  |  | 1,137.7 |  |
| Total expenses |  |  | **2,151.9** |  |  |  | 1,917.5 |  |  | **4,170.0** |  |  | 3,781.6 |  |
| Income from continuing operations before income taxes |  |  | **296.5** |  |  |  | 282.9 |  |  | **670.1** |  |  | 562.5 |  |
| Income taxes |  |  | **77.7** |  |  |  | 59.3 |  |  | **157.4** |  |  | 134.0 |  |
| Income from continuing operations, net of related income taxes |  |  | **218.8** |  |  |  | 223.6 |  |  | **512.7** |  |  | 428.5 |  |
| Income from discontinued operations, net of related income taxes |  |  | **—** | |  |  | 15.3 |  |  | **—** | |  | 15.9 |  |
| Net income |  |  | **218.8** |  |  |  | 238.9 |  |  | **512.7** |  |  | 444.4 |  |
| Preferred stock dividends |  |  | **8.3** |  |  |  | — |  |  | **16.5** |  |  | ¾ |  |
| Net income available to common stockholders |  | **$** | **210.5** |  |  | $ | 238.9 |  | **$** | **496.2** |  | $ | 444.4 |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

***Three Months Ended June 30, 2006 Compared to Three Months Ended June 30, 2005***

Premiums and other considerations increased $155.7 million, or 16%, to $1,104.6 million for the three months ended June 30, 2006, from $948.9 million for the three months ended June 30, 2005. The increase was primarily due to a $90.8 million increase from the Life and Health Insurance segment, primarily related to increased covered medical members and improved retention in our health insurance business and strong sales and stable retention in our specialty benefits business. The increase also reflected a $66.6 million increase from the U.S. Asset Management and Accumulation segment, primarily a result of an increase in premiums from single premium group annuities with life contingencies, which are typically used to fund defined benefit pension plan terminations. The premium income we receive from these contracts fluctuates due to the variability in the number and size of pension plan terminations in the market, the interest rate environment and our ability to attract new sales.

Fees and other revenues increased $46.0 million, or 11%, to $451.3 million for the three months ended June 30, 2006, from $405.3 million for the three months ended June 30, 2005. The increase was primarily due to a $43.8 million increase from the U.S. Asset Management and Accumulation segment primarily

related to an increase in account values stemming from continued strong full-service accumulation net cash flow and strong performance in the equity markets.

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Net investment income increased $75.6 million, or 9%, to $911.6 million for the three months ended June 30, 2006, from $836.0 million for the three months ended June 30, 2005. The increase was primarily related to an increase in average annualized yield on invested assets and cash and a $1,483.3 million, or 3%, increase in average invested assets and cash. The yield on average invested assets and cash was 6.1% for the three months ended June 30, 2006 and 5.8% for the three months ended June 30, 2005.

Net realized/unrealized capital losses increased $29.3 million to $19.1 million of net realized/unrealized capital losses for the three months ended June 30, 2006, from $10.2 million of net realized/unrealized capital gains for the three months ended June 30, 2005. The increase was due to the non-recurrence of a large recovery of previously impaired securities as the result of a litigation settlement that occurred in second quarter 2005 and increased impairments in 2006 as the result of a change in our ability and intent to hold certain fixed maturity securities until recovery due to our need to fund our recently announced acquisition of WM Advisors, losses versus gains on the mark to market of fixed maturity trading securities and fewer gains on real estate sales. Partially offsetting these increases were fewer losses on the mark to market of derivatives and fewer losses on credit triggered bond sales.

The following table highlights the contributors to net realized/unrealized capital gains and losses for the three months ended June 30, 2006.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  | **For the three months ended June 30, 2006** | | | | |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  | **Net realized/** |  |  |
|  |  | **Impairments and** | |  | **Other gains** | |  | **Hedging** | |  |  | **unrealized** | |  |
|  |  |  |  |  |  | **capital gains** | |  |
|  |  | **credit losses** | |  | **(losses)** | |  | **adjustments** | |  |  | **(losses)** | |  |
|  |  |  |  |  | **(in millions)** | | |  |  |  |  |  |  |  |
| Fixed maturity securities(1) | **$** | **(20.9)** | | **$** | **2.3** |  | **$** | **(57.2)** | | **$** | | **(75.8)** | |  |
| Fixed maturity securities, trading |  | **—** | |  | **(3.4)** | |  | **—** | |  |  | **(3.4)** | |  |
| Equity securities(2) |  | **—** | |  | **(4.2)** | |  | **—** | |  |  | **(4.2)** | |  |
| Mortgage loans on real estate(3) |  | **1.3** |  |  | **—** | |  | **—** | |  |  | **1.3** |  |  |
| Derivatives |  | **—** | |  | **—** | |  | **62.4** |  |  |  | **62.4** |  |  |
| Other(4) |  | **—** | |  | **5.2** |  |  | **(4.6)** | |  |  | **0.6** |  |  |
| Total | **$** | **(19.6** | **)** | **$** | **(0.1** | **)** | **$** | **0.6** |  |  | **$** | **(19.1** | **)** |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



1. Impairments include $0.6 million of credit impairment write-downs and $0.9 million in realized credit recoveries on the sale of previously impaired assets. As the result of the need to fund our recently announced acquisition of WM Advisors, impairments also include $16.0 million of write-downs that resulted from our determination that we no longer had the ability and intent to hold certain fixed maturity securities until they recovered in value. Credit losses include $5.2 million in realized losses related to credit triggered sales. Other gains (losses) include $2.9 million in net gains as the result of prepayment activity, gross realized gains of $0.5 million and gross realized losses of $1.1 million.
2. Other gains (losses) include $4.2 million in mark to market of net realized/unrealized losses on trading securities.
3. Impairments include $3.6 million in realized recoveries on the sale of previously impaired commercial mortgage loans and a $1.4 million increase in the commercial mortgage valuation allowance.
4. Other gains (losses) include $2.6 million in mark to market net realized/unrealized gains on certain seed money investments.

Benefits, claims and settlement expenses increased $195.1 million, or 15%, to $1,459.6 million for the three months ended June 30, 2006, from $1,264.5 million for the three months ended June 30, 2005. The increase was due to a $107.2 million increase from the Life and Health Insurance segment, primarily due to growthin the health insurance and specialty benefits businesses as well as individual life insurance methodology improvements related to reinsurance values in 2005. The increase also reflected a $87.2 million increase from the U.S. Asset Management and Accumulation segment, primarily reflecting the increase in reserves resulting from an increase in sales of single premium group annuities with life contingencies.

Dividends to policyholders increased $0.3 million to $72.5 million for the three months ended June 30, 2006, from $72.2 million for the three months ended June 30, 2005. The increase was primarily due to a $1.7 million increase from the Life and Health segment due to an increase in the individual life insurance dividend crediting rates. Partially offsetting the increase was a $1.4 million decrease in the U.S. Asset Management and Accumulation segment primarily due to a decrease in dividends for our participating pension full-service accumulation products.

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Operating expenses increased $39.0 million, or 7%, to $619.8 million for the three months ended June 30, 2006, from $580.8 million for the three months ended June 30, 2005. The increase reflected a $28.1 million increase from the U.S. Asset Management and Accumulation segment, primarily due to an increase in deferred policy acquisition costs (“DPAC”) amortization, staff related costs and non-deferred sales compensation costs. In addition, the increase was due to a $6.4 million increase in the International Asset Management and Accumulation segment primarily due to an increase in compensation costs, professional fees, and distribution expenses partially offset by the net impact of DPAC and value of business acquired (“VOBA”) unlocking.

Income taxes increased $18.4 million, or 31%, to $77.7 million for the three months ended June 30, 2006, from $59.3 million for the three months ended June 30, 2005. The effective income tax rate was 26% for the three months ended June 30, 2006, and 21% for the three months ended June 30, 2005. The effective income tax rate for the three months ended June 30, 2006, was lower than the corporate income tax rate of 35% primarily due to income tax deductions allowed for corporate dividends received and interest exclusion from taxable income. The effective income tax rate for the three months ended June 30, 2005,

was lower than the corporate income tax rate of 35% primarily due to income tax deductions allowed for corporate dividends received, tax credits on our investment in a synthetic fuel production facility, and interest exclusion from taxable income. The increase in the effective tax rate to 26% for the three months ended June 30, 2006, from 21% for the three months ended June 30, 2005, was primarily due to tax credits on our investment in a synthetic fuel production facility in 2005 with no corresponding activity for the three months ended June 30, 2006.

As a result of the foregoing factors and the inclusion of income from discontinued operations for 2005, net of related income taxes, net income decreased $20.1 million, or 8%, to $218.8 million for the three months ended June 30, 2006, from $238.9 million for the three months ended June 30, 2005. The income from discontinued operations for the three months ended June 30, 2005, was related to a gain on the sale and operating revenues of a real estate property that qualifies for discontinued operations treatment under SFAS 144*.*

Preferred stock dividends were $8.3 million for the three months ended June 30, 2006, with no corresponding activity for the three months ended June 30, 2005.

Net income available to common stockholders decreased $28.4 million, or 12%, to $210.5 million for the three months ended June 30, 2006, from $238.9 million for the three months ended June 30, 2005.

***Six Months Ended June 30, 2006 Compared to Six Months Ended June 30, 2005***

Premiums and other considerations increased $263.4 million, or 14%, to $2,146.4 million for the six months ended June 30, 2006, from $1,883.0 million for the six months ended June 30, 2005. The increase was primarily due to a $171.6 million increase from the Life and Health Insurance segment, primarily related to increased covered medical members and improved retention in our health insurance business and strong sales and stable retention in our specialty benefits business. The increase also reflected a $106.8 million increase from the U.S. Asset Management and Accumulation segment, primarily a result of an increase in premiums from single premium group annuities with life contingencies, which are typically used to fund defined benefit pension plan terminations. The premium income we receive from these contracts fluctuates due to the variability in the number and size of pension plan terminations in the market, the interest rate environment and our ability to attract new sales.

Fees and other revenues increased $77.6 million, or 9%, to $900.1 million for the six months ended June 30, 2006, from $822.5 million for the six months ended June 30, 2005. The increase was primarily due to a $72.9 million increase from the U.S. Asset Management and Accumulation segment primarily related to an increase in account values stemming from continued strong full-service accumulation net cash flow and strong performance in the equity markets.

Net investment income increased $133.9 million, or 8%, to $1,763.8 million for the six months ended June 30, 2006, from $1,629.9 million for the six months ended June 30, 2005. The increase was primarily related to an increase in average annualized yield on invested assets and cash and a $1,152.6 million, or 2%, increase in average invested assets and cash. The yield on average invested assets and cash was 6.0% for the six months ended June 30, 2006 and 5.6% for the six months ended June 30, 2005.

Net realized/unrealized capital gains increased $21.1 million to $29.8 million for the six months ended June 30, 2006, from $8.7 million for the six months ended June 30, 2005. The increase is due to the gain on the sale of stock of an equity method investment, fewer losses on the mark to market of derivatives, gains versus losses on the mark to market of certain seed money investments and fewer losses on credit triggered bond sales. Offsetting these increases were decreases resulting from the non-recurrence of a large recovery of previously impaired securities as the result of a litigation settlement that occurred in 2005,

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increased impairments in 2006 as the result of a change in our ability and intent to hold certain fixed maturity securities until recovery due to our need to fund our recently announced acquisition of WM Advisors, and fewer gains on the sale and call activity of fixed maturity securities.

The following table highlights the contributors to net realized/unrealized capital gains and losses for the six months ended June 30, 2006.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  | **For the six months ended June 30, 2006** | | | | |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  | **Net realized/** |  |  |
|  |  | **Impairments and** | |  | **Other gains** | |  | **Hedging** | |  |  | **unrealized** | |  |
|  |  |  |  |  |  | **capital gains** | |  |
|  |  | **credit losses** | |  | **(losses)** | |  | **adjustments** | |  |  | **(losses)** | |  |
|  |  |  |  |  | **(in millions)** | | |  |  |  |  |  |  |  |
| Fixed maturity securities(1) | **$** | **(29.6)** | | **$** | **4.6** |  | **$** | **(132.3)** | | **$** | | **(157.3)** | |  |
| Fixed maturity securities, trading |  | **—** | |  | **(6.9)** | |  | **—** | |  |  | **(6.9)** | |  |
| Equity securities(2) |  | **—** | |  | **4.5** |  |  | **—** | |  |  | **4.5** |  |  |
| Mortgage loans on real estate(3) |  | **0.9** |  |  | **—** | |  | **—** | |  |  | **0.9** |  |  |
| Derivatives |  | **—** | |  | **—** | |  | **142.3** |  |  |  | **142.3** |  |  |
| Other(4) |  | **—** | |  | **56.6** |  |  | **(10.3)** | |  |  | **46.3** |  |  |
| Total | **$** | **(28.7** | **)** | **$** | **58.8** |  | **$** | **(0.3** | **)** |  | **$** | **29.8** |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



1. Impairments include $8.7 million of credit impairment write-downs and $3.0 million in realized credit recoveries on the sale of previously impaired assets. As the result of the need to fund our recently announced acquisition of WM Advisors, impairments also include $16.0 million of write-downs that resulted from our determination that we no longer had the ability and intent to hold certain fixed maturity securities until they recovered in value. Credit losses include $0.2 million in realized gains and $8.1 million in realized losses related to credit triggered sales. Other gains (losses) include $2.5 million in net gains as the result of prepayment activity, gross realized gains of $4.2 million and gross realized losses of $2.1 million.
2. Other gains (losses) include $4.1 million in mark to market of net realized/unrealized gains on trading securities.

1. Impairments include $2.5 million in realized losses due to the sale of commercial mortgage loans, $3.6 million in realized recoveries on the sale of previously impaired commercial mortgage loans, and a $0.7 million decrease in the commercial mortgage valuation allowance.
2. Other gains (losses) include a $44.3 million realized gain on the sale of stock of an equity method investment and $10.4 million in mark to market net realized/unrealized gains on certain seed money investments.

Benefits, claims and settlement expenses increased $302.6 million, or 12%, to $2,801.4 million for the six months ended June 30, 2006, from $2,498.8 million for the six months ended June 30, 2005. The increase was due to a $162.5 million increase from the Life and Health Insurance segment, primarily due to growth in the health insurance and specialty benefits businesses. The increase also reflected a $140.2 million increase from the U.S. Asset Management and Accumulation segment, primarily reflecting the increase in reserves resulting from an increase in sales of single premium group annuities with life contingencies.

Dividends to policyholders decreased $0.7 million to $144.4 million for the six months ended June 30, 2006, from $145.1 million for the six months ended June 30, 2005. The decrease was primarily due to a $2.4 million decrease in dividends for our participating pension full-service accumulation products. Partially offsetting the decrease was a $1.7 million increase in dividends for our Life and Health segment primarily due to an increase in the individual life insurance dividend crediting rates.

Operating expenses increased $86.5 million, or 8%, to $1,224.2 million for the six months ended June 30, 2006, from $1,137.7 million for the six months ended June 30, 2005. The increase reflected a $51.5 million increase from the U.S. Asset Management and Accumulation segment, primarily due to an increase in DPAC amortization, staff related costs and non-deferred sales compensation costs. The increase was also due to a $35.7 million increase from the Life and Health Insurance segment, primarily due to growth in the specialty benefits and insured medical businesses, partially offset by lower non-deferred sales related expenses in our individual life insurance business.

Income taxes increased $23.4 million, or 17%, to $157.4 million for the six months ended June 30, 2006, from $134.0 million for the six months ended June 30, 2005. The effective income tax rate was 23% for the six months ended June 30, 2006, and 24% for the six months ended June 30, 2005. The effective income tax rate for the six months ended June 30,

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2006, was lower than the corporate income tax rate of 35% primarily due to income tax deductions allowed for corporate dividends received, a favorable court ruling on a contested IRS issue for 1991 and later years, and interest exclusion from taxable income. The effective income tax rate for the six months ended June 30, 2005, was lower than the corporate income tax rate of 35% primarily due to income tax deductions allowed for corporate dividends received, tax credits on our investment in a synthetic fuel production facility and interest exclusion from taxable income.

As a result of the foregoing factors and the inclusion of income from discontinued operations for 2005, net of related income taxes, net income increased $68.3 million, or 15%, to $512.7 million for the six months ended June 30, 2006, from $444.4 million for the six months ended June 30, 2005. The income from discontinued operations for the six months ended June 30, 2005, was related to a gain on the sale and operating revenues of a real estate property that qualifies for discontinued operations treatment under SFAS 144.

Preferred stock dividends were $16.5 million for the six months ended June 30, 2006, with no corresponding activity for the six months ended June 30,

2005.

Net income available to common stockholders increased $51.8 million, or 12%, to $496.2 million for the six months ended June 30, 2006, from $444.4 million for the six months ended June 30, 2005.

**Results of Operations by Segment**

We use segment operating earnings for goal setting, determining employee compensation, and evaluating performance on a basis comparable to that used by securities analysts. Segment operating earnings are determined by adjusting U.S. GAAP net income available to common stockholders for net realized/unrealized capital gains and losses, as adjusted, and other after-tax adjustments we believe are not indicative of overall operating trends. Note that after-tax adjustments have occurred in the past and could recur in future reporting periods. While these items may be significant components in understanding and assessing our consolidated financial performance, we believe the presentation of segment operating earnings enhances the understanding of our results of operations by highlighting earnings attributable to the normal, ongoing operations of our businesses.

The following table presents segment information as of or for the periods indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **For the three months ended** | | | | |  |  | **For the six months ended** | | | | |  |
|  |  | **June 30,** | | |  |  |  |  | **June 30,** | | |  |  |  |
|  |  | **2006** |  |  | **2005** |  |  |  | **2006** |  |  | **2005** |  |  |
|  |  |  |  |  | **(in millions**) | | | |  |  |  |  |  |  |
| **Operating revenues by segment** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Asset Management and Accumulation | **$** | **1,116.2** |  | $ | 971.1 |  | **$** | | **2,166.0** |  | $ | 1,928.4 |  |  |
| International Asset Management and Accumulation |  | **164.2** |  |  | 158.2 |  |  |  | **307.6** |  |  | 291.0 |  |  |
| Life and Health Insurance |  | **1,183.1** |  |  | 1,089.5 |  |  |  | **2,342.7** |  |  | 2,158.1 |  |  |
| Corporate and Other(1) |  | **3.8** |  |  | (28.0) | |  |  | **(5.9)** | |  | (38.1) | |  |
| Total segment operating revenues |  | **2,467.3** |  |  | 2,190.8 |  |  |  | **4,810.4** |  |  | 4,339.4 |  |  |
| Add: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Net realized/unrealized capital gains (losses), including recognition of front-end fee |  | **(18.9)** | |  |  |  |  |  | **29.7** |  |  |  |  |  |
| revenues and certain market value adjustments to fee revenues(2) |  |  | 10.6 |  |  |  |  |  | 6.6 |  |  |
| Subtract: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Operating revenues from a discontinued real estate investment |  | **¾** |  |  | 1.0 |  |  |  | **¾** |  |  | 1.9 |  |  |
| Total revenue per consolidated statements of operations | **$** | **2,448.4** |  | $ | 2,200.4 |  |  | **$** | **4,840.1** |  | $ | 4,344.1 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Operating earnings (loss) by segment, net of related income taxes:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| U.S. Asset Management and Accumulation | **$** | **151.2** |  | $ | 130.5 |  | **$** | | **309.0** |  |  | 269.1 |  |  |  |
| International Asset Management and Accumulation |  | **16.1** |  |  | 19.1 |  |  |  | **33.7** |  |  | 28.6 |  |  |  |
| Life and Health Insurance |  | **65.2** |  |  | 76.3 |  |  |  | **135.6** |  |  | 145.8 |  |  |  |
| Corporate and Other |  | **(7.3)** | |  | (4.9) | |  |  | **(12.9)** | |  | (13.3) | |  |  |
| Total segment operating earnings, net of related income taxes |  | **225.2** |  |  | 221.0 |  |  |  | **465.4** |  |  | 430.2 |  |  |  |
| Net realized/unrealized capital gains (losses), as adjusted(2) |  | **(12.9)** | |  | 3.2 |  |  |  | **12.0** |  |  | (0.5) | |  |  |
| Other after-tax adjustments(3) |  | **(1.8)** | |  | 14.7 |  |  |  | **18.8** |  |  | 14.7 |  |  |  |
| Net income available to common stockholders per consolidated statements of |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **$** | **210.5** |  | $ | 238.9 |  | **$** | | **496.2** |  | $ | 444.4 |  |  |  |
| operations |  |  |  |  |  |  |
| 50 |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  | **June 30, 2006** | |  | **December 31, 2005** | |
|  |  | **(in millions)** | | | |  |
| **Assets by segment:** |  |  |  |  |  |  |
| U.S. Asset Management and Accumulation(4) | **$** | **108,160.0** |  | $ | 103,506.1 |  |
| International Asset Management and Accumulation |  | **6,833.2** |  |  | 6,856.2 |  |
| Life and Health Insurance |  | **13,951.7** |  |  | 14,080.2 |  |
| Corporate and Other(5) |  | **2,484.5** |  |  | 2,592.9 |  |
| Total consolidated assets | **$** | **131,429.4** |  | $ | 127,035.4 |  |
|  |  |  |  |  |  |  |



1. Includes inter-segment eliminations primarily related to internal investment management fee revenues and commission fee revenues paid to U.S. Asset Management and Accumulation agents for selling Life and Health Insurance segment insurance products.
2. In addition to sales activity and other than temporary impairments, net realized/unrealized capital gains (losses) include unrealized gains (losses) on mark to market changes in certain seed money investments and investments classified as trading securities, as well as unrealized gains (losses) on certain derivatives. Net realized/unrealized capital gains (losses), as adjusted, are net of income taxes, net realized capital gains and losses distributed, minority interest capital gains and losses, related changes in the amortization pattern of deferred policy acquisition and sales inducement costs, recognition of front-end fee revenues for sales charges on pension products and services and certain market value adjustments to fee revenues.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **For the three months ended** | | | | |  |  | **For the six months ended** | | | | |  |
|  |  | **June 30,** | | |  |  |  |  | **June 30,** | | |  |  |  |
|  |  | **2006** |  |  | **2005** |  |  |  | **2006** |  |  | **2005** |  |  |
|  |  |  |  |  | **(in millions)** | | | |  |  |  |  |  |  |
| Net realized/unrealized capital gains (losses) | **$** | **(19.1)** | | $ | 10.2 |  | **$** | | **29.8** |  | $ | 8.7 |  |  |
| Certain market value adjustments to fee revenues |  | **(0.3)** | |  | (1.0) | |  |  | **(1.2)** | |  | (3.9) | |  |
| Recognition of front-end fee revenues |  | **0.5** |  |  | 1.4 |  |  |  | **1.1** |  |  | 1.8 |  |  |
| Net realized/unrealized capital gains (losses), including recognition of front-end fee |  | **(18.9)** | |  |  |  |  |  | **29.7** |  |  |  |  |  |
| revenues and certain market value adjustments to fee revenues |  |  | 10.6 |  |  |  |  |  | 6.6 |  |  |
| Amortization of deferred policy acquisition and sales inducement costs related to net |  | **(0.6)** | |  |  |  |  |  | **(1.2)** | |  |  |  |  |
| realized capital gains (losses) |  |  | (4.4) | |  |  |  | (3.9) | |  |
| Capital losses (gains) distributed |  | **¾** |  |  | 0.2 |  |  |  | **(3.6)** | |  | (1.2) | |  |
| Minority interest capital losses (gains) |  | **1.8** |  |  | (0.2) | |  |  | **(1.8)** | |  | (0.2) | |  |
| Net realized/unrealized capital gains (losses), including recognition of front-end fee |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| revenues and certain market value adjustments to fee revenues, net of related |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| amortization of deferred policy acquisition costs and sales inducement costs, capital |  | **(17.7)** | |  |  |  |  |  | **23.1** |  |  |  |  |  |
| losses (gains) distributed, and minority interest capital losses (gains) |  |  | 6.2 |  |  |  |  |  | 1.3 |  |  |
| Income tax effect |  | **4.8** |  |  | (3.0) | |  |  | **(11.1)** | |  | (1.8) | |  |
| Net realized/unrealized capital gains (losses), as adjusted | **$** | **(12.9** | **)** | $ | 3.2 |  |  | **$** | **12.0** |  | $ | (0.5 | ) |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

1. For the three months ended June 30, 2006, other after-tax adjustments of $1.8 million included the negative effect of a change in estimate associated with a favorable court ruling on a contested IRS issue for 1991 and later years.

For the three months ended June 30, 2005, other after-tax adjustments reflect a $14.7 million gain on sale of a real estate property that qualifies for discontinued operations treatment under SFAS 144.

For the six months ended June 30, 2006, other after-tax adjustments of $18.8 million included the positive effect of a favorable court ruling on a contested IRS issue for 1991 and later years.

For the six months ended June 30, 2005, other after-tax adjustments reflect a $14.7 million gain on sale of a real estate property that qualifies for discontinued operations treatment under SFAS 144.

1. U.S. Asset Management and Accumulation separate account assets include shares of the Principal Financial Group stock allocated to a separate account, a result of our demutualization. The value of the separate account was $775.5 million and $726.6 million at June 30, 2006 and December 31, 2005, respectively. Changes in the fair value of the separate account are reflected in both separate account assets and separate account liabilities.

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1. Includes inter-segment elimination amounts related to an internal line of credit and internally generated mortgage loans. The Corporate and Other segment managed a revolving line of credit used by other segments. The U.S. Asset Management and Accumulation segment and Life and Health Insurance segment reported mortgage loan assets issued for real estate joint ventures. These mortgage loans were reported as liabilities in the Corporate and Other segment.

**U.S. Asset Management and Accumulation Segment**

***U.S. Asset Management and Accumulation Segment Summary Financial Data***

The following table presents certain summary financial data relating to the U.S. Asset Management and Accumulation segment for the periods indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  | **For the three months ended** | | | | | |  |  | **For the six months ended** | | | | |  |
|  |  |  |  | **June 30,** | | | |  |  |  |  | **June 30,** | | |  |  |  |
|  |  |  |  | **2006** |  |  |  | **2005** |  |  |  | **2006** |  |  | **2005** |  |  |
|  |  |  |  |  |  |  |  | **(in millions)** | | | |  |  |  |  |  |  |
|  | **Operating Earnings Data:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Operating revenues(1): |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Premiums and other considerations | **$** | | **140.7** |  | $ | | 74.1 |  | **$** | | **239.5** |  | $ | 132.7 |  |  |
|  | Fees and other revenues |  |  | **328.1** |  |  |  | 284.1 |  |  |  | **651.0** |  |  | 580.1 |  |  |
|  | Net investment income |  |  | **647.4** |  |  |  | 612.9 |  |  |  | **1,275.5** |  |  | 1,215.6 |  |  |
|  | Total operating revenues |  |  | **1,116.2** |  |  |  | 971.1 |  |  |  | **2,166.0** |  |  | 1,928.4 |  |  |
|  | Expenses: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Benefits, claims and settlement expenses, including dividends to policyholders |  |  | **615.6** |  |  |  | 529.5 |  |  |  | **1,167.1** |  |  | 1,029.1 |  |  |
|  | Operating expenses |  |  | **303.8** |  |  |  | 270.8 |  |  |  | **602.3** |  |  | 550.1 |  |  |
|  | Total expenses |  |  | **919.4** |  |  |  | 800.3 |  |  |  | **1,769.4** |  |  | 1,579.2 |  |  |
|  | Operating earnings before income taxes |  |  | **196.8** |  |  |  | 170.8 |  |  |  | **396.6** |  |  | 349.2 |  |  |
|  | Income taxes |  |  | **45.6** |  |  |  | 40.3 |  |  |  | **87.6** |  |  | 80.1 |  |  |
|  | Operating earnings |  |  | **151.2** |  |  |  | 130.5 |  |  |  | **309.0** |  |  | 269.1 |  |  |
|  | Net realized/unrealized capital losses, as adjusted |  |  | **(1.2)** | |  |  | (2.5) | |  |  | **(4.5)** | |  | (0.1) | |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **U.S. GAAP Reported:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Net income available to common stockholders | **$** | | **150.0** |  | $ | | 128.0 |  | **$** | | **304.5** |  | $ | 269.0 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



1. Excludes net realized/unrealized capital gains (losses) and their impact on recognition of front-end fee revenues and certain market value adjustments to fee revenues.

***Three Months Ended June 30, 2006 Compared to Three Months Ended June 30, 2005***

Premiums and other considerations increased $66.6 million, or 90%, to $140.7 million for the three months ended June 30, 2006, from $74.1 million for the three months ended June 30, 2005. The increase primarily resulted from a $60.8 million increase in full-service payout sales of single premium group annuities with life contingencies, which are typically used to fund defined benefit plan terminations. The premium income received from these contracts fluctuates due to the variability in the number and size of pension plan terminations, the interest rate environment and the ability to attract new sales.

Fees and other revenues increased $44.0 million, or 15%, to $328.1 million for the three months ended June 30, 2006, from $284.1 million for the three months ended June 30, 2005. Full-service accumulation fees and other revenues increased $25.4 million primarily due to an increase in account values stemming from continued strong net cash flow and strong performance in the equity markets. In addition, Principal Global Investors fees and other revenues increased $12.7 million primarily due to an increase in management fees related to our real estate, fixed income and equity businesses.

Net investment income increased $34.5 million, or 6%, to $647.4 million for the three months ended June 30, 2006, from $612.9 million for the three months ended June 30, 2005. The increase reflects a $1,006.0 million, or 2%, increase in average invested assets and cash for the segment and an increase in the average annualized yield on invested assets and cash, which was 5.8% for the three months ended June 30, 2006 and 5.7% for the three months ended June 30, 2005.

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Benefits, claims and settlement expenses, including dividends to policyholders, increased $86.1 million, or 16%, to $615.6 million for the three months ended June 30, 2006, from $529.5 million for the three months ended June 30, 2005. The increase primarily resulted from a $59.9 million increase in our full-service payout business as a result of increased sales of single premium group annuities with life contingencies. Also contributing to the increase was a

$14.4 million increase in our individual annuity business due to several factors, including: an increase in cost of interest credited, higher benefit payments, and an increase in reserves stemming from an increase in sales related to our life payout annuity business.

Operating expenses increased $33.0 million, or 12%, to $303.8 million for the three months ended June 30, 2006, from $270.8 million for the three months ended June 30, 2005. The increase primarily resulted from a $24.5 million increase in full-service accumulation operating expenses due to an increase in DPAC amortization, staff related costs and non-deferred sales compensation costs. Furthermore, Principal Global Investors operating expenses increased $5.9 million primarily due to the fact that expenses associated with the origination of securitized mortgages are now expensed rather than deferred and recognized as a

reduction in securitization revenue, as was the case prior to the U.S. Bank joint venture. In addition, individual annuity operating expenses increased $5.2 million primarily due to an increase in DPAC amortization and growth in the block of business.

Income taxes increased $5.3 million, or 13%, to $45.6 million for the three months ended June 30, 2006, from $40.3 million for the three months ended June 30, 2005. The effective income tax rates for this segment were 23% and 24% for the three months ended June 30, 2006 and 2005, respectively. The effective income tax rates for the three months ended June 30, 2006 and 2005, were lower than the corporate income tax rate of 35%, as a result of income tax deductions allowed for corporate dividends received and interest exclusion from taxable income.

As a result of the foregoing factors, operating earnings increased $20.7 million, or 16%, to $151.2 million for the three months ended June 30, 2006, from $130.5 million for the three months ended June 30, 2005.

Net realized/unrealized capital losses, as adjusted, decreased $1.3 million, or 52%, to $1.2 million for the three months ended June 30, 2006, from

$2.5 million for the three months ended June 30, 2005. The decrease is due to fewer losses on the mark to market of derivatives and fewer losses on the sale and

call activity of fixed maturity securities. These were partially offset by the non-recurrence of a large recovery of previously impaired securities as the result of a

litigation settlement that occurred in second quarter 2005.

As a result of the foregoing factors for the three months ended June 30, 2006, net income available to common stockholders increased $22.0 million, or 17%, to $150.0 million from $128.0 million for the three months ended June 30, 2005.

***Six Months Ended June 30, 2006 Compared to Six Months Ended June 30, 2005***

Premiums and other considerations increased $106.8 million, or 80%, to $239.5 million for the six months ended June 30, 2006, from $132.7 million for the six months ended June 30, 2005. The increase primarily resulted from a $91.0 million increase in full-service payout sales of single premium group annuities with life contingencies, which are typically used to fund defined benefit plan terminations. The premium income received from these contracts fluctuates due to the variability in the number and size of pension plan terminations, the interest rate environment and the ability to attract new sales. In addition, individual payout annuity premiums and other considerations increased $15.8 million due to increased sales from certain distribution channels.

Fees and other revenues increased $70.9 million, or 12%, to $651.0 million for the six months ended June 30, 2006, from $580.1 million for the six months ended June 30, 2005. Full-service accumulation fees and other revenues increased $47.8 million primarily due to an increase in account values stemming from continued strong net cash flow and strong performance in the equity markets. In addition, Principal Global Investors fees and other revenues increased $12.9 million primarily due to an increase in management fees related to our real estate, fixed income and equity businesses.

Net investment income increased $59.9 million, or 5%, to $1,275.5 million for the six months ended June 30, 2006, from $1,215.6 million for the six months ended June 30, 2005. The increase reflects a $746.7 million, or 2%, increase in average invested assets and cash for the segment and an increase in the average annualized yield on invested assets and cash, which was 5.8% for the six months ended June 30, 2006 and 5.6% for the six months ended June 30, 2005.

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Benefits, claims and settlement expenses, including dividends to policyholders, increased $138.0 million, or 13%, to $1,167.1 million for the six months ended June 30, 2006, from $1,029.1 million for the six months ended June 30, 2005. The increase primarily resulted from an $89.5 million increase in our full-service payout business as a result of increased sales of single premium group annuities with life contingencies. Also contributing to the increase was a

$28.6 million increase in our individual annuity business due to several factors, including: an increase in cost of interest credited, higher benefit payments, and an increase in reserves stemming from an increase in sales related to our life payout annuity business.

Operating expenses increased $52.2 million, or 9%, to $602.3 million for the six months ended June 30, 2006, from $550.1 million for the six months ended June 30, 2005. The increase primarily resulted from a $37.9 million increase in full-service accumulation operating expenses due to an increase in DPAC amortization, staff related costs and non-deferred sales compensation costs. In addition, individual annuity operating expenses increased $8.4 million primarily due to an increase in DPAC amortization and growth in the block of business. Furthermore, Principal Global Investors operating expenses increased $8.0 million primarily due to the fact that expenses associated with the origination of securitized mortgages are now expensed rather than treated as a reduction in securitization revenue, as was the case prior to the U.S. Bank joint venture.

Income taxes increased $7.5 million, or 9%, to $87.6 million for the six months ended June 30, 2006, from $80.1 million for the six months ended June 30, 2005. The effective income tax rates for this segment were 22% and 23% for the six months ended June 30, 2006 and 2005, respectively. The effective income tax rates for the six months ended June 30, 2006 and 2005, were lower than the corporate income tax rate of 35%, as a result of income tax deductions allowed for corporate dividends received and interest exclusion from taxable income.

As a result of the foregoing factors, operating earnings increased $39.9 million, or 15%, to $309.0 million for the six months ended June 30, 2006, from $269.1 million for the six months ended June 30, 2005.

Net realized/unrealized capital losses, as adjusted, increased $4.4 million to $4.5 million for the six months ended June 30, 2006, from $0.1 million for the six months ended June 30, 2005. The increase was due to the non-recurrence of a large recovery of previously impaired securities as the result of a litigation settlement that occurred in 2005 and losses versus gains on the sale and call activity of fixed maturity securities offset by gains versus losses on the mark to market of derivatives.

As a result of the foregoing factors for the six months ended June 30, 2006, net income available to common stockholders increased $35.5 million, or 13%, to $304.5 million from $269.0 million for the six months ended June 30, 2005.

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**International Asset Management and Accumulation Segment**

***International Asset Management and Accumulation Segment Summary Financial Data***

The following table presents certain summary financial data of the International Asset Management and Accumulation segment for the periods indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  | **For the three months ended** | | | |  |  |  | **For the six months ended** | | | | |  |
|  |  |  |  | **June 30,** | | |  |  |  | **June 30,** | | |  |  |  |
|  |  |  | **2006** |  |  | **2005** |  |  |  | **2006** |  |  | **2005** |  |  |
|  |  |  |  |  |  |  | **(in millions)** | | |  |  |  |  |  |  |
|  | **Operating Earnings Data:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Operating revenues(1): |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Premiums and other considerations | **$** | | **62.3** |  | $ | 64.3 | **$** | | **131.3** |  | $ | 146.4 |  |  |
|  | Fees and other revenues |  |  | **27.5** |  |  | 24.1 |  |  | **55.7** |  |  | 46.7 |  |  |
|  | Net investment income |  |  | **74.4** |  |  | 69.8 |  |  | **120.6** |  |  | 97.9 |  |  |
|  | Total operating revenues |  |  | **164.2** |  |  | 158.2 |  |  | **307.6** |  |  | 291.0 |  |  |
|  | Expenses: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Benefits, claims and settlement expenses |  |  | **113.1** |  |  | 111.0 |  |  | **206.1** |  |  | 205.6 |  |  |
|  | Operating expenses |  |  | **32.0** |  |  | 25.7 |  |  | **62.5** |  |  | 51.9 |  |  |
|  | Total expenses |  |  | **145.1** |  |  | 136.7 |  |  | **268.6** |  |  | 257.5 |  |  |
|  | Operating earnings before income taxes |  |  | **19.1** |  |  | 21.5 |  |  | **39.0** |  |  | 33.5 |  |  |
|  | Income taxes |  |  | **3.0** |  |  | 2.4 |  |  | **5.3** |  |  | 4.9 |  |  |
|  | Operating earnings |  |  | **16.1** |  |  | 19.1 |  |  | **33.7** |  |  | 28.6 |  |  |
|  | Net realized/unrealized capital losses, as adjusted |  |  | **(4.8)** | |  | ¾ |  |  | **(3.9)** | |  | (0.7) | |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **U.S. GAAP Reported:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Net income available to common stockholders | **$** | | **11.3** |  | $ | 19.1 | **$** | | **29.8** |  | $ | 27.9 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



1. Excludes net realized/unrealized capital gains (losses).

***Three Months Ended June 30, 2006 Compared to Three Months Ended June 30, 2005***

Premiums and other considerations decreased $2.0 million, or 3%, to $62.3 million for the three months ended June 30, 2006, from $64.3 million for the three months ended June 30, 2005. A decrease of $7.1 million in Chile and Mexico due to decreased sales of single premium annuities with life contingencies was partially offset by an increase of $5.1 million due to the strengthening of the Chilean and Mexican peso versus the U.S. dollar.

Fees and other revenues increased $3.4 million, or 14%, to $27.5 million for the three months ended June 30, 2006, from $24.1 million for the three months ended June 30, 2005. An increase of $1.3 million in India was a result of an increase in fees from PPIAC that began operations in February 2005 and an increase in fees from growth in assets under management. An increase of $1.1 million in Hong Kong was a result of increased fees caused by growth in assets under management. In addition, an increase of $1.0 million in Chile was primarily due to increased fees caused by growth in assets under management and higher insurance charges.

Net investment income increased $4.6 million, or 7%, to $74.4 million for the three months ended June 30, 2006, from $69.8 million for the three months ended June 30, 2005. The increase was primarily due to an increase of $403.9 million, or 17%, in average invested assets and cash, excluding our equity method investments in subsidiaries. The increase was partially offset by a decrease in the annualized yield on average invested assets and cash, excluding our equity method investments in subsidiaries, which was 9.2% for the three months ended June 30, 2006, compared to 10.4% for the three months ended June 30, 2005.

Benefits, claims and settlement expenses increased $2.1 million, or 2%, to $113.1 million for the three months ended June 30, 2006, from $111.0 million for the three months ended June 30, 2005. The increase is due to a $9.1 million strengthening of the Chilean and Mexican peso versus the U.S. dollar. This increase was primarily offset by a decrease of $7.0 million in Chile and Mexico primarily due to lower changes in reserves resulting from a decrease in sales of single premium annuities with life contingencies in 2006 as well as lower interest credited to customers.

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Operating expenses increased $6.3 million, or 25%, to $32.0 million for the three months ended June 30, 2006, from $25.7 million for the three months ended June 30, 2005. An increase of $1.8 million in Mexico was due to higher distribution expenses, professional fees, and sales compensation partially offset by DPAC and VOBA unlocking in 2006. An increase of $1.3 million in India was due to higher compensation costs in the mutual fund business and PPIAC that began operations in February 2005. In addition, an increase of $1.1 million in Hong Kong was due to increased incentive compensation costs, higher marketing expenses, and higher occupancy costs.

Income taxes increased $0.6 million, or 25%, to $3.0 million for the three months ended June 30, 2006, from $2.4 million for the three months ended June 30, 2005. An increase of $1.0 million at International headquarters was primarily due to a tax benefit recorded in 2005 as the result of applying a favorable provision in the American Jobs Creation Act to the 2005 dividend from Mexico. Partially offsetting the increase in income taxes is a decrease due to lower aggregate pre-tax earnings in 2006 for our international operating companies.

As a result of the foregoing factors, operating earnings decreased $3.0 million, or 16%, to $16.1 million for the three months ended June 30, 2006, from $19.1 million for the three months ended June 30, 2005.

Net realized/unrealized capital losses, as adjusted, increased $4.8 million for the three months ended June 30, 2006. The increase was primarily related to a $3.5 million increase in Chile due to mark-to-market losses on derivatives in 2006 that are held to more effectively match the invested asset portfolio to our policyholder liability risks.

As a result of the foregoing factors, net income available to common stockholders decreased $7.8 million to $11.3 million for the three months ended June 30, 2006, from $19.1 million for the three months ended June 30, 2005.

***Six Months Ended June 30, 2006 Compared to Six Months Ended June 30, 2005***

Premiums and other considerations decreased $15.1 million, or 10%, to $131.3 million for the six months ended June 30, 2006, from $146.4 million for the six months ended June 30, 2005. A decrease of $26.2 million in Chile and Mexico due to decreased sales of single premium annuities with life contingencies was partially offset by an increase of $11.1 million due to the strengthening of the Chilean and Mexican peso versus the U.S. dollar.

Fees and other revenues increased $9.0 million, or 19%, to $55.7 million for the six months ended June 30, 2006, from $46.7 million for the six months ended June 30, 2005. An increase of $2.8 million in India was primarily a result of an increase in fees from PPIAC that began operations in February 2005, along with an increase in fees caused by a growth in assets under management. An increase of $2.3 million in Hong Kong was due to an increase in fees caused by a growth in assets under management. In addition, an increase of $2.2 in Chile was primarily due to an increase in fees caused by a growth in assets under management and higher insurance charges.

Net investment income increased $22.7 million, or 23%, to $120.6 million for the six months ended June 30, 2006, from $97.9 million for the six months ended June 30, 2005. The increase was primarily due to an increase of $403.8 million, or 17%, in average invested assets and cash, excluding our equity method investment in subsidiaries. In addition, the increase was due to higher earnings from our equity method investments in subsidiaries.

Benefits, claims and settlement expenses increased $0.5 million to $206.1 million for the six months ended June 30, 2006, from $205.6 million for the six months ended June 30, 2005. An increase of $17.0 million is due to the strengthening of the Mexican and Chilean pesos versus the U.S. dollar. This increase is mostly offset by $16.6 million decrease in reserve expenses in Mexico and Chile due to decreased sales of single premium annuities with life contingencies.

Operating expenses increased $10.6 million, or 20%, to $62.5 million for the six months ended June 30, 2006, from $51.9 million for the six months ended June 30, 2005. An increase of $4.3 million is related to higher compensation costs in the mutual fund business and PPIAC that began operations in February 2005 in India as well as increased incentive compensation costs, higher marketing expenses, and higher occupancy costs in Hong Kong. An increase of $2.3 million in Mexico was primarily due to higher distribution expenses, professional fees, and sales compensation in 2006. Furthermore, an increase of $1.6 million is due to the strengthening of the Mexican and Chilean pesos versus the U.S. dollar.

Income taxes increased $0.4 million, or 8%, to $5.3 million for the six months ended June 30, 2006, from $4.9 million for the six months ended June 30, 2005. The increase was primarily due to a tax benefit recorded in 2005 as the result of applying a favorable provision in the American Jobs Creation Act to the 2005 dividend from Mexico. Partially offsetting this increase are tax benefits recognized in 2006 as a result of increased pre-tax losses at International headquarters in 2006.

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As a result of the foregoing factors, operating earnings increased $5.1 million, or 18%, to $33.7 million for the six months ended June 30, 2006, from $28.6 million for the six months ended June 30, 2005.

Net realized/unrealized capital losses, as adjusted, increased $3.2 million to $3.9 million for the six months ended June 30, 2006, from $0.7 million for the six months ended June 30, 2005. The increase was primarily due to a $2.0 million increase in Chile due to mark-to-market losses in 2006 on derivatives that are held to more effectively match the invested asset portfolio to our policyholder liability risks.

As a result of the foregoing factors, net income available to common stockholders increased $1.9 million, or 7%, to $29.8 million for the six months ended June 30, 2006, from $27.9 million for the six months ended June 30, 2005.

**Life and Health Insurance Segment**

***Life and Health Insurance Segment Summary Financial Data***

The following table presents certain summary financial data relating to the Life and Health Insurance segment for the periods indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  | **For the three months ended** | | | |  |  | **For the six months ended** | | | | |
|  |  |  | **June 30,** | | |  |  |  | **June 30,** | | |  |  |
|  |  |  | **2006** |  |  | **2005** |  |  | **2006** |  |  | **2005** |  |
|  |  |  |  |  |  | **(in millions)** | | |  |  |  |  |  |
| **Operating Earnings Data:** |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Operating revenues(1): |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Premiums and other considerations | **$** | | **900.1** | $ | | 809.3 | **$** | | **1,773.0** |  | $ | 1,601.4 |  |
| Fees and other revenues |  |  | **111.5** |  |  | 110.7 |  |  | **224.8** |  |  | 222.6 |  |
| Net investment income |  |  | **171.5** |  |  | 169.5 |  |  | **344.9** |  |  | 334.1 |  |
| Total operating revenues |  |  | **1,183.1** |  |  | 1,089.5 |  |  | **2,342.7** |  |  | 2,158.1 |  |
| Expenses: |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Benefits, claims and settlement expenses |  |  | **733.6** |  |  | 626.4 |  |  | **1,431.9** |  |  | 1,269.4 |  |
| Dividends to policyholders |  |  | **73.0** |  |  | 71.3 |  |  | **144.9** |  |  | 143.2 |  |
| Operating expenses |  |  | **278.0** |  |  | 276.5 |  |  | **561.4** |  |  | 525.6 |  |
| Total expenses |  |  | **1,084.6** |  |  | 974.2 |  |  | **2,138.2** |  |  | 1,938.2 |  |
| Operating earnings before income taxes |  |  | **98.5** |  |  | 115.3 |  |  | **204.5** |  |  | 219.9 |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | Income taxes |  |  | **33.3** |  |  |  | 39.0 |  |  | **68.9** |  |  | 74.1 |  |  |
|  | Operating earnings |  |  | **65.2** |  |  |  | 76.3 |  |  | **135.6** |  |  | 145.8 |  |  |
|  | Net realized/unrealized capital gains (losses), as adjusted |  |  | **(5.2)** | |  |  | 1.2 |  |  | **(5.0)** | |  | 0.5 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **U.S. GAAP Reported:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Net income available to common stockholders | **$** | | **60.0** |  | $ | | 77.5 | **$** | | **130.6** |  | $ | 146.3 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



1. Excludes net realized/unrealized capital gains (losses).

***Three Months Ended June 30, 2006 Compared to Three Months Ended June 30, 2005***

Premiums and other considerations increased $90.8 million, or 11%, to $900.1 million for the three months ended June 30, 2006, from $809.3 million for the three months ended June 30, 2005. Health insurance premiums increased $52.2 million, primarily from increased covered medical members and improved retention. In addition, specialty benefits insurance premiums increased $45.3 million, primarily due to strong sales and stable retention.

Fees and other revenues increased $0.8 million, or 1%, to $111.5 million for the three months ended June 30, 2006, from $110.7 million for the three months ended June 30, 2005. Fee revenues from our individual life insurance business increased $2.5 million, primarily due to growth in our fee-based universal and variable universal life insurance business. Partially offsetting this increase was a $1.4 million decrease in fee revenues from our health insurance business primarily due to a decrease in fee-for-service medical members. In addition, specialty benefits insurance fee revenues decreased $0.3 million, primarily due to lower cost-of-insurance fees in the group universal life insurance business.

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Net investment income increased $2.0 million, or 1%, to $171.5 million for the three months ended June 30, 2006, from $169.5 million for the three months ended June 30, 2005. The increase primarily relates to an increase in the average annualized yield on invested assets and cash. The average annualized yield on invested assets and cash was 6.4% for the three months ended June 30, 2006, compared to 6.3% for the three months ended June 30, 2005. Partially offsetting the increase was a $123.9 million, or 1%, decrease in average invested assets and cash for the segment.

Benefits, claims and settlement expenses increased $107.2 million, or 17%, to $733.6 million for the three months ended June 30, 2006, from

$626.4 million for the three months ended June 30, 2005. Health insurance benefits, claims and settlement expenses increased $56.6 million primarily due to

increased medical covered members and higher claim costs per member. Despite lower loss ratios, specialty benefits insurance benefits, claims and settlement

expenses increased $26.9 million, primarily due to an increase in insured members. In addition, individual life insurance benefits, claims, and settlement

expenses increased $23.7 million primarily the result of methodology improvements related to reinsurance values in 2005 and increased death benefit costs in

2006.

Dividends to policyholders increased $1.7 million, or 2%, to $73.0 million for the three months ended June 30, 2006, from $71.3 million for the three months ended June 30, 2005. The increase is primarily related to an increase in the individual life insurance dividend crediting rates.

Operating expenses increased $1.5 million, or 1%, to $278.0 million for the three months ended June 30, 2006, from $276.5 million for the three months ended June 30, 2005. Specialty benefits insurance operating expenses increased $11.2 million due to growth in the business. Health insurance operating expenses increased $4.8 million, primarily due to growth in the insured medical business. Partially offsetting the increases was a $14.5 million decrease in individual life insurance operating expenses due to lower non-deferred sales related expenses and lower DPAC amortization related to higher claims expense.

Income taxes decreased $5.7 million, or 15%, to $33.3 million for the three months ended June 30, 2006, from $39.0 million for the three months ended June 30, 2005. The effective income tax rate for the segment was 34% for the three months ended June 30, 2006 and 2005. The effective income tax rates for the three months ended June 30, 2006 and 2005, were lower than the corporate income tax rate of 35% primarily due to the interest exclusion from taxable income.

As a result of the foregoing factors, operating earnings decreased $11.1 million, or 15%, to $65.2 million for the three months ended June 30, 2006, from $76.3 million for the three months ended June 30, 2005.

Net realized/unrealized capital losses, as adjusted, increased $6.4 million to $5.2 million of net realized/unrealized capital losses for the three months ended June 30, 2006, from $1.2 million of net realized/unrealized capital gains for the three months ended June 30, 2005. The increase was primarily due to the non-recurrence of a large recovery of previously impaired securities received in 2005 as the result of a litigation settlement and increased impairments in 2006 as the result of a change in our ability and intent to hold certain fixed maturity securities until recovery due to the need to fund our recently announced acquisition of WM Advisors. The increases were partially offset by a software impairment in 2005 with no corresponding activity in 2006, gains versus losses on the sale of fixed maturity securities, and more recoveries on commercial mortgage loans.

As a result of the foregoing factors, net income available to common stockholders decreased $17.5 million, or 23%, to $60.0 million for the three months ended June 30, 2006, from $77.5 million for the three months ended June 30, 2005.

***Six Months Ended June 30, 2006 Compared to Six Months Ended June 30, 2005***

Premiums and other considerations increased $171.6 million, or 11%, to $1,773.0 million for the six months ended June 30, 2006, from $1,601.4 million for the six months ended June 30, 2005. Health insurance premiums increased $97.2 million, primarily from strong sales and improved retention. In addition, specialty benefits insurance premiums increased $91.6 million, primarily due to strong sales and steady retention.

Fees and other revenues increased $2.2 million, or 1%, to $224.8 million for the six months ended June 30, 2006, from $222.6 million for the six months ended June 30, 2005. Fee revenues from our individual life insurance business increased $3.4 million, primarily due to growth in our fee-based universal and variable universal life insurance business. Partially offsetting this increase was a $1.0 million decrease in fee revenues from our health insurance business primarily due to a decrease in fee-for-service medical members.

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Net investment income increased $10.8 million, or 3%, to $344.9 million for the six months ended June 30, 2006, from $334.1 million for the six months ended June 30, 2005. The increase primarily relates to an increase in the average annualized yield on invested assets and cash. The average annualized yield on invested assets and cash was 6.4% for the six months ended June 30, 2006, compared to 6.2% for the six months ended June 30, 2005. Partially offsetting the increase was a $28.3 million decrease in average invested assets and cash for the segment.

Benefits, claims and settlement expenses increased $162.5 million, or 13%, to $1,431.9 million for the six months ended June 30, 2006, from

$1,269.4 million for the six months ended June 30, 2005. Health insurance benefits, claims and settlement expenses increased $93.3 million primarily due to

growth in the business and higher claim costs per member. Despite lower loss ratios, specialty benefits insurance benefits, claims and settlement expenses

increased $52.0 million, primarily due to an increase in insured members.

Dividends to policyholders increased $1.7 million, or 1%, to $144.9 million for the six months ended June 30, 2006, from $143.2 million for the six months ended June 30, 2005. The increase is primarily related to an increase in the individual life insurance dividend crediting rates.

Operating expenses increased $35.8 million, or 7%, to $561.4 million for the six months ended June 30, 2006, from $525.6 million for the six months ended June 30, 2005. Specialty benefits insurance operating expenses increased $25.8 million due to growth in the business. Health insurance operating expenses increased $17.7 million, primarily due to growth in the insured medical business. Partially offsetting the increases was a $7.7 million decrease in individual life insurance operating expenses due to lower non-deferred sales related expenses.

Income taxes decreased $5.2 million, or 7%, to $68.9 million for the six months ended June 30, 2006, from $74.1 million for the six months ended June 30, 2005. The effective income tax rate for the segment was 34% for the six months ended June 30, 2006 and 2005. The effective income tax rates for the six months ended June 30, 2006 and 2005, were lower than the corporate income tax rate of 35% primarily due to the interest exclusion from taxable income.

As a result of the foregoing factors, operating earnings decreased $10.2 million, or 7%, to $135.6 million for the six months ended June 30, 2006, from $145.8 million for the six months ended June 30, 2005.

Net realized/unrealized capital losses, as adjusted, increased $5.5 million to $5.0 million of net realized/unrealized capital losses for the six months ended June 30, 2006, from $0.5 million of net realized/unrealized capital gains for the six months ended June 30, 2005. The increase was primarily due to the non-recurrence of a large recovery of previously impaired securities received in 2005 as the result of a litigation settlement and increased impairments in 2006 as the result of a change in our ability and intent to hold certain fixed maturity securities until recovery due to the need to fund our recently announced acquisition of WM Advisors. These increases were partially offset by gains versus losses on the sale of fixed maturity securities, a software impairment in 2005 with no corresponding activity in 2006, and more recoveries on commercial mortgage loans.

As a result of the foregoing factors, net income available to common stockholders decreased $15.7 million, or 11%, to $130.6 million for the six months ended June 30, 2006, from $146.3 million for the six months ended June 30, 2005.

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**Corporate and Other Segment**

***Corporate and Other Segment Summary Financial Data***

The following table presents certain summary financial data relating to the Corporate and Other segment for the periods indicated:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **For the three months ended** | | | | |  |  |  | **For the six months ended** | | | | |  |
|  |  |  | **June 30,** | | | |  |  |  | **June 30,** | | |  |  |  |
|  |  | **2006** |  |  | **2005** | |  |  |  | **2006** |  |  | **2005** |  |  |
|  |  |  |  |  |  |  | **(in millions)** | | |  |  |  |  |  |  |
|  | **Operating Earnings Data:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Operating revenues(1): |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Total operating revenues | **$** | **3.8** |  | $ | | (28.0) | | **$** | **(5.9)** | | $ | (38.1) | |  |
|  | Expenses: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Total expenses |  | **1.3** |  |  |  | 1.9 |  |  | **(3.4)** | |  | 1.4 |  |  |
|  | Operating earnings (loss) before income taxes |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | **2.5** |  |  |  | (29.9) | |  | **(2.5)** | |  | (39.5) | |  |
|  | Income taxes (benefits) |  | **1.5** |  |  |  | (25.0) | |  | **(6.1)** | |  | (26.2) | |  |
|  | Preferred stock dividends |  | **8.3** |  |  |  | — |  |  | **16.5** |  |  | — |  |  |
|  | Operating loss |  | **(7.3)** | |  |  | (4.9) | |  | **(12.9)** | |  | (13.3) | |  |
|  | Net realized/unrealized capital gains (losses), as adjusted |  | **(1.7)** | |  |  | 4.5 |  |  | **25.4** |  |  | (0.2) | |  |
|  | Other after-tax adjustments |  | **(1.8)** | |  |  | 14.7 |  |  | **18.8** |  |  | 14.7 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **U.S. GAAP Reported:** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  | Net income (loss) available to common stockholders | **$** | **(10.8)** | | $ | | 14.3 |  | **$** | **31.3** |  | $ | 1.2 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



1. Excludes net realized/unrealized capital gains (losses).

***Three Months Ended June 30, 2006 Compared to Three Months Ended June 30, 2005***

Total operating revenues increased $31.8 million to $3.8 million for the three months ended June 30, 2006, from negative $28.0 million for the three months ended June 30, 2005. Net investment income increased $30.1 million primarily due to a decrease in investment expenses related to a significant variable interest in a coal-based synthetic fuel production facility as well as an increase in average annualized investment yields for the segment. The decrease in investment expense from this investment is more than offset by an increase in income taxes due to fewer estimated Section 29 tax credits generated from fuel production.

Total expense decreased $0.6 million, or 32% to $1.3 million for the three months ended June 30, 2006, from $1.9 million for the three months ended

June 30, 2005. The decrease in total expenses was primarily the result of a $4.1 million decrease in interest related to federal income tax audit activities.

Partially offsetting the decrease in total expenses is a $3.0 million increase in interest expense related to the issuance of corporate debt.

Income taxes increased $26.5 million to $1.5 million for the three months ended June 30, 2006, from $25.0 million of income tax benefits for the three months ended June 30, 2005. The increase was primarily due to fewer estimated Section 29 tax credits from our investment in a synthetic fuel production facility as well as an increase in operating earnings before income taxes and preferred stock dividends.

Preferred stock dividends were $8.3 million for the three months ended June 30, 2006, with no corresponding activity for the three months ended June 30, 2005. The preferred stock dividends were a result of issuing preferred stock in June 2005.

As a result of the foregoing factors, operating loss increased $2.4 million, or 49%, to $7.3 million for the three months ended June 30, 2006, from $4.9 million for the three months ended June 30, 2005.

Net realized/unrealized capital losses, as adjusted, increased $6.2 million to $1.7 million of net realized/unrealized losses for the three months ended June 30, 2006, from $4.5 million of net realized/unrealized gains for the three months ended June 30, 2005. The increase was due to the non-recurrence of a large recovery of previously impaired securities received in 2005 as the result of a litigation settlement and increased impairments in 2006 as the result of a change in our ability and intent to hold certain fixed maturity securities until recovery due to the need to fund our recently announced acquisition of WM Advisors.

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As a result of the foregoing factors and the inclusion of other after-tax adjustments, net loss available to common stockholders increased

$25.1 million to $10.8 million for the three months ended June 30, 2006, from $14.3 million of net income for the three months ended June 30, 2005. For the three months ended June 30, 2006, net loss included the negative effect of after-tax adjustments totaling $1.8 million related to the change in estimate associated with a favorable court ruling on a contested IRS issue for 1991 and later years. For the three months ended June 30, 2005, net income included the positive effect of other after-tax adjustments totaling $14.7 million due to a gain on sale of a real estate property that qualified for discontinued operations treatment under SFAS 144.

***Six Months Ended June 30, 2006 Compared to Six Months Ended June 30, 2005***

Total operating revenues increased $32.2 million, or 85%, to negative $5.9 million for the six months ended June 30, 2006, from negative $38.1 million for the six months ended June 30, 2005. Net investment income increased $35.2 million reflecting an increase in average annualized investment yields as well as a decrease in investment expenses related to a significant variable interest in a coal-based synthetic fuel production facility. The decrease in investment expense from this investment is more than offset by an increase in income taxes due to fewer estimated Section 29 tax credits generated from fuel production. Partially offsetting the increase in total revenues was a decrease of $3.5 million in fee revenue for transitional services provided to CitiMortgage, Inc., in the prior year, related to the sale of Principal Residential Mortgage, Inc., which was mostly offset by a corresponding change in total expense.

Total expenses decreased $4.8 million to negative $3.4 million for the six months ended June 30, 2006, from $1.4 million for the six months ended June 30, 2005. The decrease in total expenses was partially due to a $3.8 million decrease in interest related to federal income tax audit activities as well as $3.4 million decrease in transitional services provided to CitiMortgage, Inc., in the prior year, related to the sale of Principal Residential Mortgage, which was mostly offset in total revenue. The decrease in total expenses was partially offset by a $4.4 million increase in interest related to the issuance of corporate debt.

Income tax benefits decreased $20.1 million, or 77%, to $6.1 million for the six months ended June 30, 2006, from $26.2 million for the six months ended June 30, 2005. The decrease was primarily due to a decrease in operating loss before income taxes and preferred stock dividends as well as a decrease in the estimated Section 29 tax credits from our investment in a synthetic fuel production facility in 2006.

Preferred stock dividends were $16.5 million for the six months ended June 30, 2006, with no corresponding activity for the six months ended June 30, 2005. The preferred stock dividends were a result of issuing preferred stock in June 2005.

As a result of the foregoing factors, operating loss decreased $0.4 million, or 3%, to $12.9 million for the six months ended June 30, 2006, from $13.3 million for the six months ended June 30, 2005.

Net realized/unrealized capital gains, as adjusted, increased $25.6 million to $25.4 million of net realized/unrealized capital gains for the six months ended June 30, 2006, from $0.2 million net realized/unrealized capital losses for the six months ended June 30, 2005. The increase was primarily due to the gain on sale of stock of an equity method investment offset in part by the non-recurrence of a large recovery of previously impaired securities received in 2005 as the result of a litigation settlement and increased impairments in 2006 as the result of a change in our ability and intent to hold certain fixed maturity securities until recovery due to the need to fund our recently announced acquisition of WM Advisors.

As a result of the foregoing factors and the inclusion of other after-tax adjustments, net income available to common stockholders increased

$30.1 million to $31.3 million for the six months ended June 30, 2006, from $1.2 million for the six months ended June 30, 2005. For the six months ended

June 30, 2006, net income included the positive effect of other after-tax adjustments of $18.8 million related to a favorable court ruling on a contested IRS

issue for 1991 and later years. For the six months ended June 30, 2005, net income included the positive effect of other after-tax adjustments totaling

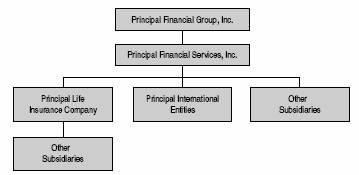
$14.7 million due to a gain on sale of real estate property that qualified for discontinued operations treatment under SFAS 144.

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**Liquidity and Capital Resources**

Our legal entity organizational structure has an impact on our ability to meet cash flow needs as an organization. Following is a simplified organizational structure.



***Dividends from Principal Life***

The payment of stockholder dividends by Principal Life to its parent company is limited by Iowa laws. Under Iowa laws, Principal Life may pay dividends only from the earned surplus arising from its business and must receive the prior approval of the Insurance Commissioner of the State of Iowa (“the Commissioner”) to pay a stockholder dividend if such a stockholder dividend would exceed certain statutory limitations. The current statutory limitation is the greater of:

* 10% of Principal Life’s statutory policyholder surplus as of the previous year-end; or
* the statutory net gain from operations from the previous calendar year.

Iowa law gives the Commissioner discretion to disapprove requests for dividends in excess of these limits. Based on this limitation and 2005 statutory results, Principal Life could pay approximately $630.7 million in stockholder dividends in 2006 without exceeding the statutory limitation.

On February 28, 2006, Principal Life declared a common stock dividend to its parent company of up to $625.0 million, $425.0 million of which has been paid as of June 30, 2006. On May 16, 2006, Principal Life declared an extraordinary dividend to its parent company in an amount of up to $550.0 million. As required by Iowa law, Principal Life did seek permission from the Commissioner to pay this dividend. On May 17, 2006, the Commissioner approved this dividend and $550.0 million was subsequently paid on May 22, 2006.

***Shelf Registration***

***Registration Statement.*** Although we generate adequate cash flow to meet the needs of our normal operations, periodically the need may arise to issuedebt to fund internal expansion, acquisitions, investment opportunities and retirement of existing debt and equity. In December 2003, we filed a shelf registration statement with the SEC, which became effective on June 30, 2004. The shelf registration totals $3.0 billion, with the ability to issue debt securities, preferred stock, common stock, warrants, stock purchase contracts and stock purchase units of Principal Financial Group, Inc (“PFG”) and trust preferred securities of three subsidiary trusts. If we issue additional securities, we intend to use the proceeds from the sale of the securities for general corporate purposes, including working capital, capital expenditures, investments in subsidiaries, share repurchase, acquisitions and refinancing of debt, including commercial paper and other short-term indebtedness. Principal Financial Services, Inc. unconditionally guarantees our obligations with respect to one or more series of debt securities described in the shelf registration statement.

***Preferred Stock Issuances.*** On June 16, 2005, we issued 13.0 million shares of non-cumulative perpetual preferred stock under our shelf registration fornet proceeds of $542.0 million. Substantially all of the preferred securities proceeds were used to repurchase shares of outstanding common stock. Following our issuance of perpetual preferred stock, we now have the ability to issue up to $2.45 billion of debt securities, preferred stock, common stock, warrants, stock purchase contracts and stock purchase units of PFG and trust preferred securities of three subsidiary trusts, under the shelf registration.

***Preferred Stock Dividend Restrictions and Payments.*** The certificates of designations for the preferred stock restrict the declaration of preferreddividends if we fail to meet specified capital adequacy, net income or stockholders’ equity levels. As of June 30, 2006, we have no preferred dividend restrictions.

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On March 30, 2006, we paid a dividend of $8.2 million, equal to $1.39 per share on Series A non-cumulative perpetual preferred stock and equal to

$0.41 per share on Series B non-cumulative perpetual preferred stock, to stockholders of record as of March 15, 2006. On June 30, 2006, we paid a dividend of

$8.3 million, equal to $1.39 per share on Series A non-cumulative perpetual preferred stock and equal to $0.41 per share on Series B non-cumulative perpetual

preferred stock, to stockholders of record as of June 15, 2006.

***Common Stock Issued and Treasury Stock Acquired***

Our Board of Directors has authorized various repurchase programs under which we are allowed to purchase shares of our outstanding common stock. Shares repurchased under these programs are accounted for as treasury stock, carried at cost and reflected as a reduction to stockholders’ equity. The repurchases

are made in the open market or through privately negotiated transactions, from time to time, depending on market conditions.

On May 19, 2006, following our Board of Directors’ share repurchase authorization, we entered into an accelerated common stock repurchase agreement with a third party investment bank for an aggregate purchase price of $500.0 million. On this date, we paid $500.0 million and received the initial delivery of 7.7 million common shares, while retaining the right to receive additional common shares depending on the volume weighted average share price of our common stock over the program’s duration. The maximum number of shares eligible for repurchase under this program is 19.5 million common shares. The program will be completed in the fourth quarter 2006, at which time we will receive any remaining common shares owed to us under this agreement.

In November 2005, our Board of Directors authorized a repurchase program of up to $250.0 million of our outstanding common stock. This program was completed in May 2006. We acquired 5.1 million shares in the open market at an aggregate cost of $250.0 million under this program.

***International Asset Management and Accumulation Operations***

Our Brazilian, Hong Kong, Chilean, and Mexican operations produced positive cash flow from operations for the six months ended June 30, 2006 and 2005. These cash flows have been historically maintained at the local country level for strategic expansion purposes and local capital requirements. Our international operations have required infusions of capital primarily to fund acquisitions and to a lesser extent, to meet the cash flow and capital requirements of certain operations. Our capital funding of these operations is consistent with our long-term strategy to establish viable companies that can sustain future growth from internally generated sources. Based on reviews of our current capital needs and strategic opportunities within our foreign operations, we have repatriated and will continue to repatriate a portion of the capital from certain countries in 2006.

***Sources and Uses of Cash of Consolidated Operations***

Activity, as reported in our consolidated statements of cash flows, provides relevant information regarding our sources and uses of cash. The following discussion of our operating, investing and financing portions of the cash flows excludes cash flows attributable to our discontinued operations, which were as follows:

**For the six months ended**

**June 30,**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **2006** |  |  |  |  | **2005** |  |
|  |  |  | **(in millions)** | | | |  |  |
| **Cash flows attributable to discontinued operations:** |  |  |  |  |  |  |  |  |
| Net cash used in operating activities | **$** | | **—** | | $ | | (0.1) | |
| Net cash used in investing activities |  |  | **—** | |  |  | (0.1) | |
| Net cash used in discontinued operations |  | **$** | **—** |  |  | $ | (0.2 | ) |
|  |  |  |  |  |  |  |  |  |

Net cash provided by operating activities was $1,104.8 million and $806.4 million for the six months ended June 30, 2006 and 2005, respectively. The increase in cash provided by operations was primarily related to the payment in 2005 of an IRS deficiency related to the examination for 1999 – 2001.

Net cash used in investing activities was $2,068.0 million and $762.8 million for the six months ended June 30, 2006 and 2005, respectively. The increase in cash used in investing activities between periods was primarily related to an increase in acquisitions, a decrease in the sales, and fewer maturities of available for sale securities, an increase in mortgage loans acquired as well as a reduction in real estate acquired and sold. This increase in cash used in investing activities was partially offset by a sale of stock of an equity method investment in 2006.

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Net cash provided by financing activities was $538.8 million and $675.7 million for the six months ended June 30, 2006 and 2005, respectively. The decrease in cash provided by financing activities is due to the issuance of preferred stock in the prior year with no corresponding issuance in the current year as well as a reduction of short-term debt proceeds in the current year. In the first quarter of 2005, short term debt was issued to fund the IRS deficiency. These decreases were partially offset by an increase in net deposits of investment contracts and a reduction in the amount of treasury stock acquired in the current year.

As discussed in Item 1, “Financial Statements, Notes to Unaudited Consolidated Financial Statements – March 31, 2006, Note 12 – Subsequent Event”, on July 25, 2006, we announced a definitive agreement to acquire WM Advisors Inc. and its subsidiaries. Upon closing of this transaction, expected in fourth quarter 2006 or early 2007, we will pay approximately $740.0 million in cash. The closing of this transaction is subject to regulatory and other approvals.

Given the historical cash flow of our subsidiaries and the financial results of these subsidiaries, we believe the cash flow from our consolidated operating activities over the next year will provide sufficient liquidity for our operations, as well as satisfy interest payments and any payments related to debt servicing.

***Ratio of Earnings to Fixed Charges***

The ratio of earnings to fixed charges is a measure of our ability to cover fixed costs with current period earnings. A high ratio indicates that earnings are sufficiently covering committed expenses. The following table sets forth, for the periods indicated, our ratios of:

* earnings to fixed charges before interest credited on investment products; and
* earnings to fixed charges.

We calculate the ratio of “earnings to fixed charges before interest credited on investment products” by dividing the sum of income from continuing operations before income taxes (BT), interest expense (I), interest factor of rental expense (IF) less undistributed income from equity investees (E) by the sum of interest expense (I), interest factor of rental expense (IF) and dividends on majority-owned subsidiary redeemable preferred securities (non-intercompany) (D). The formula for this ratio is: (BT+I+IF-E)/(I+IF+D).

We calculate the ratio of “earnings to fixed charges” by dividing the sum of income from continuing operations before income taxes (BT), interest expense (I), interest factor of rental expense (IF) less undistributed income from equity investees (E) and the addition of interest credited on investment

products (IC) by interest expense (I), interest factor of rental expense (IF), dividends on majority-owned subsidiary redeemable preferred securities (non-intercompany) (D) and interest credited on investment products (IC). The formula for this calculation is: (BT+I+IF-E+IC)/(I+IF+D+IC). “Interest credited on investment products” includes interest paid on guaranteed investment contracts, funding agreements and other investment-only pension products. Similar to debt, these products have a total fixed return and a fixed maturity date.

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **For the six months** | | | |  | **For the year ended** | | |  |  |  |
|  | **ended June 30,** | | | |  | **December 31,** | | |  |  |  |
|  | **2006** |  | **2005** |  | **2005** | **2004** | |  | **2003** |  |  |
| Ratio of earnings to fixed charges and preferred dividends before interest credited on | **10.9** |  |  |  |  |  |  |  |  |  |  |
| investment products |  | 13.5 |  | 11.1 | 9.5 | |  | 7.5 |  |  |
| Ratio of earnings to fixed charges | **2.3** |  | 2.2 |  | 2.1 | 2.0 | |  | 1.9 |  |  |

***Contractual Obligations and Commercial Commitments***

As of June 30, 2006 we had $894.2 million of long-term debt outstanding compared to $898.8 million at December 31, 2005. There have been no significant changes to contractual obligations and commitments since December 31, 2005.

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***Short-Term Debt***

As of June 30, 2006, we had credit facilities with various financial institutions in an aggregate amount of $890.3 million. As of June 30, 2006 we had $424.4 million of outstanding borrowings related to our credit facilities with $427.1 million of assets pledged as support, compared to $476.4 million of outstanding borrowings at December 31, 2005 with $110.6 million of assets pledged as support. Assets pledged consisted primarily of commercial mortgages and securities. Our credit facilities also include a $600.0 million back-stop facility to provide 100% support for our commercial paper program, of which there were no outstanding balances as of June 30, 2006.

**Off-Balance Sheet Arrangements**

***Synthetic Collateralized Debt Obligation.*** On June 21, 2006, we invested $285.0 million in a secured limited recourse note issued by a segregatedportfolio company. The note represents Class B notes. Class A notes are senior and Class C through Class F notes are subordinated to Class B notes. The entity entered into a credit default swap with a third party providing credit protection in exchange for a fee. Defaults in an underlying reference portfolio will only affect the note if cumulative losses of a synthetic reference portfolio exceed the loss attachment point on the portfolio. We have determined we are not the primary beneficiary, as we do not hold the majority of the risk of loss. Our maximum exposure to loss as a result of our involvement with this entity is our recorded investment of $285.0 million as of June 30, 2006.

***Guarantees and Indemnifications***

In the normal course of business, we have provided guarantees to third parties primarily related to a former subsidiary, joint ventures and industrial revenue bonds. These agreements generally expire from 2006 through 2019. The maximum exposure under these agreements as of June 30, 2006, was approximately $166.0 million; however, we believe the likelihood is remote that material payments will be required and therefore have not accrued for a liability on our consolidated statements of financial position. Should we be required to perform under these guarantees, we generally could recover a portion of the loss from third parties through recourse provisions included in agreements with such parties, the sale of assets held as collateral that can be liquidated in the event that performance is required under the guarantees or other recourse generally available to us, therefore, such guarantees would not result in a material adverse effect on our business or financial position. It is possible that such outcomes could materially affect net income in a particular quarter or annual period. The fair value of such guarantees is not material.

In connection with the 2002 sale of BT Financial Group, we agreed to indemnify the purchaser, Westpac Banking Corporation (“Westpac”), for among other things, the costs associated with potential late filings made by BT Financial Group in New Zealand prior to Westpac’s ownership, up to a maximum of A$250.0 million Australian dollars (approximately U.S. $186.0 million as of June 30, 2006). New Zealand securities regulations allow Australian issuers to issue their securities in New Zealand provided that certain documents are appropriately filed with the New Zealand Registrar of Companies. Specifically, the regulations require that any amendments to constitutions and compliance plans be filed in New Zealand. In April 2003, the New Zealand Securities Commission opined that such late filings would result in certain New Zealand investors having a right to return of their investment plus interest at 10% per annum from the date of investment. This technical issue affected many in the industry.

On December 24, 2004, Westpac lodged several warranty and indemnification claims related to the sale of BT Financial Group. The claims aggregated approximately A$50.0 million Australian dollars (approximately U.S. $37.0 million as of June 30, 2006) with the majority of the claims (approximately A$45.0 million Australian dollars, or U.S. $33.0 million as of June 30, 2006) related to fund pricing and accounting issues around a tax asset called future income tax benefit (“FITB”). FITB is an asset used in calculating unit pricing of funds. Westpac claimed that BT Financial Group incorrectly accrued FITB assets in valuing asset portfolios of BT funds in Australia and New Zealand and that as a result fund values were overstated.

The claims made by Westpac related to both indemnifications were settled and paid by us in 2006. This settlement did not have a material impact on net income.

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We are also subject to various other indemnification obligations issued in conjunction with certain transactions, primarily the sale of Principal Residential Mortgage, Inc., and other divestitures, acquisitions and financing transactions whose terms range in duration and often are not explicitly defined.

Certain portions of these indemnifications may be capped, while other portions are not subject to such limitations; therefore, the overall maximum amount of the obligation under the indemnifications cannot be reasonably estimated. While we are unable to estimate with certainty the ultimate legal and financial liability with respect to these indemnifications, we believe the likelihood is remote that material payments would be required under such indemnifications and therefore such indemnifications would not result in a material adverse effect on our business or financial position. It is possible that such outcomes could materially affect net income in a particular quarter or annual period. The fair value of such indemnifications is not material.

**Investments**

We had total consolidated assets as of June 30, 2006, of $131.4 billion, of which $58.1 billion were invested assets. The rest of our total consolidated assets are comprised primarily of separate account assets for which we do not bear investment risk. Because we generally do not bear any investment risk on assets held in separate accounts, the discussion and financial information below does not include such assets. Of our invested assets, $55.1 billion were held by our U.S. operations and the remaining $3.0 billion were held by our International Asset Management and Accumulation segment.

**U.S. Investment Operations**

Our U.S. invested assets are managed by Principal Global Investors, a subsidiary of Principal Life. Our primary investment objective is to maximize after-tax returns consistent with acceptable risk parameters. We seek to protect policyholders’ benefits by optimizing the risk/return relationship on an ongoing basis, through asset/liability matching, reducing the credit risk, avoiding high levels of investments that may be redeemed by the issuer, maintaining sufficiently liquid investments and avoiding undue asset concentrations through diversification. We are exposed to three primary sources of investment risk:

* credit risk, relating to the uncertainty associated with the continued ability of a given obligor to make timely payments of principal and interest;
* interest rate risk, relating to the market price and/or cash flow variability associated with changes in market yield curves; and
* equity risk, relating to adverse fluctuations in a particular common stock.

Our ability to manage credit risk is essential to our business and our profitability. We devote considerable resources to the credit analysis of each new investment. We manage credit risk through industry, issuer and asset class diversification. Our Investment Committee, appointed by our Board of Directors, is responsible for establishing all investment policies and approving or authorizing all investments, except the Executive Committee of the Board must approve any investment transaction exceeding $500.0 million. As of June 30, 2006, there are ten members on the Investment Committee, two of whom are members of our Board of Directors. The remaining members are senior management members representing various areas of our company.

We also seek to reduce call or prepayment risk arising from changes in interest rates in individual investments. We limit our exposure to investments that are prepayable without penalty prior to maturity at the option of the issuer, and we require additional yield on these investments to compensate for the risk that the issuer will exercise such option. We assess option risk in all investments we make and, when we take that risk, we price for it accordingly.

Our Fixed Income Securities Committee, consisting of fixed income securities senior management members, approves the credit rating for the fixed maturity securities we purchase. Teams of security analysts organized by industry focus either on the public or private markets and analyze and monitor these investments. In addition, we have teams who specialize in residential mortgage-backed securities, commercial mortgage-backed securities, asset-backed securities, and public below investment grade securities. We establish a credit reviewed list of approved public issuers to provide an efficient way for our portfolio managers to purchase liquid bonds for which credit review has already been completed. Issuers remain on the list for one year unless removed by our analysts. Our analysts monitor issuers on the list on a continuous basis with a formal review documented annually or more frequently if material events affect the issuer. The analysis includes both fundamental and technical factors. The fundamental analysis encompasses both quantitative and qualitative analysis of the issuer.

The qualitative analysis includes an assessment of both accounting and management aggressiveness. In addition, technical indicators such as stock price volatility and credit default swap levels are monitored.

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Our Fixed Income Securities Committee also reviews private transactions on a continuous basis to assess the quality ratings of our privately placed investments. We regularly review our investments to determine whether we should re-rate them, employing the following criteria:

* material declines in the issuer’s revenues or margins;
* significant management or organizational changes;
* significant uncertainty regarding the issuer’s industry;
* debt service coverage or cash flow ratios that fall below industry-specific thresholds;
* violation of financial covenants; and
* other business factors that relate to the issuer.

A dedicated risk management team is responsible for centralized monitoring of the commercial mortgage portfolio. We apply a variety of strategies to minimize credit risk in our commercial mortgage loan portfolio. When considering the origination of new commercial mortgage loans, we review the cash flow fundamentals of the property, make a physical assessment of the underlying security, conduct a comprehensive market analysis and compare against industry lending practices. We use a proprietary risk rating model to evaluate all new and a majority of existing loans within the portfolio. The proprietary risk model is designed to stress projected cash flows under simulated economic and market downturns. Our lending guidelines are designed to encourage 75% or less loan-to-value ratios and a debt service coverage ratio of at least 1.2 times. We analyze investments outside of these guidelines based on cash flow quality, tenancy and other factors. The weighted average loan-to-value ratio at origination for brick and mortar commercial mortgages in our portfolio was 69% and the debt service coverage ratio at loan inception was 1.6 times as of June 30, 2006.

We have limited exposure to equity risk in our common stock portfolio. Equity securities accounted for only 1% of our U.S. invested assets as of June 30, 2006.

Our investment decisions and objectives are a function of the underlying risks and product profiles of each primary business operation. In addition, we diversify our product portfolio offerings to include products that contain features that will protect us against fluctuations in interest rates. Those features include adjustable crediting rates, policy surrender charges and market value adjustments on liquidations. For further information on our management of interest rate risk, see Item 3, “Quantitative and Qualitative Disclosures about Market Risk”.

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***Overall Composition of U.S. Invested Assets***

U.S. invested assets as of June 30, 2006, were predominantly of high quality and broadly diversified across asset class, individual credit, industry and geographic location. Asset allocation is determined based on cash flow and the risk/return requirements of our products. As shown in the following table, the major categories of U.S. invested assets are fixed maturity securities and commercial mortgages. The remainder is invested in real estate, residential mortgage loans, equity securities and other assets. In addition, policy loans are included in our invested assets. The following discussion analyzes the composition of U.S. invested assets, but excludes invested assets of the participating separate accounts.

**U.S. Invested Assets**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **June 30, 2006** | | |  |  |  |  | **December 31, 2005** | | | |  |
|  |  | **Carrying Amount** | | | **% of Total** |  |  |  | **Carrying Amount** |  | **% of Total** |  |  |
|  |  |  |  |  | **($ in millions)** | | | | |  |  |  |  |
| Fixed maturity securities: |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Public | **$** | **27,678.3** |  |  | **50%** | | $ | | 27,826.3 | 51% | | |  |
| Private |  | **12,821.7** |  |  | **23** |  |  |  | 12,289.4 | 23 | |  |  |
| Equity securities |  | **775.9** |  |  | **1** |  |  |  | 764.0 | 1 | |  |  |
| Mortgage loans: |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Commercial |  | **9,963.8** |  |  | **18** |  |  |  | 9,890.7 | 18 | |  |  |
| Residential |  | **1,068.0** |  |  | **2** |  |  |  | 1,088.5 | 2 | |  |  |
| Real estate held for sale |  | **141.9** |  |  | **—** | |  |  | 133.8 |  | — | |  |
| Real estate held for investment |  | **843.0** |  |  | **2** |  |  |  | 853.9 | 2 | |  |  |
| Policy loans |  | **843.2** |  |  | **2** |  |  |  | 827.7 | 2 | |  |  |
| Other investments |  | **1,010.5** |  |  | **2** |  |  |  | 755.3 |  | 1 |  |  |
| Total invested assets |  | **55,146.3** |  |  | **100%** | |  |  | 54,429.6 |  | 100% | |  |
| Cash and cash equivalents |  | **1,154.7** |  |  |  |  |  |  | 1,585.1 |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Total invested assets and cash | **$** | **56,301.0** |  |  |  |  | $ | | 56,014.7 |  |  |  |  |
| ***U.S. Investment Results*** |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

The following tables present the yield and investment income, excluding net realized/unrealized gains and losses for our U.S. invested assets. The annualized yield on U.S. invested assets and on cash and cash equivalents was 6.0% for the three months ended June 30, 2006, compared to 5.5% for the three months ended June 30, 2005. The annualized yield on U.S. invested assets and on cash and cash equivalents was 5.9% for the six months ended June 30, 2006, compared to 5.5% for the six months ended June 30, 2005. We calculate annualized yields using a simple average of asset classes at the beginning and end of the reporting period.

**U.S. Invested Assets**

**Investment Income Yields by Asset Type**

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  | **For the three months ended June 30,** | | | | |  |  |  |  |  |
|  |  | **2006** |  |  |  |  | **2005** |  |  |  |  |  |
|  |  | **Yield** |  | **Amount** |  |  | **Yield** |  | **Amount** |  |  |  |
|  |  |  |  | **($ in millions)** | | |  |  |  |  |  |  |
| Fixed maturity securities | **6.1%** | | **$** | **613.9** |  |  | 5.8% | $ | 575.3 |  |  |  |
| Equity securities | **6.3** | |  | **12.3** |  |  | 6.8 |  | 12.4 |  |  |  |
| Mortgage loans — commercial | **6.6** | |  | **163.3** |  |  | 6.6 |  | 169.2 |  |  |  |
| Mortgage loans — residential | **5.0** | |  | **13.3** |  |  | 4.5 |  | 12.8 |  |  |  |
| Real estate | **8.6** | |  | **21.3** |  |  | 5.8 |  | 14.1 |  |  |  |
| Policy loans | **5.9** | |  | **12.4** |  |  | 6.2 |  | 12.6 |  |  |  |
| Cash and cash equivalents | **3.6** | |  | **12.0** |  |  | 2.8 |  | 5.6 |  |  |  |
| Other investments | **8.8** | |  | **20.0** |  |  | (0.3) |  | (0.7) | |  |  |
| Total before investment expenses | **6.2** | |  | **868.5** |  |  | 5.8 |  | 801.3 |  |  |  |
| Investment expenses | **0.2** | |  | **31.3** |  |  | 0.3 |  | 35.1 |  |  |  |
| Net investment income | **6.0%** | | **$** | **837.2** |  |  | 5.5% | $ | 766.2 |  |  |  |
|  | 68 |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |



**U.S. Invested Assets**

**Investment Income Yields by Asset Type**

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  | **For the six months ended June 30,** | | | |  |  |  |
|  | **2006** |  |  |  |  |  | **2005** |  |  |  |
|  | **Yield** |  |  | **Amount** |  |  | **Yield** |  | **Amount** |  |
|  |  |  |  | **($ in millions)** | | |  |  |  |  |
| Fixed maturity securities | **6.0%** | **$** | | **1,211.7** |  |  | 5.8% | $ | 1,145.4 |  |
| Equity securities | **6.3** |  |  | **24.2** |  |  | 6.6 |  | 24.1 |  |
| Mortgage loans — commercial | **6.5** |  |  | **323.9** |  |  | 6.6 |  | 337.3 |  |
| Mortgage loans — residential | **4.9** |  |  | **26.6** |  |  | 4.5 |  | 25.4 |  |
| Real estate | **7.7** |  |  | **37.9** |  |  | 5.3 |  | 25.9 |  |
| Policy loans | **5.9** |  |  | **24.6** |  |  | 6.2 |  | 25.1 |  |
| Cash and cash equivalents | **3.3** |  |  | **22.4** |  |  | 2.7 |  | 10.3 |  |
| Other investments | **7.9** |  |  | **35.1** |  |  | 1.1 |  | 6.2 |  |
| Total before investment expenses | **6.1** |  |  | **1,706.4** |  |  | 5.8 |  | 1,599.7 |  |
| Investment expenses | **0.2** |  |  | **63.2** |  |  | 0.3 |  | 67.7 |  |
| Net investment income | **5.9%** |  | **$** | **1,643.2** |  |  | 5.5% | $ | 1,532.0 |  |
|  |  |  |  |  |  |  |  |  |  |  |

***Fixed Maturity Securities***

Fixed maturity securities consist of short-term investments, publicly traded debt securities, privately placed debt securities and redeemable preferred stock, and represented 73% and 74% of total U.S. invested assets as of June 30, 2006 and December 31, 2005, respectively. The fixed maturity securities portfolio was comprised, based on carrying amount, of 68% in publicly traded fixed maturity securities and 32% in privately placed fixed maturity securities as of June 30, 2006 and 69% in publicly traded fixed maturity securities and 31% in privately placed fixed maturity securities as of December 31, 2005. Included in the privately placed category as of June 30, 2006 and December 31, 2005, were $7.0 billion and $6.5 billion, respectively, of securities eligible for resale to qualified institutional buyers under Rule 144A under the Securities Act of 1933. Fixed maturity securities were diversified by category of issuer as of June 30, 2006, and December 31, 2005, as shown in the following table:

**U.S. Invested Assets**

**Fixed Maturity Securities by Type of Issuer**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **June 30, 2006** | | |  |  |  |  |  | **December 31, 2005** | | | |
|  |  | **Carrying Amount** | | | **% of Total** |  |  |  |  | **Carrying Amount** | | **% of Total** |  |
|  |  |  |  |  |  | **($ in millions)** | | | | | |  |  |
| U.S. Government and agencies | **$** | **565.5** |  |  |  | **1%** | | $ | | 555.5 |  | 1% | |
| States and political subdivisions |  | **1,350.6** |  |  |  | **3** |  |  |  | 1,283.4 |  | 3 |  |
| Non-U.S. governments |  | **424.8** |  |  |  | **1** |  |  |  | 463.0 |  | 1 |  |
| Corporate — public |  | **19,254.9** |  |  |  | **48** |  |  |  | 19,590.8 |  | 49 |  |
| Corporate — private |  | **9,952.1** |  |  |  | **25** |  |  |  | 9,901.5 |  | 25 |  |
| Residential pass-through securities |  | **1,452.7** |  |  |  | **3** |  |  |  | 1,526.0 |  | 4 |  |
| Commercial mortgage-backed securities |  | **4,281.8** |  |  |  | **11** |  |  |  | 4,118.6 |  | 10 |  |
| Residential collateralized mortgage obligations |  | **926.8** |  |  |  | **2** |  |  |  | 752.5 |  | 2 |  |
| Asset-backed securities |  | **2,290.8** |  |  |  | **6** |  |  |  | 1,924.4 |  | 5 |  |
| Total fixed maturities | **$** | **40,500.0** |  |  |  | **100** | **%** |  | $ | 40,115.7 |  | 100 | % |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |

We held $8,952.1 million of mortgage-backed and asset-backed securities as of June 30, 2006, and $8,321.5 million as of December 31, 2005.

We believe that it is desirable to hold residential mortgage-backed pass-through securities due to their credit quality and liquidity as well as portfolio diversification characteristics. Our portfolio is comprised of GNMA, FNMA and FHLMC pass-through securities. In addition, our residential collateralized mortgage obligation portfolio offers structural features that allow cash flows to be matched to our liabilities.

Commercial mortgage-backed securities provide high levels of credit protection, diversification, reduced event risk and enhanced liquidity. Commercial mortgage-backed securities are predominantly comprised of rated large pool securitizations that are individually and collectively diverse by property type, borrower and geographic dispersion.

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We purchase asset-backed securities (“ABS”) to diversify the overall credit risks of the fixed maturity securities portfolio and to provide attractive returns. The principal risks in holding asset-backed securities are structural and credit risks. Structural risks include the security’s priority in the issuer’s capital structure, the adequacy of and ability to realize proceeds from the collateral and the potential for prepayments. Credit risks involve issuer/servicer risk where collateral values can become impaired in the event of servicer credit deterioration.

Our ABS portfolio is diversified both by type of asset and by issuer. We actively monitor holdings of asset-backed securities to ensure that the risk profile of each security improves or remains consistent. Prepayments in the ABS portfolio are, in general, insensitive to changes in interest rates or are insulated to such changes by call protection features. In the event that we are subject to prepayment risk, we monitor the factors that impact the level of prepayment and prepayment speed for those asset-backed securities. In addition, we diversify the risks of asset-backed securities by holding a diverse class of securities, which limits our exposure to any one security.

The international exposure in our U.S. fixed maturity securities totaled $7,866.8 million, or 19% of total fixed maturity securities, as of June 30, 2006, comprised of corporate and foreign government fixed maturity securities. Of the $7,866.8 million as of June 30, 2006, investments totaled $2,164.2 million in the United Kingdom, $2,030.5 million in the continental European Union, $927.5 million in Asia, $726.6 million in Australia, $453.4 million in South America,

$272.6 million in Mexico and $93.4 million in Japan. The remaining $1,198.6 million is invested in 21 other countries. All international fixed maturity securities held by our U.S. operations are either denominated in U.S. dollars or have been swapped into U.S. dollar equivalents. Our international investments are analyzed internally by country and industry credit investment professionals. We control concentrations using issuer and country level exposure benchmarks, which are based on the credit quality of the issuer and the country. Our investment policy limits total international fixed maturity securities investments to 18% of total statutory general account assets with a 4% limit in emerging markets. Exposure to Canada is not included in our international exposure. As of June 30, 2006, our investments in Canada totaled $1,377.2 million.

The following tables present the amortized cost of our top ten exposures, including approved counterparty exposure limits, as of June 30, 2006, and December 31, 2005.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  |  | **June 30, 2006** | |
|  |  |  | **Amortized Cost** | |
|  |  |  | **(in millions)** |  |
| HSBC Holdings PLC(1) | **$** | | **380.5** |  |
| Bank of America Corp.(3) |  |  | **346.7** |  |
| American International Group Inc.(3) |  |  | **323.0** |  |
| MBIA Inc.(2) |  |  | **305.7** |  |
| JP Morgan Chase & Co.(3) |  |  | **304.1** |  |
| Royal Bank of Scotland Group PLC(3) |  |  | **285.6** |  |
| General Electric Co |  |  | **232.8** |  |
| Citigroup Inc.(3) |  |  | **216.6** |  |
| Verizon Communications Inc. |  |  | **203.4** |  |
| Morgan Stanley(3) |  |  | **197.1** |  |
| Total top ten exposures |  | **$** | **2,795.5** |  |
|  |  |  |  |  |



1. Includes a $238.2 million investment classified as an equity security for U.S. GAAP. The investment issuer engages in managing investment grade third party bond investments and HSBC paper. All non-HSBC paper has the ultimate benefit of price support protection provided by HSBC Bank, PLC. Since Principal Life Insurance Company has the senior priority in the issuer, we believe many third party bonds could be liquidated to satisfy our claim. While we calculate our exposure on a gross basis, the value we attribute to the underlying collateral is $125.0 million.
2. MBIA Inc. exposure is predominately comprised of the guarantee of underlying securities that are rated “A-” equivalent or better by the rating agencies on a stand alone basis. The MBIA wrap guarantees performance in the event of default of the underlying securities bringing the combined rating to AAA.
3. Includes approved counterparty limit. The actual and the stressed potential exposures are less than the approved limit.

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|  |  |  |  |
| --- | --- | --- | --- |
|  |  | **December 31, 2005** | |
|  |  | **Amortized Cost** | |
|  |  | **(in millions)** |  |
| HSBC Holdings PLC(1) | $ | 381.6 |  |
| American International Group Inc.(3) |  | 330.7 |  |
| Bank of America Corp.(3) |  | 317.5 |  |
| JP Morgan Chase & Co.(3) |  | 316.3 |  |
| Royal Bank of Scotland Group PLC(3) |  | 315.6 |  |
| MBIA Inc.(2) |  | 311.6 |  |
| General Electric Co |  | 247.5 |  |
| Citigroup Inc.(3) |  | 235.0 |  |
| Banco Santander Central Hispano SA |  | 227.4 |  |
| AT&T Inc. |  | 219.9 |  |
| Total top ten exposures | $ | 2,903.1 |  |
|  |  |  |  |



1. Includes a $238.2 million investment classified as an equity security for U.S. GAAP. The investment issuer engages in managing investment grade third party bond investments and HSBC paper. All non-HSBC paper has the ultimate benefit of price support protection provided by HSBC Bank, PLC. Since Principal Life Insurance Company has senior priority in the issuer, we believe many third party bonds could be liquidated to satisfy our claim. While we calculate our exposure on a gross basis, the value we attribute to the underlying collateral is $125.0 million.
2. MBIA Inc. exposure is predominately comprised of the guarantee of underlying securities which are rated “A-” equivalent or better by the rating agencies on a stand alone basis. The MBIA wrap guarantees performance in the event of a default of the underlying securities bringing the combined rating to AAA.
3. Includes approved counterparty limit. The actual and the stressed potential exposures are less than the approved limit.

Our top ten exposures were rated an “A” equivalent or better by the rating agencies as of June 30, 2006 and December 31, 2005. As of June 30, 2006 and December 31, 2005, no individual non-government issuer represented more than 1% of U.S. invested assets.

Valuation techniques for the fixed maturity securities portfolio vary by security type and the availability of market data. Pricing models and their underlying assumptions impact the amount and timing of unrealized gains and losses recognized, and the use of different pricing models or assumptions could

produce different financial results. Interactive Data Corporation (“IDC”) or direct broker quotes are our sources for external prices for our public bonds and those private placement securities that are actively traded in the secondary market. In cases where quoted market prices are not available, a matrix pricing valuation approach is used. Securities are grouped into pricing categories that vary by asset class, sector, rating, and average life. Each pricing category is assigned a risk spread based on studies of observable public market data or market clearing data from the investment professionals assigned to specific security classes. The expected cash flows of the security are then discounted back at the current Treasury curve plus the appropriate risk spread. Although the matrix valuation approach provides a fair valuation of each pricing category, the valuation of an individual security within each pricing category may actually be impacted by company specific factors. Certain market events that could impact the valuation of securities include issuer credit ratings, business climate, management changes, litigation, and government actions among others. The resulting prices are then reviewed by pricing analysts. All loans placed on the “watch list” are valued individually by the investment analysts or the analysts that focus on troubled securities (“Workout Group”). Although we believe our estimates reasonably reflect the fair value of those securities, the key assumptions about risk premiums, performance of underlying collateral (if any) and other factors involve significant assumptions and may not reflect those of an active market. To the extent that bonds have longer maturity dates, management’s estimate of fair value may involve greater subjectivity since they involve judgment about events well into the future. Every month, there is a comprehensive review of all impaired securities and problem loans by a group consisting of the Chief Investment Officer, the Portfolio Managers, and the Workout Group. The valuation of impaired bonds for which there is no quoted price is typically based on the present value of the future cash flows expected to be received. If the company is likely to continue operations, the estimate of future cash flows is typically based on the expected operating cash flows of the company that are available to make payments of the bonds. If the company is likely to liquidate, the estimate of future cash flows is based on an estimate of the liquidation value of its net assets.

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The Securities Valuation Office (“SVO”) of the National Association of Insurance Commissioners (“NAIC”) evaluates most of the fixed maturity securities that we and other U.S. insurance companies hold. The SVO evaluates the bond investments of insurers for regulatory reporting purposes and assigns securities to one of six investment categories. The NAIC designations closely mirror the nationally recognized securities rating organizations’ credit ratings for marketable bonds. NAIC designations 1 and 2 include bonds considered investment grade by such rating organizations. Bonds are considered investment grade when rated “Baa3” or higher by Moody’s, or “BBB-” or higher by Standard & Poor’s. NAIC designations 3 through 6 are referred to as below investment grade. Bonds are considered below investment grade when rated “Ba1” or lower by Moody’s, or “BB+” or lower by Standard & Poor’s. As of June 30, 2006, the percentage, based on estimated fair value, of total publicly traded and privately placed fixed maturity securities that were investment grade with an NAIC designation 1 or 2 was 95%.

We also monitor the credit drift of our corporate fixed maturity securities portfolio. Credit drift is defined as the ratio of the percentage of rating downgrades, including defaults, divided by the percentage of rating upgrades. We measure credit drift once each fiscal year, assessing the changes in our internally developed credit ratings that have occurred during the year. Standard & Poor’s annual credit ratings drift ratio measures the credit rating change, within a specific year, of companies that have been assigned ratings by Standard & Poor’s. The annual internal credit drift ratio on corporate fixed maturity securities we held in our general account was a more favorable ratio at 0.56 times compared to the Standard & Poor’s drift ratio of 0.78 times, as of December 31, 2005.

The following table presents our total fixed maturity securities by NAIC designation and the equivalent ratings of the nationally recognized securities rating organizations as of June 30, 2006, and December 31, 2005, as well as the percentage, based on estimated fair value, that each designation comprises:

**U.S. Invested Assets**

**Fixed Maturity Securities by Credit Quality(1)**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **Rating** |  |  |  |  | **June 30, 2006** | | |  |  |  |  | **December 31, 2005** | | | |  |  |  |
|  |  |  |  | **Amortized** | |  | **Carrying** | | **% of Total** |  |  | **Amortized** |  |  | **Carrying** | | **% of Total** |  |  |
| **NAIC Rating** |  | **Agency** |  |  |  | **Carrying** | |  |  |  | **Carrying** | |  |
|  | **Equivalent** |  |  | **Cost** | |  | **Amount** | | **Amount** | |  | **Cost** |  |  | **Amount** | | **Amount** | |  |
|  |  |  |  |  |  |  |  |  |  | **($ in millions)** | | | |  |  |  |  |  |  |  |
| 1 | Aaa/Aa/A | | **$** | | **23,021.7** |  | **$** | **23,059.2** |  | **57%** | | $ | 21,593.3 | $ | | 22,361.9 |  | 56% | |  |
| 2 | Baa | |  |  | **15,343.1** |  |  | **15,436.7** |  | **38** |  |  | 14,978.4 |  |  | 15,590.7 |  | 39 |  |  |
| 3 | Ba | |  |  | **1,690.4** |  |  | **1,732.1** |  | **4** |  |  | 1,701.7 |  |  | 1,801.6 |  | 4 |  |  |
| 4 | B | |  |  | **224.4** |  |  | **228.5** |  | **1** |  |  | 258.5 |  |  | 271.2 |  | 1 |  |  |
| 5 | Caa and lower | |  |  | **11.4** |  |  | **11.2** |  | **—** | |  | 14.3 |  |  | 14.4 |  | — | |  |
| 6 | In or near default | |  |  | **32.9** |  |  | **32.3** |  | **—** | |  | 76.2 |  |  | 75.9 |  | — | |  |
|  |  | Total fixed maturities |  | **$** | **40,323.9** |  | **$** | **40,500.0** |  | **100** | **%** | $ | 38,622.4 |  | $ | 40,115.7 |  | 100 | % |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



1. Includes 64 securities with an amortized cost of $691.2 million, gross gains of $1.4 million, gross losses of $15.5 million and a carrying amount of $677.1 million as of June 30, 2006, that are still pending a review and assignment of a rating by the SVO. Due to the timing of when fixed maturity securities are purchased, legal documents are filed, and the review by the SVO, there will always be securities in our portfolio that are unrated over a reporting period. In these instances, an equivalent rating is assigned based on our fixed income analyst’s assessment.

We believe that our long-term fixed maturity securities portfolio is well diversified among industry types and between publicly traded and privately placed securities. Each year, we direct the majority of our net cash inflows into investment grade fixed maturity securities. Our current policy is to limit the percentage of cash flow invested in below investment grade assets to 7% of cash flow. As of June 30, 2006, we had invested 4.0% of new cash flow for the year in below investment grade assets. While the general account investment returns have improved due to the below investment grade asset class, we manage its growth strategically by limiting it to 10% of the total fixed maturity securities portfolios.

We invest in privately placed fixed maturity securities to enhance the overall value of the portfolio, increase diversification and obtain higher yields than are possible with comparable quality public market securities. Generally, private placements provide broader access to management information, strengthened negotiated protective covenants, call protection features and, where applicable, a higher level of collateral. They are, however, generally not freely tradable because of restrictions imposed by federal and state securities laws and illiquid trading markets.

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The following table shows the carrying amount of our corporate fixed maturity securities by Salomon industry category, as well as the percentage of the total corporate portfolio that each Salomon industry category comprises as of June 30, 2006, and December 31, 2005.

**U.S. Invested Assets**

**Corporate Fixed Maturity Securities by Salomon Industry**

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **June 30, 2006** | | |  |  |  |  | **December 31, 2005** | | | |
|  |  | **Carrying Amount** | | | **% of Total** |  |  |  | **Carrying Amount** | | **% of Total** |  |
|  |  |  |  |  |  | **($ in millions)** | | | | |  |  |
| **Industry Class** |  |  |  |  |  |  |  |  |  |  |  |  |
| Finance — Bank | **$** | **3,667.3** |  |  |  | **13%** | | $ | 3,451.0 |  | 12% | |
| Finance — Insurance |  | **2,983.2** |  |  |  | **10** |  |  | 3,010.3 |  | 10 |  |
| Finance — Other |  | **4,407.3** |  |  |  | **15** |  |  | 4,090.1 |  | 14 |  |
| Industrial — Consumer |  | **1,043.7** |  |  |  | **3** |  |  | 1,067.2 |  | 4 |  |
| Industrial — Energy |  | **2,498.8** |  |  |  | **9** |  |  | 2,718.4 |  | 9 |  |
| Industrial — Manufacturing |  | **5,113.1** |  |  |  | **17** |  |  | 5,223.3 |  | 18 |  |
| Industrial — Other |  | **108.4** |  |  |  | **—** | |  | 106.4 |  | — | |
| Industrial — Service |  | **4,548.4** |  |  |  | **16** |  |  | 4,548.7 |  | 15 |  |
| Industrial — Transport |  | **812.6** |  |  |  | **3** |  |  | 848.6 |  | 3 |  |
| Utility — Electric |  | **2,317.6** |  |  |  | **8** |  |  | 2,568.6 |  | 9 |  |
| Utility — Other |  | **44.8** |  |  |  | **—** | |  | 47.9 |  | — | |
| Utility — Telecom |  | **1,661.8** |  |  |  | **6** |  |  | 1,811.8 |  | 6 |  |
| Total | **$** | **29,207.0** |  |  |  | **100** | **%** | $ | 29,492.3 |  | 100 | % |
|  |  |  |  |  |  |  |  |  |  |  |  |  |

We monitor any decline in the credit quality of fixed maturity securities through the designation of “problem securities”, “potential problem securities” and “restructured securities”. We define problem securities in our fixed maturity portfolio as securities: (i) as to which principal and/or interest payments are in default or where default is perceived to be imminent in the near term, or (ii) issued by a company that went into bankruptcy subsequent to the acquisition of such securities. We define potential problem securities in our fixed maturity portfolio as securities included on an internal “watch list” for which management has concerns as to the ability of the issuer to comply with the present debt payment terms and which may result in the security becoming a problem or being restructured. The decision whether to classify a performing fixed maturity security as a potential problem involves significant subjective judgments by our management as to the likely future industry conditions and developments with respect to the issuer. We define restructured securities in our fixed maturity portfolio as securities where a concession has been granted to the borrower related to the borrower’s financial difficulties that would not have otherwise been considered. We determine that restructures should occur in those instances where greater economic value will be realized under the new terms than through liquidation or other disposition and may involve a change in contractual cash flows. If at the time of restructure, the present value of the new future cash flows is less than the current cost of the asset being restructured, a realized capital loss is recorded in net income and a new cost basis is established.

We have a process in place to identify securities that could potentially have a credit impairment that is other than temporary. This process involves monitoring market events that could impact issuers’ credit ratings, business climate, management changes, litigation and government actions, and other similar factors. This process also involves monitoring late payments, pricing levels, downgrades by rating agencies, key financial ratios, financial statements, revenue forecasts and cash flow projections as indicators of credit issues.

Every month, a group of individuals including the Chief Investment Officer, our Portfolio Managers, members of our Workout Group, and representatives from Investment Accounting review all securities to determine whether an other than temporary decline in value exists and whether losses should be recognized. The analysis focuses on each issuer’s ability to service its debts in a timely fashion and the length of time the security has been trading below cost. Formal documentation of the analysis and the Company’s decision is prepared and approved by management.

We consider relevant facts and circumstances in evaluating whether the credit impairment of a security is other than temporary. Relevant facts and circumstances considered include: (1) the length of time the fair value has been below cost; (2) the financial position and access to capital of the issuer, including the current and future impact of any specific events; and (3) our ability and intent to hold the security to maturity or until it recovers in value. To the extent we determine that a security is deemed to be other than temporarily impaired, the difference between amortized cost and fair value would be charged to earnings.

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There are a number of significant risks and uncertainties inherent in the process of monitoring credit impairments and determining if an impairment is other than temporary. These risks and uncertainties include: (1) the risk that our assessment of an issuer’s ability to meet all of its contractual obligations will change based on changes in the credit characteristics of that issuer, (2) the risk that the economic outlook will be worse than expected or have more of an impact on the issuer than anticipated, (3) the risk that our investment professionals are making decisions based on fraudulent or misstated information in the financial statements provided by issuers and (4) the risk that new information obtained by us or changes in other facts and circumstances lead us to change our intent to hold the security to maturity or until it recovers in value. Any of these situations could result in a charge to earnings in a future period.

The net realized loss relating to other than temporary credit impairments of fixed maturity securities was $5.7 million for the six months ended June 30, 2006. The single largest other than temporary credit impairment represented less than 0.1% of U.S. fixed maturity securities as of June 30, 2006. As the result of the recently announced acquisition of WM Advisors, we also recognized $16.0 million of impairment write-downs for the six months ended June 30, 2006, that resulted from our determination that we no longer had the ability and intent to hold certain fixed maturity securities until they recovered in value.

For the six months ended June 30, 2006, we realized $10.2 million of gross losses upon disposal of bonds excluding hedging adjustments. Included in this $10.2 million is $8.1 million related to sales of fifteen credit impaired and credit related names. We generally intend to hold securities in unrealized loss positions until they mature or recover. However, we do sell bonds under certain circumstances such as when we have evidence of a significant deterioration in the issuer’s creditworthiness, when a change in regulatory requirements modifies what constitutes a permissible investment or the maximum level of investments held or when there is an increase in capital requirements or a change in risk weights of debt securities. Sales generate both gains and losses.

The following tables present our fixed maturity securities available-for-sale by industry category and the associated gross unrealized gains and losses as of June 30, 2006, and December 31, 2005.

**U.S. Invested Assets**

**Fixed Maturity Securities Available-for-Sale by Industry Category**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  | **June 30, 2006** | | |  |  |  |  |  |  |
|  |  |  | **Amortized** |  |  | **Gross** |  |  | **Gross** | |  | **Carrying** |  |  |
|  |  |  |  |  | **Unrealized** |  | **Unrealized** | | |  |  |  |
|  |  |  | **Cost** |  |  | **Gains** |  |  | **Losses** | |  | **Amount** |  |  |
|  |  |  |  |  |  | **(in millions)** | | |  |  |  |  |  |  |
| Finance — Bank | **$** | | **3,687.0** | **$** | | **57.7** | **$** | | **77.6** |  | **$** | **3,667.1** |  |  |
| Finance — Insurance |  |  | **3,019.5** |  |  | **34.8** |  |  | **71.2** |  |  | **2,983.1** |  |  |
| Finance — Other |  |  | **4,388.2** |  |  | **112.7** |  |  | **93.9** |  |  | **4,407.0** |  |  |
| Industrial — Consumer |  |  | **1,048.4** |  |  | **19.9** |  |  | **24.6** |  |  | **1,043.7** |  |  |
| Industrial — Energy |  |  | **2,424.4** |  |  | **104.9** |  |  | **30.9** |  |  | **2,498.4** |  |  |
| Industrial — Manufacturing |  |  | **5,098.7** |  |  | **108.7** |  |  | **94.9** |  |  | **5,112.5** |  |  |
| Industrial — Other |  |  | **109.5** |  |  | **0.9** |  |  | **2.0** |  |  | **108.4** |  |  |
| Industrial — Service |  |  | **4,516.4** |  |  | **106.7** |  |  | **75.3** |  |  | **4,547.8** |  |  |
| Industrial — Transport |  |  | **786.8** |  |  | **33.6** |  |  | **7.8** |  |  | **812.6** |  |  |
| Utility — Electric |  |  | **2,289.1** |  |  | **66.7** |  |  | **38.4** |  |  | **2,317.4** |  |  |
| Utility — Other |  |  | **41.3** |  |  | **3.5** |  |  | **—** | |  | **44.8** |  |  |
| Utility — Telecom |  |  | **1,634.3** |  |  | **52.2** |  |  | **24.9** |  |  | **1,661.6** |  |  |
| Total corporate securities |  |  | **29,043.6** |  |  | **702.3** |  |  | **541.5** |  |  | **29,204.4** |  |  |
| U.S. Government and agencies |  |  | **553.0** |  |  | **0.5** |  |  | **9.7** |  |  | **543.8** |  |  |
| States and political subdivisions |  |  | **1,305.4** |  |  | **29.7** |  |  | **13.4** |  |  | **1,321.7** |  |  |
| Non-U.S. governments |  |  | **397.2** |  |  | **29.1** |  |  | **1.5** |  |  | **424.8** |  |  |
| Mortgage-backed and other asset-backed securities |  |  | **8,866.7** |  |  | **169.6** |  |  | **189.0** |  |  | **8,847.3** |  |  |
| Total fixed maturity securities, available-for-sale |  | **$** | **40,165.9** |  | **$** | **931.2** |  | **$** | **755.1** |  | **$** | **40,342.0** |  |  |
|  | 74 |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**U.S. Invested Assets**

**Fixed Maturity Securities Available-for-Sale by Industry Category**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  | **December 31, 2005** | | | | |  |  |  |  |  |
|  |  |  | **Amortized** |  |  | **Gross** | |  | **Gross** | |  |  | **Carrying** | |  |
|  |  |  |  |  | **Unrealized** | |  | **Unrealized** | |  |  |  |
|  |  |  | **Cost** |  |  | **Gains** | |  | **Losses** | |  |  | **Amount** | |  |
|  |  |  |  |  |  | **(in millions)** | | |  |  |  |  |  |  |  |
| Finance — Bank | $ | | 3,354.9 | $ | | 110.6 |  | $ | 14.5 |  | $ | | 3,451.0 |  |  |
| Finance — Insurance |  |  | 2,915.0 |  |  | 111.3 |  |  | 16.0 |  |  |  | 3,010.3 |  |  |
| Finance — Other |  |  | 3,932.5 |  |  | 181.5 |  |  | 23.9 |  |  |  | 4,090.1 |  |  |
| Industrial — Consumer |  |  | 1,038.0 |  |  | 36.5 |  |  | 7.3 |  |  |  | 1,067.2 |  |  |
| Industrial — Energy |  |  | 2,506.5 |  |  | 220.2 |  |  | 8.3 |  |  |  | 2,718.4 |  |  |
| Industrial — Manufacturing |  |  | 5,060.9 |  |  | 201.4 |  |  | 39.0 |  |  |  | 5,223.3 |  |  |
| Industrial — Other |  |  | 104.4 |  |  | 2.3 |  |  | 0.3 |  |  |  | 106.4 |  |  |
| Industrial — Service |  |  | 4,369.6 |  |  | 204.4 |  |  | 25.3 |  |  |  | 4,548.7 |  |  |
| Industrial — Transport |  |  | 795.1 |  |  | 57.0 |  |  | 3.5 |  |  |  | 848.6 |  |  |
| Utility — Electric |  |  | 2,455.3 |  |  | 123.8 |  |  | 10.5 |  |  |  | 2,568.6 |  |  |
| Utility — Other |  |  | 41.2 |  |  | 6.7 |  |  | — | |  |  | 47.9 |  |  |
| Utility — Telecom |  |  | 1,701.8 |  |  | 118.6 |  |  | 8.6 |  |  |  | 1,811.8 |  |  |
| Total corporate securities |  |  | 28,275.2 |  |  | 1,374.3 |  |  | 157.2 |  |  |  | 29,492.3 |  |  |
| U.S. Government and agencies |  |  | 557.9 |  |  | 1.8 |  |  | 4.2 |  |  |  | 555.5 |  |  |
| States and political subdivisions |  |  | 1,222.6 |  |  | 45.7 |  |  | 3.8 |  |  |  | 1,264.5 |  |  |
| Non-U.S. governments |  |  | 416.2 |  |  | 47.2 |  |  | 0.4 |  |  |  | 463.0 |  |  |
| Mortgage-backed and other asset-backed securities |  |  | 8,045.5 |  |  | 267.8 |  |  | 77.9 |  |  |  | 8,235.4 |  |  |
| Total fixed maturity securities, available-for-sale |  | $ | 38,517.4 |  | $ | 1,736.8 |  | $ | 243.5 |  |  | $ | 40,010.7 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

The total unrealized losses on our fixed maturity securities available-for-sale were $755.1 million and $243.5 million as of June 30, 2006 and December 31, 2005, respectively. Of the $755.1 million in gross unrealized losses as of June 30, 2006, there were $5.3 million in losses attributed to securities scheduled to mature in one year or less, $128.8 million is attributed to securities scheduled to mature between one to five years, $244.0 million is attributed to securities scheduled to mature between five to ten years, $188.0 million is attributed to securities scheduled to mature after ten years, and $189.0 million is related to mortgage-backed and other asset-backed securities. The gross unrealized losses as of June 30, 2006 were concentrated primarily in the Mortgage-backed and other asset-backed securities, Industrial — Manufacturing, Financial — Other, Financial — Bank, and Industrial — Services sectors. The gross unrealized losses as of December 31, 2005 were concentrated primarily in the Mortgage-backed and other asset-backed securities, Industrial — Manufacturing, Industrial — Services, and Financial — Other sectors.

The following tables present our fixed maturity securities available-for-sale by investment grade and below investment grade and the associated gross unrealized gains and losses as of June 30, 2006, and December 31, 2005.

**U.S. Invested Assets**

**Fixed Maturity Securities Available-for-Sale by Quality**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  | **June 30, 2006** | | | |  |  |  |  |  |
|  |  |  | **Amortized** | |  | **Gross** | |  | **Gross** |  |  | **Carrying** |  |  |
|  |  |  |  | **Unrealized** | |  | **Unrealized** |  |  |  |  |
|  |  |  | **Cost** | |  | **Gains** | |  | **Losses** |  |  | **Amount** |  |  |
|  |  |  |  |  |  | **(in millions)** | | |  |  |  |  |  |  |
| Investment Grade: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Public | **$** | | **26,470.0** |  | **$** | **519.0** |  | **$** | **491.2** | **$** | | **26,497.8** |  |  |
| Private |  |  | **11,737.8** |  |  | **337.2** |  |  | **233.9** |  |  | **11,841.1** |  |  |
| Below Investment Grade: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Public |  |  | **1,101.1** |  |  | **31.7** |  |  | **15.9** |  |  | **1,116.9** |  |  |
| Private |  |  | **857.0** |  |  | **43.3** |  |  | **14.1** |  |  | **886.2** |  |  |
| Total fixed maturity securities, available-for-sale |  | **$** | **40,165.9** |  | **$** | **931.2** |  | **$** | **755.1** |  | **$** | **40,342.0** |  |  |
|  | 75 |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**U.S. Invested Assets**

**Fixed Maturity Securities Available-for-Sale by Quality**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  | **December 31, 2005** | | | |  |  |  |  |  |
|  |  |  | **Amortized** |  |  | **Gross** | |  | **Gross** |  |  | **Carrying** | |  |
|  |  |  |  |  | **Unrealized** | |  | **Unrealized** |  |  |  |
|  |  |  | **Cost** |  |  | **Gains** | |  | **Losses** |  |  | **Amount** | |  |
|  |  |  |  |  |  | **(in millions)** | | |  |  |  |  |  |  |
| Investment Grade: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Public | $ | | 25,638.9 | $ | | 1,024.9 |  | $ | 164.3 | $ | | 26,499.5 |  |  |
| Private |  |  | 10,827.8 |  |  | 584.5 |  |  | 64.2 |  |  | 11,348.1 |  |  |
| Below Investment Grade: |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Public |  |  | 1,263.4 |  |  | 54.4 |  |  | 9.9 |  |  | 1,307.9 |  |  |
| Private |  |  | 787.3 |  |  | 73.0 |  |  | 5.1 |  |  | 855.2 |  |  |
| Total fixed maturity securities, available-for-sale |  | $ | 38,517.4 |  | $ | 1,736.8 |  | $ | 243.5 |  | $ | 40,010.7 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

**U.S. Invested Assets**

**Unrealized Losses on Investment Grade Fixed Maturity Securities**

**Available-for-Sale by Aging Category**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  | **June 30, 2006** | | | |  |  |  |  |  |  |  |  |  |
|  |  | **Public** | | |  |  |  | **Private** | | |  |  |  | **Total** | | | |  |  |  |
|  |  | **Carrying** |  |  | **Gross** |  |  | **Carrying** |  |  | **Gross** |  |  | **Carrying** | |  |  | **Gross** |  |  |
|  |  |  |  | **Unrealized** | |  |  |  | **Unrealized** |  |  |  |  | **Unrealized** | |  |
|  |  | **Amount** |  |  | **Losses** | |  | **Amount** |  |  | **Losses** |  |  | **Amount** | |  |  | **Losses** | |  |
|  |  |  |  |  |  |  |  | **(in millions)** | | | |  |  |  |  |  |  |  |  |  |
| Three months or less | **$** | **2,922.4** | **$** | | **30.3** |  | **$** | **1,479.5** | **$** | | **23.4** | **$** | | **4,401.9** |  | **$** | | **53.7** |  |  |
| Greater than three to six months |  | **4,454.5** |  |  | **133.1** |  |  | **1,859.2** |  |  | **65.0** |  |  | **6,313.7** |  |  |  | **198.1** |  |  |
| Greater than six to nine months |  | **1,573.0** |  |  | **53.9** |  |  | **656.7** |  |  | **28.4** |  |  | **2,229.7** |  |  |  | **82.3** |  |  |
| Greater than nine to twelve months |  | **3,825.2** |  |  | **176.1** |  |  | **1,387.6** |  |  | **79.4** |  |  | **5,212.8** |  |  |  | **255.5** |  |  |
| Greater than twelve to twenty-four months |  | **1,783.3** |  |  | **73.0** |  |  | **461.9** |  |  | **16.8** |  |  | **2,245.2** |  |  |  | **89.8** |  |  |
| Greater than twenty-four to thirty-six months |  | **399.3** |  |  | **19.6** |  |  | **295.8** |  |  | **16.4** |  |  | **695.1** |  |  |  | **36.0** |  |  |
| Greater than thirty-six months |  | **43.7** |  |  | **5.2** |  |  | **57.9** |  |  | **4.5** |  |  | **101.6** |  |  |  | **9.7** |  |  |
| Total fixed maturities, available-for-sale | **$** | **15,001.4** |  | **$** | **491.2** |  | **$** | **6,198.6** |  | **$** | **233.9** |  | **$** | **21,200.0** |  |  | **$** | **725.1** |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

**U.S. Invested Assets**

**Unrealized Losses on Investment Grade Fixed Maturity Securities**

**Available-for-Sale by Aging Category**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  | **December 31, 2005** | | | |  |  |  |  |  |  |  |  |  |
|  |  | **Public** | | |  |  |  | **Private** | | |  |  |  | **Total** | | | |  |  |  |
|  |  | **Carrying** | |  | **Gross** |  |  | **Carrying** |  |  | **Gross** |  |  | **Carrying** | |  |  | **Gross** |  |  |
|  |  |  | **Unrealized** |  |  |  |  | **Unrealized** |  |  |  |  | **Unrealized** | |  |
|  |  | **Amount** | |  | **Losses** |  |  | **Amount** |  |  | **Losses** |  |  | **Amount** | |  |  | **Losses** | |  |
|  |  |  |  |  |  |  |  | **(in millions)** | | | |  |  |  |  |  |  |  |  |  |
| Three months or less | $ | 1,907.9 |  | $ | 11.3 | $ | | 774.3 | $ | | 6.3 | $ | | 2,682.2 |  | $ | | 17.6 |  |  |
| Greater than three to six months |  | 4,332.5 |  |  | 79.6 |  |  | 1,574.5 |  |  | 29.3 |  |  | 5,907.0 |  |  |  | 108.9 |  |  |
| Greater than six to nine months |  | 416.3 |  |  | 12.9 |  |  | 109.5 |  |  | 2.8 |  |  | 525.8 |  |  |  | 15.7 |  |  |
| Greater than nine to twelve months |  | 1,032.0 |  |  | 22.3 |  |  | 212.3 |  |  | 5.2 |  |  | 1,244.3 |  |  |  | 27.5 |  |  |
| Greater than twelve to twenty-four months |  | 1,191.2 |  |  | 33.3 |  |  | 457.2 |  |  | 14.7 |  |  | 1,648.4 |  |  |  | 48.0 |  |  |
| Greater than twenty-four to thirty-six months |  | 118.5 |  |  | 4.8 |  |  | 161.8 |  |  | 5.9 |  |  | 280.3 |  |  |  | 10.7 |  |  |
| Greater than thirty-six months |  | 1.4 |  |  | 0.1 |  |  | — |  |  | — |  |  | 1.4 |  |  |  | 0.1 |  |  |
| Total fixed maturities, available-for-sale | $ | 8,999.8 |  | $ | 164.3 |  | $ | 3,289.6 |  | $ | 64.2 |  | $ | 12,289.4 |  |  | $ | 228.5 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

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**U.S. Invested Assets**

**Unrealized Losses on Below Investment Grade Fixed Maturity Securities**

**Available-for-Sale by Aging Category**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  | **June 30, 2006** | | | |  |  |  |  |  |  |  |  |  |
|  |  | **Public** | | |  |  |  | **Private** | | |  |  |  | **Total** | | | |  |  |  |
|  |  | **Carrying** | |  | **Gross** |  |  | **Carrying** | |  | **Gross** |  |  | **Carrying** | |  |  | **Gross** |  |  |
|  |  |  | **Unrealized** |  |  |  | **Unrealized** |  |  |  |  | **Unrealized** | |  |
|  |  | **Amount** | |  | **Losses** |  |  | **Amount** | |  | **Losses** |  |  | **Amount** | |  |  | **Losses** | |  |
|  |  |  |  |  |  |  |  | **(in millions)** | | | |  |  |  |  |  |  |  |  |  |
| Three months or less | **$** | **161.8** |  | **$** | **3.4** | **$** | | **80.1** |  | **$** | **1.0** | **$** | | **241.9** |  | **$** | | **4.4** |  |  |
| Greater than three to six months |  | **81.9** |  |  | **2.5** |  |  | **96.3** |  |  | **3.0** |  |  | **178.2** |  |  |  | **5.5** |  |  |
| Greater than six to nine months |  | **45.7** |  |  | **0.7** |  |  | **72.3** |  |  | **3.7** |  |  | **118.0** |  |  |  | **4.4** |  |  |
| Greater than nine to twelve months |  | **79.3** |  |  | **5.0** |  |  | **69.2** |  |  | **3.3** |  |  | **148.5** |  |  |  | **8.3** |  |  |
| Greater than twelve to twenty-four months |  | **84.9** |  |  | **4.3** |  |  | **52.9** |  |  | **3.0** |  |  | **137.8** |  |  |  | **7.3** |  |  |
| Greater than twenty-four to thirty-six months |  | **—** | |  | **—** |  |  | **0.6** |  |  | **0.1** |  |  | **0.6** |  |  |  | **0.1** |  |  |
| Greater than thirty-six months |  | **—** | |  | **—** |  |  | **—** | |  | **—** |  |  | **—** | |  |  | **—** | |  |
| Total fixed maturities, available-for-sale | **$** | **453.6** |  | **$** | **15.9** |  | **$** | **371.4** |  | **$** | **14.1** |  | **$** | **825.0** |  |  | **$** | **30.0** |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

**U.S. Invested Assets**

**Unrealized Losses on Below Investment Grade Fixed Maturity Securities**

**Available-for-Sale by Aging Category**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  | **December 31, 2005** | | | |  |  |  |  |  |  |  |  |  |
|  |  | **Public** | | |  |  |  | **Private** | | |  |  |  | **Total** | | | |  |  |  |
|  |  | **Carrying** | |  | **Gross** |  |  | **Carrying** | |  | **Gross** |  |  | **Carrying** | |  |  | **Gross** |  |  |
|  |  |  | **Unrealized** |  |  |  | **Unrealized** |  |  |  |  | **Unrealized** | |  |
|  |  | **Amount** | |  | **Losses** |  |  | **Amount** | |  | **Losses** |  |  | **Amount** | |  |  | **Losses** | |  |
|  |  |  |  |  |  |  |  | **(in millions)** | | | |  |  |  |  |  |  |  |  |  |
| Three months or less | $ | 121.9 |  | $ | 0.7 | $ | | 55.8 |  | $ | 1.8 | $ | | 177.7 |  | $ | | 2.5 |  |  |
| Greater than three to six months |  | 81.9 |  |  | 4.7 |  |  | 36.4 |  |  | 0.8 |  |  | 118.3 |  |  |  | 5.5 |  |  |
| Greater than six to nine months |  | 50.8 |  |  | 0.8 |  |  | 36.8 |  |  | 1.2 |  |  | 87.6 |  |  |  | 2.0 |  |  |
| Greater than nine to twelve months |  | 49.2 |  |  | 1.9 |  |  | 18.4 |  |  | 0.5 |  |  | 67.6 |  |  |  | 2.4 |  |  |
| Greater than twelve to twenty-four months |  | 36.9 |  |  | 1.2 |  |  | 8.5 |  |  | 0.3 |  |  | 45.4 |  |  |  | 1.5 |  |  |
| Greater than twenty-four to thirty-six months |  | — | |  | — |  |  | 0.6 |  |  | 0.1 |  |  | 0.6 |  |  |  | 0.1 |  |  |
| Greater than thirty-six months |  | 49.9 |  |  | 0.6 |  |  | 19.8 |  |  | 0.4 |  |  | 69.7 |  |  |  | 1.0 |  |  |
| Total fixed maturities, available-for-sale | $ | 390.6 |  | $ | 9.9 |  | $ | 176.3 |  | $ | 5.1 |  | $ | 566.9 |  |  | $ | 15.0 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

Of total gross unrealized losses as of June 30, 2006 and December 31, 2005, $725.1 million and $228.5 million were related to investment grade securities, respectively. Gross unrealized losses related to below investment grade securities were $30.0 million and $15.0 million as of June 30, 2006 and December 31, 2005, respectively.

The following tables present the carrying amount and gross unrealized losses on fixed maturity securities available-for-sale, where the estimated fair value has declined and remained below amortized cost by 20% or more as of June 30, 2006, and December 31, 2005.

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**U.S. Invested Assets**

**Unrealized Losses on Fixed Maturity Securities**

**Available-for-Sale by Aging Category**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  | **June 30, 2006** | | |  |  |  |  |  |  |  |  |  |
|  |  | **Problem, Potential Problem,** | | | |  |  |  | **All Other Fixed Maturity** | | | | |  | **Total** | | |  |  |  |
|  |  | **and Restructured** | | | |  |  |  | **Securities** | | |  |  |  |  |  |  |
|  |  | **Carrying** |  |  | **Gross** |  |  |  | **Carrying** | |  | **Gross** |  |  | **Carrying** |  |  | **Gross** |  |  |
|  |  |  |  | **Unrealized** |  |  |  |  | **Unrealized** | |  |  |  | **Unrealized** | |  |
|  |  | **Amount** |  |  | **Losses** |  |  |  | **Amount** | |  | **Losses** | |  | **Amount** |  |  | **Losses** | |  |
|  |  |  |  |  |  |  |  |  | **(in millions)** | | |  |  |  |  |  |  |  |  |  |
| Three months or less | **$** | | **—** | | **$** | **—** | **$** | | **—** | | **$** | **—** | | **$** | **—** | **$** | | **—** | |  |
| Greater than three to six months |  |  | **—** | |  | **—** |  |  | **—** | |  | **—** | |  | **—** |  |  | **—** | |  |
| Greater than six to nine months |  |  | **—** | |  | **—** |  |  | **2.7** |  |  | **1.0** |  |  | **2.7** |  |  | **1.0** |  |  |
| Greater than nine to twelve months | | | **—** | |  | **—** |  |  | **—** | |  | **—** | |  | **—** |  |  | **—** | |  |
| Greater than twelve months |  |  | **—** |  |  | **—** |  |  | **—** |  |  | **—** |  |  | **—** |  |  | **—** |  |  |
| Total fixed maturity securities, |  | **$** | **—** |  | **$** | **—** |  | **$** | **2.7** |  | **$** | **1.0** |  | **$** | **2.7** | **$** | | **1.0** |  |  |
| available-for-sale |  |  |  |  |
|  |  |  |  |  |  | |  |  | |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  | **U.S. Invested Assets** | | | | | |  |  |  |  |  |  |  |  |  |  |
|  | **Unrealized Losses on Fixed Maturity Securities Available-for-Sale by Aging Category** | | | | | | | | | | | | | |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  | **December 31, 2005** | | | | |  |  |  |  |  |  |  |
|  |  | **Problem, Potential Problem,** | | | |  |  |  | **All Other Fixed Maturity** | | | | |  | **Total** | | |  |  |  |
|  |  | **and Restructured** | | | |  |  |  | **Securities** | | |  |  |  |  |  |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **Carrying** |  |  |  | **Gross** |  |  | **Carrying** | |  | **Gross** |  |  | **Carrying** | |  | **Gross** |  |  |
|  |  |  |  |  | **Unrealized** |  |  |  | **Unrealized** | |  |  | **Unrealized** | |  |
|  |  | **Amount** |  |  |  | **Losses** |  |  | **Amount** | |  | **Losses** | |  | **Amount** | |  | **Losses** | |  |
|  |  |  |  |  |  |  |  |  | **(in millions)** | | |  |  |  |  |  |  |  |  |  |
| Three months or less | $ | | — | | $ | — | $ | | 4.2 |  | $ | 2.1 |  | $ | 4.2 |  | $ | 2.1 |  |  |
| Greater than three to six months |  |  | — | |  | — |  |  | — | |  | — | |  | — | |  | — | |  |
| Greater than six to nine months |  |  | — | |  | — |  |  | — | |  | — | |  | — | |  | — | |  |
| Greater than nine to twelve months |  |  | — | |  | — |  |  | — | |  | — | |  | — | |  | — | |  |
| Greater than twelve months |  |  | — |  |  | — |  |  | — |  |  | — |  |  | — |  |  | — |  |  |
| Total fixed maturity securities, | $ | | — | | $ | — | $ | | 4.2 |  | $ | 2.1 |  | $ | 4.2 |  | $ | 2.1 |  |  |
| available-for-sale |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

Gross unrealized losses on fixed maturity securities where the estimated fair value has been 20% or more below amortized cost were $1.0 million as of June 30, 2006 and $2.1 million as of December 31, 2005. There were no gross unrealized losses attributed to those securities considered to be “problem”, “potential problem” or “restructured” as of June 30, 2006 and December 31, 2005.

The following table presents the total carrying amount of our fixed maturity portfolio, as well as its problem, potential problem and restructured fixed maturities for the periods indicated:

**U.S. Invested Assets**

**Problem, Potential Problem and Restructured Fixed Maturities at Carrying Amount**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  | **June 30,** | | **December 31,** | | |  |  |
|  |  |  | **2006** |  |  | **2005** |  |  |  |
|  |  |  | **($ in millions)** | | | |  |  |  |
| Total fixed maturity securities (public and private) | **$** | | **40,500.0** |  | $ | 40,115.7 |  |  |  |
| Problem fixed maturity securities |  |  |  |  |  |  |  |  |  |
| **$** | **7.6** |  | $ | 42.0 |  |  |  |
| Potential problem fixed maturity securities |  |  | **56.6** |  |  | 101.6 |  |  |  |
| Restructured fixed maturity securities |  |  | **10.1** |  |  | — | |  |  |
| Total problem, potential problem and restructured fixed maturity securities |  | **$** | **74.3** |  | $ | 143.6 |  |  |  |
| Total problem, potential problem and restructured fixed maturity securities as a percent |  |  |  |  |  |  |  |  |  |
|  |  | **0%** | |  |  |  |  |  |
| of total fixed maturity securities |  |  |  | 0% | |  |  |
| 78 |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |



***Mortgage Loans***

Mortgage loans consist primarily of commercial mortgage loans on real estate. At June 30, 2006, commercial mortgage loans aggregated to

$9,963.8 million. Commercial mortgage loans on real estate are generally reported at cost adjusted for amortization of premiums and accrual of discounts,

computed using the interest method, and net of valuation allowances. Commercial mortgage loans held for sale are carried at the lower of cost or fair value, less

cost to sell, and reported as mortgage loans in the statements of financial position.

Commercial mortgages play an important role in our investment strategy by:

* providing strong risk-adjusted relative value in comparison to other investment alternatives;
* enhancing total returns; and
* providing strategic portfolio diversification.

As a result, we have focused on constructing a solid, high quality portfolio of mortgages. Our portfolio is generally comprised of mortgages with conservative loan-to-value ratios, high debt service coverages and general purpose property types with a strong credit tenancy.

Our commercial loan portfolio consists of primarily non-recourse, fixed rate mortgages on fully or near fully leased properties. The mortgage portfolio is comprised of general-purpose industrial properties, manufacturing office properties and credit oriented retail properties.

California accounted for 18% of our commercial mortgage loan portfolio as of June 30, 2006. We are, therefore, exposed to potential losses resulting from the risk of catastrophes, such as earthquakes, that may affect the region. Like other lenders, we generally do not require earthquake insurance for properties on which we make commercial mortgage loans. With respect to California properties, however, we obtain an engineering report specific to each property. The report assesses the building’s design specifications, whether it has been upgraded to meet seismic building codes and the maximum loss that is likely to result from a variety of different seismic events. We also obtain a report that assesses, by building and geographic fault lines, the amount of loss our commercial mortgage loan portfolio might suffer under a variety of seismic events.

Our commercial loan portfolio is highly diversified by borrower. As of June 30, 2006, 37% of the U.S. commercial mortgage loan portfolio was comprised of mortgage loans with principal balances of less than $10.0 million. The total number of commercial mortgage loans outstanding as of June 30, 2006 and December 31, 2005 was 1,264 and 1,309, respectively. The average loan size of our commercial mortgage portfolio was $7.9 million as of June 30, 2006.

We actively monitor and manage our commercial mortgage loan portfolio. Substantially all loans within the portfolio are analyzed regularly and are internally rated, based on a proprietary risk rating cash flow model, in order to monitor the financial quality of these assets. Based on ongoing monitoring, mortgage loans with a likelihood of becoming delinquent are identified and placed on an internal “watch list”. Among criteria which would indicate a potential problem are: imbalances in ratios of loan to value or contract rents to debt service, major tenant vacancies or bankruptcies, borrower sponsorship problems, late payments, delinquent taxes and loan relief/restructuring requests.

We review our mortgage loan portfolio and analyze the need for a valuation allowance for any loan which is delinquent for 60 days or more, in process of foreclosure, restructured, on the “watch list”, or which currently has a valuation allowance. We categorize loans, which are delinquent, loans in process of foreclosure, and loans to borrowers in bankruptcy as “problem” loans. Potential problem loans are loans placed on an internal “watch list” for which management has concerns as to the ability of the borrower to comply with the present loan payment terms and which may result in the loan becoming a problem or being restructured. The decision whether to classify a performing loan as a potential problem involves significant subjective judgments by management as to the likely future economic conditions and developments with respect to the borrower. We categorize loans for which the original terms of the mortgages have been modified or for which interest or principal payments have been deferred as “restructured” loans. We also consider matured loans that are refinanced at below market rates as restructured.

The valuation allowance for commercial mortgage loans includes a loan specific allowance for impaired loans and a provision for losses based on past loss experience believed to be adequate to absorb estimated probable credit losses. The changes in this valuation allowance are reported as a net realized/unrealized capital loss on our consolidated statements of operations.

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Commercial mortgage loans on real estate are considered impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to contractual terms of the loan agreement. When we determine that a loan is impaired, a valuation allowance is established or a direct write-down of the loan is recorded for the difference between the carrying amount of the mortgage loan and the estimated value. Estimated value is based on either the present value of the expected future cash flows discounted at the loan’s effective interest rate, the loan’s observable market price or fair value of the collateral. When a valuation allowance is established, subsequent recoveries are charged to the valuation allowance and subsequent losses may be charged to the valuation allowance or as a direct write-down of the loan.

The determination of the calculation and the adequacy of the mortgage loan loss provision based on past experience and mortgage impairments is subjective. Our periodic evaluation and assessment of the adequacy of the provision for losses and the need for mortgage impairments is based on known and inherent risks in the portfolio, adverse situations that may affect the borrower’s ability to repay, the estimated value of the underlying collateral, composition of the loan portfolio, current economic conditions, loss experience and other relevant factors. The current portfolio statistics and past loss experience produced a provision for the Principal Life general account totaling $32.2 million. The evaluation of our impaired loan component of the allowance is subjective, as it requires estimating the amounts and timing of future cash flows expected to be received on impaired loans. Our financial position is sensitive to changes in estimated cash flows from mortgages, the value of the collateral, and changes in the economic environment in general. Decreases in the valuation allowance aggregated to $0.2 million for the six months ended June 30, 2006, and $9.2 million for the year ended December 31, 2005.

The following table represents our commercial mortgage valuation allowance for the periods indicated:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  | **U.S. Invested Assets** | |  |  |  |  |  |
| **Commercial Mortgage Valuation Allowance** | | | | |  |  |  |
|  |  |  | **June 30,** | | **December 31,** | | |
|  |  |  | **2006** |  |  | **2005** |  |
|  |  |  | **($ in millions)** | | | |  |
| Beginning balance | **$** | | **33.2** |  | $ | 42.4 |  |
| Provision |  |  | **2.1** |  |  | 6.7 |  |
| Release |  |  | **(2.3)** | |  | (15.9) | |
| Ending balance |  | **$** | **33.0** |  | $ | 33.2 |  |
| Valuation allowance as % of carrying value before reserves |  |  | **1%** | |  | 1% | |

The following table presents the carrying amounts of problem, potential problem and restructured commercial mortgages relative to the carrying amount of all commercial mortgages for the periods indicated:

**U.S. Invested Assets**

**Problem, Potential Problem and Restructured Commercial Mortgages at Carrying Amount**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  | **June 30,** | |  | **December 31,** | | |  |
|  |  |  | **2006** |  |  |  | **2005** |  |  |
|  |  |  | **($ in millions)** | | | | |  |  |
| Total commercial mortgages | **$** | | **9,963.8** |  | $ | | 9,890.7 |  |  |
| Problem commercial mortgages(1) |  |  |  |  |  |  |  |  |  |
| **$** | **10.6** |  | $ | 10.4 |  |  |
| Potential problem commercial mortgages |  |  | **9.1** |  |  |  | 10.2 |  |  |
| Restructured commercial mortgages |  |  | **23.2** |  |  |  | 65.1 |  |  |
| Total problem, potential problem and restructured commercial mortgages |  | **$** | **42.9** |  |  | $ | 85.7 |  |  |
| Total problem, potential problem and restructured commercial mortgages as a percent |  |  |  |  |  |  |  |  |  |
|  |  | **1%** | |  |  |  |  |  |
| of total commercial mortgages |  |  |  |  | 1% | |  |



1. Problem commercial mortgages include mortgage loans in foreclosure of $10.5 million as of June 30, 2006. This is the same mortgage loan that was in foreclosure as of December 31, 2005.

***Equity Real Estate***

We hold commercial equity real estate as part of our investment portfolio. As of June 30, 2006, and December 31, 2005, the carrying amount of equity real estate investment was $984.9 million and $987.7 million, or 2% and 2%, of U.S. invested assets, respectively. Our commercial equity real estate is held in the form of wholly owned real estate, real estate acquired upon foreclosure of commercial mortgage loans, and majority owned interests in real estate joint ventures.

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Equity real estate is categorized as either “real estate held for investment” or “real estate held for sale”. Real estate held for investment totaled

$843.0 million as of June 30, 2006, and $853.9 million as of December 31, 2005. The carrying value of real estate held for investment is generally adjusted for

impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Such impairment adjustments are

recorded as realized investment losses and accordingly, are reflected in our consolidated results of operations. For the years ended June 30, 2006 and December

31, 2005, there were no such impairment adjustments.

The carrying amount of real estate held for sale as of June 30, 2006, and December 31, 2005, was $141.9 million and $133.8 million, net of valuation allowances of $4.2 million and $4.2 million, respectively. Once we identify a real estate property to be sold and commence a plan for marketing the property, we classify the property as held for sale. We establish a valuation allowance subject to periodic revisions, if necessary, to adjust the carrying value of the property to reflect the lower of its current carrying value or the fair value, less associated selling costs.

We use research, both internal and external, to recommend appropriate product and geographic allocations and changes to the equity real estate portfolio.

We monitor product, geographic and industry diversification separately and together to determine the most appropriate mix.

Equity real estate is distributed across geographic regions of the country with larger concentrations in the South Atlantic, Pacific, and West South Central regions of the United States as of June 30, 2006. By property type, there is a concentration in office buildings and industrial sites that represented approximately 68% of the equity real estate portfolio as of June 30, 2006.

**Other Investments**

Our other investments totaled $1,010.5 million as of June 30, 2006, compared to $755.3 million as of December 31, 2005. Derivatives accounted for $723.8 million in other investments as of June 30, 2006. The remaining invested assets include equity method investments, which include properties owned jointly with venture partners and operated by the partners.

**International Investment Operations**

As of June 30, 2006, our international investment operations consist of the investments of Principal International comprised of $3.0 billion in invested assets. Principal Global Investors advises each Principal International affiliate on investment policies and strategies that are consistent with the products they offer. Due to the regulatory constraints in each country, each company maintains its own investment policies.

**Overall Composition of International Invested Assets**

As shown in the following table, the major categories of international invested assets as of June 30, 2006, and December 31, 2005, were fixed maturity securities and residential mortgage loans:

**International Invested Assets**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **June 30, 2006** | | |  |  |  |  | **December 31, 2005** | | | |  |  |
|  |  | **Carrying Amount** | | | **% of Total** |  |  |  | **Carrying Amount** |  | **% of Total** |  |  |  |
|  |  |  |  |  |  | **($ in millions)** | | | |  |  |  |  |  |
| Fixed maturity securities |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Public | **$** | **2,045.4** |  |  |  | **69%** $ | | | 2,114.1 | 69% | | |  |  |
| Private |  | **—** | | |  | **—** | | | 0.6 |  | — | |  |  |
| Equity securities |  | **49.6** |  |  |  | **2** |  |  | 50.7 | 2 | |  |  |  |
| Mortgage loans |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| Residential |  | **512.1** |  |  |  | **17** |  |  | 505.1 | 17 | |  |  |  |
| Real estate held for investment |  | **12.3** |  |  |  | **—** | | | 11.7 |  | — | |  |  |
| Other investments |  | **358.3** |  |  |  | **12** |  |  | 358.2 |  | 12 |  |  |  |
| Total invested assets |  | **2,977.7** |  |  |  | **100%** | |  | 3,040.4 |  | 100% | |  |  |
| Cash and cash equivalents |  | **62.2** |  |  |  |  |  |  | 56.2 |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |
| Total invested assets and cash | **$** | **3,039.9** |  |  |  |  |  | $ | 3,096.6 |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | 81 |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

**Market Risk Exposures and Risk Management**

Market risk is the risk that we will incur losses due to adverse fluctuations in market rates and prices. Our primary market risk exposure is to changes in interest rates, although we also have exposures to changes in equity prices and foreign currency exchange rates.

The active management of market risk is an integral part of our operations. We manage our overall market risk exposure within established risk tolerance ranges by using the following approaches:

* rebalance our existing asset or liability portfolios;
* control the risk structure of newly acquired assets and liabilities; or

* use derivative instruments to modify the market risk characteristics of existing assets or liabilities or assets expected to be purchased.

**Interest Rate Risk**

Interest rate risk is the risk that we will incur economic losses due to adverse changes in interest rates. One source of interest rate risk is the inherent difficulty in obtaining assets that mature or have their rate reset at the exact same time as the liabilities they support. Assets may have to be reinvested or sold in the future to meet the liability cashflows in unknown interest rate environments. Also, there may be timing differences between when new liabilities are priced and when assets are purchased or procured that can cause fluctuations in profitability if interest rates move materially in the interim. A third source of interest rate risk is the prepayment options embedded within asset and liability contracts that can alter the cash flow profiles from what was originally expected.

One of the measures we use to quantify our exposure to interest rate risk is duration. To calculate duration, we project asset and liability cashflows. These cash flows are discounted to a net present value basis using a spot yield curve, which is a blend of the spot yield curves for each of the asset types in the portfolio. Duration is calculated by re-calculating these cashflows, re-determining the net present value based upon an alternative level of interest rates, and determining the percentage change in fair value.

We manage interest rate risks in a number of ways. Differences in durations between assets and liabilities are measured and kept within acceptable tolerances. Derivatives are also commonly used to mitigate interest rate risk due to cashflow mismatches and timing differences. Prepayment risk is controlled by limiting our exposure to investments that are prepayable without penalty prior to maturity at the option of the issuer. We also require additional yield on these investments to compensate for the risk the issuer will exercise such option. Prepayment risk is also controlled by limiting the sales of liabilities with features such as puts or other options that can be exercised against the company at inopportune times.

**Duration-Managed.** Our exposure to interest rate risk stems largely from our substantial holdings of guaranteed fixed rate liabilities in our U.S. AssetManagement and Accumulation segment. We actively manage the duration of assets and liabilities in these products by minimizing the difference between the two. We have established a maximum tolerance for this difference and seek to stay within this tolerance.

As of June 30, 2006, the difference between the asset and liability durations on our primary duration managed portfolio was +.02. This duration gap indicates that, as of this date, the sensitivity of the fair value of our assets to interest rate movements is greater than that of the fair value of our liabilities. Our goal is to minimize the duration gap. Currently, our guidelines indicate that total duration gaps between the asset and liability portfolios should be within +/-0.25. The value of the assets in this portfolio was $31,350.2 million as of June 30, 2006.

**Duration-Monitored.** For products such as whole life insurance and term life insurance that are less sensitive to interest rate risk, and for other products such asindividual single premium deferred annuities, we manage interest rate risk based on a modeling process that considers the target average life, maturities, crediting rates and assumptions of policyholder behavior. As of June 30, 2006, the weighted-average difference between the asset and liability durations on these portfolios was +.40. This duration gap indicates that, as of this date, the sensitivity of the fair value of our assets to interest rate movements is greater than that of the fair value of our liabilities. We attempt to monitor this duration gap consistent with our overall risk/reward tolerances.

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The value of the assets in these portfolios was $15,466.0 million as of June 30, 2006.

**Non Duration-Managed.** We also have a block of participating general account pension business that passes most of the actual investment performance of theassets to the customer. The investment strategy of this block is to maximize investment return to the customer on a “best efforts” basis, and there is little or no attempt to manage the duration of this portfolio since there is little or no interest rate risk. The value of the assets in these portfolios was $3,996.8 million as of June 30, 2006.

Using the assumptions and data in effect as of June 30, 2006, we estimate that a 100 basis point immediate, parallel increase in interest rates decreases the net fair value of our portfolio by approximately $68.1 million. The following table details the estimated changes by risk management strategy. The table also gives the weighted-average duration of the asset portfolio for each category, and the net duration gap (i.e. the weighted-average difference between the asset and liability durations).

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  | **June 30, 2006** | | |  |  |  |  |  |  |  |
|  |  |  | **Value of** |  | **Duration** |  |  | **Net** |  |  |  |  | **Net** |  |  |
| **Risk Management Strategy** | |  |  |  |  | **Duration** |  |  |  |  | **Fair Value** | |  |
|  | **Total Assets** |  | **of Assets** |  |  | **Gap** |  |  |  |  | **Change** | |  |
|  |  |  | **(in millions)** |  |  |  |  |  |  |  |  |  | **(in millions)** |  |  |
| Primary duration-managed | | **$** | **31,350.2** |  |  | **3.75** |  |  | **.02** |  | **$** | | **(6.3)** | |  |
| Duration-monitored | |  | **15,466.0** |  |  | **4.99** |  |  | **.40** |  |  |  | **(61.8)** | |  |
| Non duration-managed | |  | **3,996.8** |  |  | **5.28** |  |  | **N/A** | |  |  | **N/A** | |  |
| Total | | **$** | **50,813.0** |  |  |  |  |  |  |  |  | **$** | **(68.1** | **)** |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

Our selection of a 100 basis point immediate, parallel increase or decrease in interest rates is a hypothetical rate scenario we use to demonstrate potential risk. While a 100 basis point immediate, parallel increase does not represent our view of future market changes, it is a near term reasonably possible hypothetical change that illustrates the potential impact of such events. While these fair value measurements provide a representation of interest rate sensitivity, they are based on our portfolio exposures at a point in time and may not be representative of future market results. These exposures will change as a result of ongoing portfolio transactions in response to new business, management’s assessment of changing market conditions and available investment opportunities.

**Debt Issued and Outstanding.** As of June 30, 2006, the aggregate fair value of long-term debt was $931.4 million. A 100 basis point, immediate, paralleldecrease in interest rates would increase the fair value of debt by approximately $31.3 million. Debt is not recorded at fair value on the statement of financial position.

**June 30, 2006**

**Fair Value (no accrued interest)**

|  |  |  |  |
| --- | --- | --- | --- |
| **-100 Basis Point** | **No Change** | **+100 Basis Point** |  |
| **Change** | **Change** |  |
|  | **(in millions)** |  |  |

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 8.2% notes payable, due 2009 | **$** | | **510.0** | **$** | | **496.1** |  | **$** | **482.7** |  |
| 4.59% notes payable, due 2011 |  |  | **54.6** |  |  | **52.1** |  |  | **49.8** |  |
| 4.93% notes payable, due 2011 |  |  | **45.3** |  |  | **43.2** |  |  | **41.2** |  |
| 8% surplus notes payable, due 2044 |  |  | **111.9** |  |  | **103.0** |  |  | **94.3** |  |
| Non-recourse mortgages and notes payable |  |  | **181.1** |  |  | **177.6** |  |  | **174.2** |  |
| Other mortgages and notes payable |  |  | **59.8** |  |  | **59.4** |  |  | **58.9** |  |
| Total long-term debt |  | **$** | **962.7** |  | **$** | **931.4** |  | **$** | **901.1** |  |
|  |  |  |  |  |  |  |  |  |  |  |

**Use of Derivatives to Manage Interest Rate Risk.** We use various derivative financial instruments to manage our exposure to fluctuations in interestrates, including interest rate swaps, swaptions, futures, total return swaps, mortgage-backed forwards and options. We use interest rate swaps, futures contracts and mortgage-backed forwards to hedge changes in interest rates subsequent to the issuance of an insurance liability, such as a guaranteed investment contract, but prior to the purchase of a supporting asset, or during periods of holding assets in anticipation of near term liability sales. We use interest rate swaps primarily to more closely match the interest rate characteristics of assets and liabilities. They can be used to change the sensitivity to the interest rate of specific assets and liabilities as well as an entire portfolio. We also use these instruments to hedge the interest rate exposure in our commercial mortgage-backed securitization operations. Occasionally, we will sell a callable investment-type agreement and will use written interest rate swaptions to transform the callable liability into a fixed term liability.

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**Foreign Currency Risk**

Foreign currency risk is the risk that we will incur economic losses due to adverse fluctuations in foreign currency exchange rates. This risk arises from foreign currency-denominated funding agreements issued to non-qualified institutional investors in the international market, foreign currency-denominated fixed maturity securities and demand deposits purchased, and our international operations.

We estimate that as of June 30, 2006, a 10% immediate unfavorable change in each of the foreign currency exchange rates to which we are exposed would result in no material change to the net fair value of our foreign currency denominated instruments identified above, including the currency swap agreements, because we effectively hedge foreign currency denominated instruments to minimize exchange rate impacts. The selection of a 10% immediate unfavorable change in all currency exchange rates should not be construed as a prediction by us of future market events, but rather as an illustration of the potential impact of such an event.

**Use of Derivatives to Manage Foreign Currency Risk.** The foreign currency risk on funding agreements and fixed maturity securities is minimizedby using currency swaps that swap the foreign currency interest and principal payments to our functional currency. The notional amount of our currency swap agreements associated with foreign-denominated liabilities as of June 30, 2006, was $3,235.9 million. The notional amount of our currency swap agreements associated with foreign-denominated fixed maturity securities as of June 30, 2006, was $1,351.1 million.

With regard to our international operations, we attempt to do as much of our business as possible in the functional currency of the country of operation. At times, however, we are unable to do so, and in these cases, we use foreign exchange derivatives to hedge the resulting risks. As of June 30, 2006, our operations in Chile had currency swaps with a notional amount of $24.1 million that are used to swap cash flows on U.S. dollar-denominated bonds to a local currency. Chile also utilized currency forwards with a notional amount of $51.3 million in order to mitigate currency exposure related to U.S. dollar-denominated bonds.

Additionally, we may take measures to hedge our net equity investments in our foreign subsidiaries from currency risks. Currently, there are no outstanding net equity investment hedges.

**Equity Risk**

Equity risk is the risk that we will incur economic losses due to adverse fluctuations in a particular common stock. As of June 30, 2006, the fair value of our equity securities was $825.5 million. A 10% decline in the value of the equity securities would result in an unrealized loss of $82.6 million. The selection of a 10% unfavorable change in the equity markets should not be construed as a prediction by us of future market events, but rather as an illustration of the potential impact of such an event.

We also have equity risk associated with (1) fixed deferred annuity products that credit interest to customers based on changes in an external equity index; (2) variable annuity contracts that have a guaranteed minimum withdrawal benefit (“GMWB”) rider that allows the customer to receive at least the principal deposit back through withdrawals of a specified annual amount, even if the account value is reduced to zero; (3) variable annuity contacts that have a guaranteed minimum death benefit (“GMDB”) that allows the death benefit to be paid, even if the account value has fallen below the GMDB amount;

1. investment-type contracts in which the return is tied to an external equity index; and (5) investment-type contracts in which the return is subject to minimum contractual guarantees.

**Use of Derivatives to Manage Equity Risk.** We economically hedge the fixed deferred annuity product by purchasing options that match the product’sprofile. We economically hedge the GMWB exposure using futures, options and interest rate swaps. We economically hedge the investment contract exposure using equity call options.

**Credit Risk**

Credit risk relates to the uncertainty associated with the continued ability of a given obligor to make timely payments of principal and interest. Our ability to manage credit risk is essential to our business and our profitability. See Item 2. “Management’s Discussion and Analysis of Financial Condition and Results of Operations, Investments” for additional information about credit risk.

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**Use of Derivatives to Diversify or Hedge Credit Risk.** We sometimes purchase credit default swaps to hedge credit exposures in our investmentportfolio. We sell credit default swaps to offer credit protection to investors. If there is an event of default by the referenced name, we are obligated to pay the counterparty the referenced amount of the contract and receive in return the referenced security.

We have increased our credit exposure through credit default swaps by investing in $127.5 million of various tranches of synthetic collateralized debt obligations. The outstanding notional amount as of June 30, 2006 was $565.0 million. We also invested in credit default swaps creating replicated assets with a notional amount of $775.0 million as of June 30, 2006.

In addition, on May 26, 2005, we invested $130.0 million in a secured limited recourse credit linked note issued by a grantor trust. The trust entered into a credit default swap providing credit protection on the first 45% of loss of seven mezzanine tranches totaling $288.9 million of seven synthetic reference portfolios. The risk of loss for the seven referenced mezzanine tranches begins at 4.85% and ends at 10.85% of loss on each of the seven synthetic reference portfolios. Therefore, defaults in an underlying reference portfolio will only affect the credit-linked note if cumulative losses exceed 4.85% of a synthetic reference portfolio. As of June 30, 2006, the credit default swap entered into by the trust had an outstanding notional amount of $130.0 million. The creditors of the grantor trusts have no recourse to the assets of our company.

**Derivative Summary**

Notional amounts are used to express the extent of our involvement in derivative transactions and represent a standard measurement of the volume of our derivative activity. Notional amount is not a quantification of market risk or credit risk and it may not necessarily be recorded on the balance sheet. Notional amounts represent those amounts used to calculate contractual flows to be exchanged and are not paid or received, except for contracts such as currency swaps. Actual credit exposure represents the amount owed to us under derivative contracts as of the valuation date. The following tables present our position in, and credit exposure to, derivative financial instruments as of June 30, 2006, and December 31, 2005.

**Derivative Financial Instruments — Notional Amounts**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **June 30, 2006** | | |  |  |  |  | **December 31, 2005** | | | |  |
|  |  | **Notional Amount** | | | **% of Total** |  |  |  | **Notional Amount** | | **% of Total** |  |  |
|  |  |  |  |  | **($ in millions)** | | | | | |  |  |  |
| Interest rate swaps | **$** | **10,631.6** |  |  | **54%** | | $ | | 8,531.3 |  | 50% | |  |
| Foreign currency swaps |  | **4,611.1** |  |  | **23** |  |  |  | 3,854.5 |  | 23 |  |  |
| Embedded derivative financial instruments |  | **1,482.2** |  |  | **8** |  |  |  | 1,199.5 |  | 7 |  |  |
| Credit default swaps |  | **1,480.0** |  |  | **8** |  |  |  | 1,297.6 |  | 8 |  |  |
| Swaptions |  | **663.0** |  |  | **3** |  |  |  | 684.5 |  | 4 |  |  |
| Call options |  | **245.0** |  |  | **1** |  |  |  | 189.8 |  | 1 |  |  |
| Currency forwards |  | **221.5** |  |  | **1** |  |  |  | 566.6 |  | 4 |  |  |
| Interest rate lock commitments |  | **116.0** |  |  | **1** |  |  |  | 392.3 |  | 2 |  |  |
| Total return swaps |  | **100.0** |  |  | **1** |  |  |  | 100.0 |  | 1 |  |  |
| Bond options |  | **38.5** |  |  | **—** | |  |  | 38.5 |  | — | |  |
| Futures |  | **35.3** |  |  | **—** | |  |  | 58.9 |  | — | |  |
| Mortgage-backed forwards and options |  | **17.5** |  |  | **—** | |  |  | 39.3 |  | — | |  |
| Put options |  | **0.7** |  |  | **—** | |  |  | — | | — | |  |
| Total | **$** | **19,642.4** |  |  | **100** | **%** |  | $ | 16,952.8 |  | 100 | % |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | 85 |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |



**Derivative Financial Instruments — Credit Exposures**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **June 30, 2006** | | |  |  |  |  | **December 31, 2005** | | | |  |
|  |  | **Credit Exposure** | | | **% of Total** |  |  |  | **Credit Exposure** | | **% of Total** |  |  |
|  |  |  |  |  | **($ in millions)** | | | | | |  |  |  |
| Foreign currency swaps | **$** | **449.0** |  |  | **61%** | | $ | | 339.6 |  | 72% | |  |
| Interest rate swaps |  | **242.3** |  |  | **33** |  |  |  | 89.3 |  | 19 |  |  |
| Call options |  | **21.7** |  |  | **3** |  |  |  | 18.0 |  | 4 |  |  |
| Credit default swaps |  | **15.0** |  |  | **2** |  |  |  | 14.0 |  | 3 |  |  |
| Currency forwards |  | **8.6** |  |  | **1** |  |  |  | 11.4 |  | 2 |  |  |
| Bond options |  | **0.6** |  |  | **—** |  |  |  | 0.6 |  | — |  |  |
| Total credit exposure |  | **737.2** |  |  | **100%** | |  |  | 472.9 |  | 100% | |  |
| Less: Collateral received |  | **(128.5)** | |  |  |  |  |  | (97.6) | |  |  |  |
|  |  |  |  |  |  |  |  |  |
| Total | **$** | **608.7** |  |  |  |  |  | $ | 375.3 |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |

The following table shows the interest rate sensitivity of our derivatives measured in terms of fair value. These exposures will change as a result of ongoing portfolio and risk management activities.

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  | **June 30, 2006** |  |  |  |  |  |  |
|  |  |  |  | **Weighted Average** |  |  | **Fair Value (no accrued interest)** | | |  |  |  |
|  |  |  | **Notional Amount** |  | **-100 Basis Point** |  | **No Change** |  | **+100 Basis Point** |  |  |
|  |  |  | **Term (Years)** | | **Change** |  |  | **Change** | |  |
|  |  |  |  |  |  | **($ in millions)** |  |  |  |  |  |  |
| Interest rate swaps | **$** | | **10,631.6** | **5.99(1) $** | | **4.4** | **$** | **203.3** | **$** | **376.5** |  |  |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Mortgage-backed forwards and |  | **17.5** | **.04(4)** |  | **—** | | | **—** | |  |  | **—** | |  |
| options |  |  |  |  |  |
| Swaptions |  | **663.0** | **7.10(3)** |  | **(29.1)** | |  | **(13.3)** | |  |  | **(6.0)** | |  |
| Futures |  | **27.9** | **.21(2)** |  | **(1.4)** | |  | **—** | |  |  | **1.4** |  |  |
| Total return swaps |  | **100.0** | **.12(1)** |  | **—** | | | **—** | |  |  | **—** | |  |
| Bond options |  | **38.5** | **1.63(4)** |  | **(7.2)** | |  | **0.1** |  |  |  | **1.4** |  |  |
| Total | **$** | **11,478.5** |  | **$** | **(33.3** | **)** | **$** | **190.1** |  |  | **$** | **373.3** |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |



1. Based on maturity date of swap.
2. Based on maturity date.
3. Based on option date of swaption.
4. Based on settlement date.

We use U.S. Treasury futures to manage our over/under commitment position, and our position in these contracts changes daily.

**Counterparty Risk**

In conjunction with our use of derivatives, we are exposed to counterparty risk, or the risk that the counterparty fails to perform the terms of the derivative contract. We actively manage this risk by:

* establishing exposure limits which take into account non-derivative exposure we have with the counterparty as well as derivative exposure;
* performing similar credit analysis prior to approval on each derivatives counterparty that we do when lending money on a long-term basis;
* diversifying our risk across numerous approved counterparties;
* limiting exposure to A+ credit or better;
* conducting stress-test analysis to determine the maximum exposure created during the life of a prospective transaction;

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* implementing credit support annex (collateral) agreements with selected counterparties to further limit counterparty exposures; and
* daily monitoring of counterparty credit ratings.

All new derivative counterparties are approved by the Investment Committee. We believe the risk of incurring losses due to nonperformance by our counterparties is manageable.

**Effects of Inflation**

We do not believe that inflation, in the United States or in the other countries in which we operate, has had a material effect on our consolidated operations over the past five years. In the future, however, we may be affected by inflation to the extent it causes interest rates to rise.

**Item 4. Controls and Procedures**

**Changes in Internal Control Over Financial Reporting**

There was no change in our internal control over financial reporting during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Disclosure Controls and Procedures**

In order to ensure that the information that we must disclose in our filings with the SEC is recorded, processed, summarized and reported on a timely basis, we have adopted disclosure controls and procedures. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file with or submit to the SEC is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Our Chief Executive Officer, J. Barry Griswell, and our Chief Financial Officer, Michael H. Gersie, have reviewed and evaluated our disclosure controls and procedures as of June 30, 2006, and have concluded that our disclosure controls and procedures are effective.

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**PART II – OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are regularly involved in litigation, both as a defendant and as a plaintiff, but primarily as a defendant. Litigation naming us as a defendant ordinarily arises out of our business operations as a provider of asset management and accumulation products and services, life, health and disability insurance. Some of the lawsuits are class actions, or purport to be, and some include claims for punitive damages. In addition, regulatory bodies, such as state insurance departments, the SEC, the National Association of Securities Dealers, Inc., the Department of Labor and other regulatory bodies regularly make inquiries and conduct examinations or investigations concerning our compliance with, among other things, insurance laws, securities laws, ERISA and laws governing the activities of broker-dealers.

Several lawsuits have been filed against other insurance companies and insurance brokers alleging improper conduct relating to the payment and non-disclosure of contingent compensation and bid-rigging activity. Several of these suits were filed as purported class actions. Several state attorneys general and insurance regulators have initiated industry-wide inquiries or other actions relating to compensation arrangements between insurance brokers and insurance companies and other industry issues. Beginning in March of 2005, we have received subpoenas and interrogatories from the offices of the Attorneys General of New York and Connecticut seeking information related to compensation agreements with brokers and agents and the sale of retirement products and services. We are cooperating with these inquiries. We have received other requests from regulators and other governmental authorities relating to industry issues and may receive additional such requests, including subpoenas and interrogatories, in the future.

On December 23, 2004, a lawsuit was filed in Iowa state court against us and our wholly owned subsidiaries, Principal Life Insurance Company (“Principal Life”) and Principal Financial Services, Inc., on behalf of a proposed class comprised of the settlement class in the Principal Life sales practices class action settlement, which was approved in April 2001 by the United States District Court for the Southern District of Iowa. This more recent lawsuit claims that the treatment of the settlement costs of that sales practices litigation in relation to the allocation of demutualization consideration to Principal Life policyholders was inappropriate. Demutualization allocation was done pursuant to the terms of a plan of demutualization approved by the policyholders in July 2001 and Insurance Commissioner of the State of Iowa in August 2001. The lawsuit further claims that such allocation was not accurately described to policyholders during the demutualization process and is a breach of the sales practices settlement. On January 27, 2005, we filed a notice to remove the action from state court to the United States District Court for the Southern District of Iowa. On July 22, 2005, the plaintiff’s motion to remand the action to state court was denied, and our motion to dismiss the lawsuit was granted. On September 21, 2005, the plaintiff’s motion to alter or amend the judgment was denied. On October 4, 2005, the plaintiff filed a notice of appeal to the United States Court of Appeals for the Eighth Circuit.

A lawsuit was filed against us, Principal Life, and Principal Financial Services, Inc. in the United States District Court for the Southern District of Iowa on October 31, 2005, but the plaintiff dismissed the case without prejudice on March 17, 2006. The claims and allegations in the lawsuit were substantially the same as those in the December 23, 2004 lawsuit, but the proposed class was limited to those members of the settlement class in the Principal Life sales practices class action settlement who did not own annuities and who received demutualization consideration in the form of cash under the plan of demutualization.

While the outcome of any pending or future litigation cannot be predicted, management does not believe that any pending litigation will have a material adverse effect on our business or financial position. The outcome of litigation is always uncertain, and unforeseen results can occur. It is possible that such outcomes could materially affect net income in a particular quarter or annual period.

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

The following table presents the amount of our common share purchase activity for the periods indicated:

**Issuer Purchases of Equity Securities**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  |  |  |  | **Maximum** | |  |
|  |  |  |  |  |  |  |  |  |  |  | **Number (or** | |  |
|  |  |  |  |  |  |  |  |  |  |  | **Approximate** | |  |
|  |  |  |  |  |  | **Average** | | **Total Number of** |  |  | **Dollar Value) of** | |  |
|  |  | **Total Number** | |  |  |  |  | **Shares (or Units)** | |  |
|  |  |  |  | **Price** | | **Shares (or Units)** |  |  | **that May Yet Be** | |  |
|  |  | **of** | |  |  | **Paid** | | **Purchased as Part** |  |  | **Purchased Under** | |  |
|  |  | **Shares (or** | |  |  | **per** | | **of Publicly** |  |  | **the Plans or** | |  |
| **Period** |  | **Units)** | |  |  | **Share** | | **Announced** |  |  | **Programs (in** | |  |
| **Purchased** |  |  |  | **(or Unit)** |  | **Plans or Programs** |  |  | **millions)** |  |  |
| January 1, 2006 – January 31, 2006 |  | **886,250(1)** | |  | **$** | **47.19** |  | **886,200** |  | **$** | **208.2(2)** | |  |
| February 1, 2006 – February 28, 2006 | | **824,276(1)** | | **$** | | **48.14** |  | **814,895** | **$** | | **169.0(2)** | |  |
| March 1, 2006 – March 31, 2006 | | **1,672,028(1)** | | **$** | | **49.06** |  | **1,655,200** | **$** | | **87.7(2)** | |  |
| April 1, 2006 – April 30, 2006 | | **1,102,043(1)** | | **$** | | **49.58** |  | **1,102,000** | **$** | | **33.1(2)** | |  |
| May 1, 2006 – May 31, 2006 | | **8,296,702** |  | **$** | | **64.26(3)** | | **8,296,702** | **$** | | **—(2) (3)** | |  |
| June 1, 2006 – June 30, 2006 | | **—** | | **$** | | **—** | | **—** | **$** | | **—** | |  |
| Total | | **12,781,299** |  |  |  |  |  | **12,754,997** |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |



1. The number of shares include shares of common stock utilized to execute certain stock incentive awards in 2006: 50 shares in January, 9,381 shares in February, 16,828 shares in March and 43 shares in April.
2. In November 2005, our Board of Directors authorized a repurchase program of up to $250.0 million of our outstanding common stock. On May 18, 2006, the program announced in November 2005 was completed.
3. In May 2006, our Board of Directors authorized a repurchase program of up to $500.0 million of our outstanding common stock. We paid $500.0 million and received the initial delivery of 7.7 million common shares, while retaining the right to receive additional common shares depending on

the volume weighted average share price of our common stock over the program’s duration. The program will be completed in the fourth quarter 2006.

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

At the Company’s annual meeting of stockholders on May 16, 2006, the stockholders elected five Class II directors each for a term expiring at the Company’s 2009 annual meeting. The voting results were as follows:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  | **VOTES FOR** | | **VOTES** | |  |
|  |  | **WITHHELD** | |  |
|  |  |  |  |  |  |  |
| J. Barry Griswell | 157,502,081 |  | 5,159,476 |  |  |
|  | Richard L. Keyser | 159,834,387 |  | 2,287,170 |  |  |
|  | Arjun K. Mathrani | 159,970,413 |  | 2,691,144 |  |  |
|  | Elizabeth E. Tallett | 154,468,902 |  | 8,192,655 |  |  |
|  | Therese M. Vaughan | 160,132,201 |  | 2,529,356 |  |  |

The directors whose terms of office continued and the years their terms expire are as follows:

**CLASS I DIRECTORS – TERM EXPIRES IN 2008**

Betsy J. Bernard

Jocelyn Carter-Miller

Gary E. Costley

William T. Kerr

**CLASS III DIRECTORS – TERM EXPIRES IN 2007**

Michael T. Dan

David J. Drury

C. Daniel Gelatt

Sandra L. Helton

In addition, the stockholders ratified the appointment of Ernst & Young LLP as the company’s independent auditors for 2006. The voting results are as follows:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  | **FOR** | | **AGAINST** | | **ABSTAIN** | |  |
|  |  |  |  |  |  |  |  |
|  | 159,271,666 |  | 1,190,660 |  | 2,199,231 |  |  |
|  |  |  | 90 |  |  |  |  |
|  |  |  |  |  |  |  |  |



**Item 6. Exhibits**

|  |  |  |  |
| --- | --- | --- | --- |
| **Exhibit** | | **Description** |  |
| **Number** | |  |
| 10.16 |  | Employment Agreement by and between Principal Financial Group, Inc., Principal Financial |  |
|  |  | Services, Inc., Principal Life Insurance Company and Larry D. Zimpleman (incorporated by reference to |  |
|  |  | the written description of such agreement included in Principal Financial Group, Inc.’s Current Report |  |
|  |  | on Form 8-K filed on May 19, 2006 (Commission File No. 1-16725)) |  |

1. Statement Regarding Computation of Ratio of Earnings to Fixed Charges

31.1Certification of J. Barry Griswell

31.2Certification of Michael H. Gersie

32.1Certification Pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code – J. Barry Griswell

32.2Certification Pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code – Michael H. Gersie

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**SIGNATURE**

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

PRINCIPAL FINANCIAL GROUP, INC.

Dated: August 2, 2006 By /s/ Michael H. Gersie Michael H. Gersie



Executive Vice President and Chief Financial

Officer

Duly Authorized Officer, Principal Financial

Officer, and Chief Accounting Officer

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**Exhibit Index**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Exhibit** | | | **Description** |  |  |
| **Number** | | |  |  |
|  | 10.16 |  | Employment Agreement by and between Principal Financial Group, Inc., Principal Financial Services, Inc., Principal Life Insurance |  |  |
|  |  |  | Company and Larry D. Zimpleman (incorporated by reference to the written description of such agreement included in Principal Financial |  |  |
|  |  |  | Group, Inc.’s Current Report on Form 8-K filed on May 19, 2006 (Commission File No. 1-16725)) |  |  |
| 12 | |  | Statement Regarding Computation of Ratio of Earnings to Fixed Charges |  |  |
| 31.1 | |  | Certification of J. Barry Griswell |  |  |
| 31.2 | |  | Certification of Michael H. Gersie |  |  |
| 32.1 | |  | Certification Pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code – J. Barry Griswell |  |  |
| 32.2 | |  | Certification Pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code – Michael H. Gersie |  |  |
|  |  |  | 93 |  |  |
|  |  |  |  |  |  |



|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |  | **Exhibit 12** | |
|  | **Principal Financial Group, Inc.** | | | |  |  |  |  |  |
| **Computation of Earnings to Fixed Charges Ratio** | | | | | |  |  |  |  |
|  | **For the six months** | | |  |  | **For the years ended** |  |  |  |
|  | **ended June 30,** | | |  |  | **December 31,** |  |  |  |
|  | **2006** | **2005** |  | **2005** | **2004** | **2003** | **2002** | **2001** |  |
|  |  |  |  |  | **(in millions)** |  |  |  |  |

1. Income from continuing operations before



|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | income taxes | **$** | **670.1** | $ | 562.5 | $ 1,124.3 | $ | 879.1 | $ | 820.3 | $ | 371.5 | $ | 249.9 |
| 2. | Interest expense |  | **42.8** |  | 41.3 | 81.1 |  | 96.9 |  | 117.5 |  | 99.7 |  | 97.2 |
| 3. | Interest factor of rental expense |  | **3.5** |  | 2.3 | 7.0 |  | 4.6 |  | 4.8 |  | 8.0 |  | 9.4 |

1. Undistributed (income) loss from equity

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| investees | **(30.3)** | (15.6) | (34.1) | (19.4) | (18.3) | 4.3 | (17.4) |



1. Earnings before interest credited on

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | investment products |  |  | **686.1** |  |  | 590.5 |  |  | 1,178.3 |  |  | 961.2 |  |  | 924.3 |  |  | 483.5 |  |  | 339.1 |  |  |
| 6. | | Interest credited on investment products |  |  | **433.7** |  |  | 409.1 |  |  | 832.2 |  |  | 763.7 |  |  | 735.7 |  |  | 743.4 |  |  | 773.1 |  |  |
|  | 7. | Earnings |  | **$** | **1,119.8** |  | $ | 999.6 |  | $ | 2,010.5 |  | $ | 1,724.9 |  | $ | 1,660.0 |  | $ | 1,226.9 |  | $ | 1,112.2 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| 8. | Interest expense | **$** | | **42.8** |  | $ | 41.3 | $ | | 81.1 | $ | | 96.9 | $ | | 117.5 | $ | | 99.7 | $ | | 97.2 |  |  |
|  | 9. | Interest factor of rental expense |  |  | **3.5** |  |  | 2.3 |  |  | 7.0 |  |  | 4.6 |  |  | 4.8 |  |  | 8.0 |  |  | 9.4 |  |  |
|  | 10. | Preferred stock dividends by registrant |  |  | **16.5** |  |  | — |  |  | 17.7 |  |  | — |  |  | — |  |  | — |  |  | — | |  |

1. Preferred stock dividend requirements of majority-owned subsidiaries (non-

intercompany) **—** — — — 1.2 0.4 —

1. Fixed charges before interest credited on



|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | investment products |  | **62.8** |  |  | 43.6 |  |  | 105.8 |  |  | 101.5 |  |  | 123.5 |  |  | 108.1 |  |  | 106.6 |  |  |
| 13. | | Interest credited on investment products |  | **433.7** |  |  | 409.1 |  |  | 832.2 |  |  | 763.7 |  |  | 735.7 |  |  | 743.4 |  |  | 773.1 |  |  |
|  | 14. | Fixed charges | **$** | **496.5** |  | $ | 452.7 |  | $ | 938.0 |  | $ | 865.2 |  | $ | 859.2 |  | $ | 851.5 |  | $ | 879.7 |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| 15. | Ratio of earnings to fixed charges before |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | interest credited on investment products |  | **10.9** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  | (Line item 5/Line item 12) |  |  |  | 13.5 |  |  | 11.1 |  |  | 9.5 |  |  | 7.5 |  |  | 4.5 |  |  | 3.2 |  |  |

1. Ratio of earnings to fixed charges (Line item



|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| 7/Line item 14) | **2.3** | 2.2 | 2.1 | 2.0 | 1.9 | 1.4 | 1.3 |

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**Exhibit 31.1**

**CERTIFICATIONS**

I, J. Barry Griswell, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Principal Financial Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant’s other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
   1. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
   2. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
   3. Evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
   4. Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and
5. The registrant’s other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of registrant’s board of directors (or persons performing the equivalent functions):
   1. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and
   2. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

Date: August 2, 2006

/s/ J. Barry Griswell

J. Barry Griswell



Chairman, President and Chief Executive Officer

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**Exhibit 31.2**

**CERTIFICATIONS**

I, Michael H. Gersie, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Principal Financial Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant’s other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
   1. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
   2. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
   3. Evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
   4. Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and
5. The registrant’s other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of registrant’s board of directors (or persons performing the equivalent functions):
   1. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and
   2. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

Date: August 2, 2006

/s/ Michael H. Gersie

Michael H. Gersie



Executive Vice President and Chief

Financial Officer

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**Exhibit 32.1**

**Certification Pursuant to Section 1350 of Chapter 63**

**of Title 18 of the United States Code**

I, J. Barry Griswell, Chairman, President and Chief Executive Officer of Principal Financial Group, Inc., certify that (i) the Form 10-Q for the quarter ended June 30, 2006 fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and (ii) the information contained in the Form 10-Q for the quarter ended June 30, 2006 fairly presents, in all material respects, the financial condition and results of operations of Principal Financial Group, Inc.

/s/ J. Barry Griswell

J. Barry Griswell



Chairman, President and Chief Executive Officer

Date: August 2, 2006

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**Exhibit 32.2**

**Certification Pursuant to Section 1350 of Chapter 63**

**of Title 18 of the United States Code**

I, Michael H. Gersie, Executive Vice President and Chief Financial Officer of Principal Financial Group, Inc., certify that (i) the Form 10-Q for the quarter ended June 30, 2006 fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and (ii) the information contained in the Form 10-Q for the quarter ended June 30, 2006 fairly presents, in all material respects, the financial condition and results of operations of Principal Financial Group, Inc.

/s/ Michael H. Gersie

Michael H. Gersie



Executive Vice President and Chief Financial Officer

Date: August 2, 2006

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