PRUDENTIAL FINANCIAL INC
Form 10-Q
November 02, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2006

OR

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

For the Transition Period from to

Commission File Number 001-16707

Prudential Financial, Inc.

(Exact Name of Registrant as Specified in its Charter)

New Jersey	**22-3703799**
(State or Other Jurisdiction of	**(I.R.S. Employer**
Incorporation or Organization)	**Identification Number)**

751 Broad Street

Newark, New Jersey 07102

(973) 802-6000

(Address and Telephone Number of Registrant s Principal Executive Offices)

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 ¨

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 ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

As of September 30, 2006, 477 million shares of the registrant s Common Stock (par value $0.01) were outstanding. In addition, 2 million shares of the registrant s Class B Stock, for which there is no established public trading market, were outstanding.

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FORWARD-LOOKING STATEMENTS

Certain of the statements included in this Quarterly Report on Form 10-Q, including but not limited to those in Management s Discussion and Analysis of Financial Condition and Results of Operations, constitute forward-looking statements within the meaning of the U.S. Private Securities Litigation Reform Act of 1995. Words such as expects, believes, anticipates, includes, plans, assumes, estimates, projects, should, will, shall or variations of such words are generally part of forward-looking statements. Forward-looking statements are made based on management s current expectations and beliefs concerning future developments and their potential effects upon Prudential Financial, Inc. and its subsidiaries. There can be no assurance that future developments affecting Prudential Financial, Inc. and its subsidiaries will be those anticipated by management. These forward-looking statements are not a guarantee of future performance and involve risks and uncertainties, and there are certain important factors that could cause actual results to differ, possibly materially, from expectations or estimates reflected in such forward-looking statements, including, among others: (1) general economic, market and political conditions, including the performance and fluctuations of stock, real estate and other financial markets; (2) interest rate fluctuations; (3) reestimates of our reserves for future policy benefits and claims; (4) differences between actual experience regarding mortality, morbidity, persistency, surrender experience, interest rates or market returns and the assumptions we use in pricing our products, establishing liabilities and reserves or for other purposes; (5) changes in our assumptions related to deferred policy acquisition costs, valuation of business acquired or goodwill; (6) changes in our claims-paying or credit ratings; (7) investment losses and defaults; (8) competition in our product lines and for personnel; (9) changes in tax law; (10) economic, political, currency and other risks relating to our international operations; (11) fluctuations in foreign currency exchange rates and foreign securities markets; (12) regulatory or legislative changes; (13) adverse determinations in litigation or regulatory matters and our exposure to contingent liabilities, including in connection with our divestiture or winding down of businesses; (14) domestic or international military actions, natural or man-made disasters including terrorist activities or pandemic disease, or other events resulting in catastrophic loss of life; (15) ineffectiveness of risk management policies and procedures in identifying, monitoring and managing risks; (16) effects of acquisitions, divestitures and restructurings, including possible difficulties in integrating and realizing the projected results of acquisitions; (17) changes in statutory or U.S. GAAP accounting principles, practices or policies; (18) changes in assumptions for retirement expense; (19) Prudential Financial, Inc. s primary reliance, as a holding company, on dividends or distributions from its subsidiaries to meet debt payment obligations and continue share repurchases, and the applicable regulatory restrictions on the ability of the subsidiaries to pay such dividends or distributions; and (20) risks due to the lack of legal separation between our Financial Services Businesses and our Closed Block Business. Prudential Financial, Inc. does not intend, and is under no obligation, to update any particular forward-looking statement included in this document. See Risk Factors included in the Annual Report on Form 10-K for the year ended December 31, 2005 for discussion of certain risks relating to our businesses and investment in our securities.

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Throughout this Quarterly Report on Form 10-Q, Prudential Financial and the Registrant refer to Prudential Financial, Inc., the ultimate holding company for all of our companies. Prudential Insurance refers to The Prudential Insurance Company of America, before and after its demutualization on December 18, 2001. Prudential, the Company, we and our refer to our consolidated operations before and after demutualization.

PART I FINANCIAL INFORMATION

ITEM 1. ***Financial Statements***

PRUDENTIAL FINANCIAL, INC.

Unaudited Interim Consolidated Statements of Financial Position

September 30, 2006 and December 31, 2005 (in millions, except share amounts)

	September 30, 2006	December 31, 2005
ASSETS		
Fixed maturities:		
Available for sale, at fair value (amortized cost: 2006 $153,934; 2005 $148,706)	$ 158,077	$ 154,434
Held to maturity, at amortized cost (fair value: 2006 $3,400; 2005 $3,228)	3,473	3,249
Trading account assets supporting insurance liabilities, at fair value	14,453	13,781
Other trading account assets, at fair value	1,933	1,443
Equity securities, available for sale, at fair value (cost: 2006 $5,448; 2005 $4,951)	6,410	5,843
Commercial loans	25,382	24,441
Policy loans	8,757	8,370
Securities purchased under agreements to resell	187	413
Other long-term investments	5,761	5,468
Short-term investments	4,478	3,959
Total investments	228,911	221,401
Cash and cash equivalents	9,567	7,799
Accrued investment income	2,235	2,067
Reinsurance recoverables	1,908	3,548
Deferred policy acquisition costs	10,570	9,438
Other assets	18,347	15,962
Separate account assets	175,363	157,561
TOTAL ASSETS	$ 446,901	$ 417,776
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES		
Future policy benefits	$ 105,872	$ 102,039
Policyholders account balances	80,988	75,492
Policyholders dividends	3,891	4,413
Reinsurance payables	1,405	3,069
Securities sold under agreements to repurchase	12,046	12,517
Cash collateral for loaned securities	6,915	5,818
Income taxes payable	2,954	2,214

Securities sold but not yet purchased	313	223
Short-term debt	10,765	11,114
Long-term debt	9,214	8,270
Other liabilities	13,977	12,283
Separate account liabilities	175,363	157,561
Total liabilities	423,703	395,013
COMMITMENTS AND CONTINGENT LIABILITIES (See Note 10)		
STOCKHOLDERS EQUITY		
Preferred Stock ($.01 par value; 10,000,000 shares authorized; none issued)		
Common Stock ($.01 par value; 1,500,000,000 shares authorized; 604,900,213 and 604,899,046 shares issued as of September 30, 2006 and December 31, 2005, respectively)	6	6
Class B Stock ($.01 par value; 10,000,000 shares authorized; 2,000,000 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively)		
Additional paid-in capital	20,592	20,501
Common Stock held in treasury, at cost (127,597,557 and 107,405,004 shares as of September 30, 2006 and December 31, 2005, respectively)	(6,597)	(4,925)
Accumulated other comprehensive income	894	1,234
Retained earnings	8,303	5,947
Total stockholders equity	23,198	22,763
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 446,901	$ 417,776

See Notes to Unaudited Interim Consolidated Financial Statements

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PRUDENTIAL FINANCIAL, INC.

Unaudited Interim Consolidated Statements of Operations

Three and Nine Months Ended September 30, 2006 and 2005 (in millions, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
REVENUES				
Premiums	$ 3,364	$ 3,399	$ 10,331	$ 10,316
Policy charges and fee income	583	662	1,921	1,891
Net investment income	2,871	2,665	8,381	7,792
Realized investment gains (losses), net	389	230	246	1,223
Asset management fees and other income	1,269	835	2,944	2,623
Total revenues	8,476	7,791	23,823	23,845
BENEFITS AND EXPENSES				
Policyholders benefits	3,516	3,381	10,631	10,399
Interest credited to policyholders account balances	918	642	2,123	1,998
Dividends to policyholders	729	695	1,877	2,025
General and administrative expenses	1,765	1,955	5,939	5,674
Total benefits and expenses	6,928	6,673	20,570	20,096
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	1,548	1,118	3,253	3,749
Income tax expense (benefit)	411	(261)	908	520
INCOME FROM CONTINUING OPERATIONS	1,137	1,379	2,345	3,229
Income (loss) from discontinued operations, net of taxes	68	(15)	46	(53)
NET INCOME	$ 1,205	$ 1,364	$ 2,391	$ 3,176
EARNINGS PER SHARE (See Note 6)				
Financial Services Businesses				
Basic:				
Income from continuing operations per share of Common Stock	$ 2.29	$ 2.66	$ 4.62	$ 5.73
Income (loss) from discontinued operations, net of taxes	0.14	(0.03)	0.10	(0.10)
Net income per share of Common Stock	$ 2.43	$ 2.63	$ 4.72	$ 5.63
Diluted:				
Income from continuing operations per share of Common Stock	$ 2.24	$ 2.62	$ 4.53	$ 5.64
Income (loss) from discontinued operations, net of taxes	0.14	(0.03)	0.09	(0.10)

Net income per share of Common Stock	$ 2.38	$ 2.59	$ 4.62	$ 5.54
Closed Block Business				
Net income per share of Class B Stock basic and diluted	$ 18.50	$ 11.50	$ 44.50	$ 135.50

See Notes to Unaudited Interim Consolidated Financial Statements

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PRUDENTIAL FINANCIAL, INC.

Unaudited Interim Consolidated Statement of Stockholders Equity

Nine Months Ended September 30, 2006 (in millions)

	Common Stock	Class B Stock	Additional Paid-in Capital	Retained Earnings	Common Stock Held In Treasury	Accumulated Other Comprehensive Income / (Loss)	Total Stockholders Equity
Balance, December 31, 2005	$ 6	$	$ 20,501	$ 5,947	$ (4,925)	$ 1,234	$ 22,763
Common Stock acquired					(1,873)		(1,873)
Stock-based compensation programs			91	(35)	201		257
Comprehensive income (loss):							
Net income				2,391			2,391
Other comprehensive loss, net of taxes						(340)	(340)
Total comprehensive income							2,051
Balance, September 30, 2006	$ 6	$	$ 20,592	$ 8,303	$ (6,597)	$ 894	$ 23,198

See Notes to Unaudited Interim Consolidated Financial Statements

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PRUDENTIAL FINANCIAL, INC.

Unaudited Interim Consolidated Statements of Cash Flows

Nine Months Ended September 30, 2006 and 2005 (in millions)

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 2,391	$ 3,176
Adjustments to reconcile net income to net cash provided by operating activities:		
Realized investment (gains) losses, net	(246)	(1,223)
Policy charges and fee income	(511)	(620)
Interest credited to policyholders account balances	2,123	1,998
Depreciation and amortization, including premiums and discounts	272	447
Change in:		
Deferred policy acquisition costs	(1,011)	(542)
Future policy benefits and other insurance liabilities	1,917	1,917
Trading account assets supporting insurance liabilities and other trading account assets	(1,059)	(1,033)
Income taxes payable	698	404
Securities sold but not yet purchased	(58)	(220)
Other, net	(2,495)	(365)
Cash flows from operating activities	2,021	3,939
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from the sale/maturity/prepayment of:		
Fixed maturities, available for sale	72,303	68,842
Fixed maturities, held to maturity	228	454
Equity securities, available for sale	3,039	2,206
Commercial loans	3,580	3,871
Policy loans	963	993
Other long-term investments	1,371	670
Short-term investments	8,924	10,619
Payments for the purchase of:		
Fixed maturities, available for sale	(75,765)	(76,307)
Fixed maturities, held to maturity	(461)	(994)
Equity securities, available for sale	(3,242)	(2,434)
Commercial loans	(4,461)	(3,216)
Policy loans	(1,089)	(843)
Other long-term investments	(925)	(391)
Short-term investments	(9,264)	(10,262)
Acquisition of businesses, net of cash acquired	724	
Other, net	111	(150)
Cash flows used in investing activities	(3,964)	(6,942)
CASH FLOWS FROM FINANCING ACTIVITIES		
Policyholders account deposits	17,505	15,298
Policyholders account withdrawals	(15,392)	(14,700)
Net change in securities sold under agreements to repurchase and cash collateral for loaned securities	2,584	253
Cash dividends paid on Common Stock	(53)	(44)
Net change in financing arrangements (maturities 90 days or less)	(459)	2,942
Common Stock acquired	(1,855)	(1,453)
Common Stock reissued for exercise of stock options	117	132
Proceeds from the issuance of debt (maturities longer than 90 days)	2,357	1,876
Repayments of debt (maturities longer than 90 days)	(1,058)	(782)

Cash payments to or in respect of eligible policyholders	(93)	(135)
Excess tax benefits from share-based payment arrangements	51	
Other, net		
Cash flows from financing activities	3,704	3,387
Effect of foreign exchange rate changes on cash balances	7	(80)
NET INCREASE IN CASH AND CASH EQUIVALENTS	1,768	304
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	7,799	8,072
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 9,567	$ 8,376

See Notes to Unaudited Interim Consolidated Financial Statements

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PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements

1. BUSINESS AND BASIS OF PRESENTATION

Prudential Financial, Inc. (Prudential Financial) and its subsidiaries (collectively, Prudential or the Company) provide a wide range of insurance, investment management, and other financial products and services to both retail and institutional customers throughout the United States and in many other countries. Principal products and services provided include life insurance, annuities, mutual funds, pension and retirement related investments and administration, and asset management. In addition, the Company provides securities brokerage services indirectly through a minority ownership in a joint venture. The Company has organized its principal operations into the Financial Services Businesses and the Closed Block Business. The Financial Services Businesses operate through three operating divisions: Insurance, Investment, and International Insurance and Investments. The Company s real estate and relocation services business as well as businesses that are not sufficiently material to warrant separate disclosure and businesses to be divested are included in Corporate and Other operations within the Financial Services Businesses. The Closed Block Business, which includes the Closed Block (see Note 4), is managed separately from the Financial Services Businesses. The Closed Block Business was established on the date of demutualization and includes the Company s in force participating insurance and annuity products and assets that are used for the payment of benefits and policyholder dividends on these products, as well as other assets and equity that support these products and related liabilities. In connection with the demutualization, the Company has ceased offering these participating products.

Basis of Presentation

The Unaudited Interim Consolidated Financial Statements include the accounts of Prudential Financial, entities over which the Company exercises control, including majority-owned subsidiaries and minority-owned entities such as limited partnerships in which the Company is the general partner, and variable interest entities in which the Company is considered the primary beneficiary. The Unaudited Interim Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) on a basis consistent with reporting interim financial information in accordance with instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission (SEC). Intercompany balances and transactions have been eliminated.

In the opinion of management, all adjustments necessary for a fair statement of the financial position and results of operations have been made. All such adjustments are of a normal, recurring nature. Interim results are not necessarily indicative of the results that may be expected for the full year. These financial statements should be read in conjunction with the Company s audited Consolidated Financial Statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The most significant estimates include those used in determining deferred policy acquisition costs, goodwill, valuation of business acquired, investments, future policy benefits, pension and other postretirement benefits, provision for income taxes, reserves for contingent liabilities and reserves for losses in connection with unresolved legal matters.

Reclassifications

Certain amounts in prior periods have been reclassified to conform to the current period presentation.

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PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements (Continued)

2. ACCOUNTING POLICIES AND PRONOUNCEMENTS

Accounting Pronouncements Adopted

In November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments. This FSP provides impairment models for determining whether to record impairment losses associated with investments in certain equity and debt securities, primarily by referencing existing accounting guidance. It also requires income to be accrued on a level-yield basis following an impairment of debt securities, where reasonable estimates of the timing and amount of future cash flows can be made. The Company adopted this guidance effective January 1, 2006, and it did not have a material effect on the Company s consolidated results of operations.

In June 2005, the Emerging Issues Task Force (EITF) of the FASB reached a consensus on Issue No. 04-5, Investor s Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights. This Issue first presumes that general partners in a limited partnership control that partnership and should therefore consolidate that partnership, and then provides that the general partners may overcome the presumption of control if the limited partners have: (1) the substantive ability to dissolve or liquidate the limited partnership, or otherwise to remove the general partners without cause or (2) the ability to participate effectively in significant decisions that would be expected to be made in the ordinary course of the limited partnership s business. This guidance became effective for new or amended arrangements after June 29, 2005, and became effective January 1, 2006 for all arrangements existing as of June 29, 2005 that remain unmodified. The Company s adoption of this guidance did not have a material effect on the Company s consolidated financial position or results of operations.

In June 2005, the FASB issued Statement No. 133 Implementation Issue No. B39, Embedded Derivatives: Application of Paragraph 13(b) to Call Options That are Exercisable Only by the Debtor. Implementation Issue No. B39 indicates that debt instruments where the right to accelerate the settlement of debt can be exercised only by the debtor do not meet the criteria of Paragraph 13(b) of Statement No. 133, and therefore should not individually lead to such options being considered embedded derivatives. Such options must still be evaluated under paragraph 13(a) of Statement No. 133. This implementation guidance is effective for the first fiscal quarter beginning after December 15, 2005. The Company s adoption of this guidance effective January 1, 2006 did not have a material effect on the Company s consolidated financial position or results of operations as the guidance is consistent with the Company s existing accounting policy.

Adoption of Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment

The Company adopted SFAS No. 123(R), Share-Based Payment on January 1, 2006. This standard requires that the cost resulting from all share-based payments be recognized in the financial statements and requires all entities to apply the fair value based measurement method in accounting for share-based payment transactions with employees except for equity instruments held by employee share ownership plans. As described more fully below, the Company had previously adopted the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, as amended, prospectively for all new stock options granted to employees on or after January 1, 2003. Upon adoption of SFAS No. 123(R), there were no unvested stock options issued prior to January 1, 2003, and, therefore, the adoption of SFAS No. 123(R) had no impact to the Company s consolidated financial condition or results of operations. Upon the adoption of SFAS No. 123(R), the Company revised its approach to the recognition of compensation costs for awards granted to retirement-eligible employees and awards that vest when an employee becomes retirement-eligible, as described more fully below.

The Company issues employee share-based compensation awards, under a plan authorized by the Board of Directors, that are subject to specific vesting conditions; generally the awards vest ratably over a three-year

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PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements (Continued)

period, the nominal vesting period, or at the date the employee retires (as defined by the plan), if earlier. For awards granted prior to January 1, 2006 that specify an employee vests in the award upon retirement, the Company accounts for those awards using the nominal vesting period approach. Under this approach, the Company records compensation expense over the nominal vesting period. If the employee retires before the end of the nominal vesting period, any remaining unrecognized compensation cost is recognized at the date of retirement.

Upon the adoption of SFAS No. 123(R), the Company revised its approach to apply the non-substantive vesting period approach to all new share-based compensation awards granted after January 1, 2006. Under this approach, all compensation cost is recognized on the date of grant for awards issued to retirement-eligible employees, or over the period from the grant date to the date retirement eligibility is achieved, if that is expected to occur during the nominal vesting period. The Company continues to apply the nominal vesting period approach for the portion of unvested outstanding awards issued prior to the adoption of SFAS No. 123(R).

If the Company had accounted for all share-based compensation awards granted after January 1, 2003 under the non-substantive vesting period approach, net income of the Financial Services Businesses for the three and nine months ended September 30, 2006 would have been increased by $3 million, or $0.01 per share of Common Stock, on both a basic and diluted basis, and $9 million, or $0.02 per share of Common Stock, on both a basic and diluted basis, respectively. Net income of the Financial Services Businesses for the three and nine months ended September 30, 2005 would have been decreased by $2 million, with no reportable impact to the earnings per share of Common Stock, on both a basic and diluted basis, and $8 million, or $0.02 per share of Common Stock, on both a basic and diluted basis, respectively.

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PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements (Continued)

As noted above, effective January 1, 2003, the Company changed its accounting for employee stock options to adopt the fair value recognition provisions of SFAS No. 123, as amended, prospectively for all new stock options granted to employees on or after January 1, 2003. Prior to January 1, 2003, the Company accounted for employee stock options using the intrinsic value method of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Under this method, the Company did not recognize any stock-based compensation expense for employee stock options as all options granted had an exercise price equal to the market value of the underlying Common Stock on the date of grant. If the Company had accounted for all employee stock options granted prior to January 1, 2003 under the fair value-based measurement method of SFAS No. 123, net income and earnings per share for the three and nine months ended September 30, 2006 would have been unchanged, since, as of January 1, 2006, there were no unvested employee stock options issued prior to January 1, 2003. Net income and earnings per share for the three and nine months ended September 30, 2005, would have been as follows:

	Three Months Ended September 30, 2005		Nine Months Ended September 30, 2005	
	Financial Services Businesses	Closed Block Business	Financial Services Businesses	Closed Block Business
	(in millions, except per share amounts)			
Net income, as reported	$ 1,322	$ 42	$ 2,842	$ 334
Add: Total employee stock option compensation expense included in reported net income, net of taxes	8		22	
Deduct: Total employee stock option compensation expense determined under the fair value based method for all awards, net of taxes	(9)		(32)	
Pro forma net income	$ 1,321	$ 42	$ 2,832	$ 334
Earnings per share:				
Basic as reported	$ 2.63	$ 11.50	$ 5.63	$ 135.50
Basic pro forma	$ 2.63	$ 11.50	$ 5.61	$ 135.50
Diluted as reported	$ 2.59	$ 11.50	$ 5.54	$ 135.50
Diluted pro forma	$ 2.59	$ 11.50	$ 5.52	$ 135.50

The fair value of each option issued prior to January 1, 2003 for purposes of the pro forma information presented above was estimated on the date of grant using a Black-Scholes option-pricing model. For options issued on or after January 1, 2003, the fair value of each option was estimated on the date of grant using a binomial option-pricing model.

The Company accounts for non-employee stock options using the fair value method in accordance with EITF No. 96-18 Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services and related interpretations in accounting for its non-employee stock options.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R). This statement

PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements (Continued)

requires an employer on a prospective basis to recognize the overfunded or underfunded status of its defined benefit pension and postretirement plans as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. This requirement, along with the required disclosures, is effective for fiscal years ending after December 15, 2006. The Company is still in the process of assessing the impact of recognizing the funded status of its plans, but currently anticipates recording a net after-tax reduction to Accumulated other comprehensive income within stockholders equity of approximately $500 million as of December 31, 2006.

SFAS No. 158 also requires an employer on a prospective basis to measure the funded status of its plans as of its fiscal year-end, and is effective for fiscal years ending after December 15, 2008. The Company is currently assessing the impact that changing from a September 30 measurement date to a December 31 measurement date will have on the Company s consolidated financial position and results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and requires additional disclosures about fair value measurements. This Statement does not require any new fair value measurements, but the application of this Statement could change current practices in determining fair value. The Company plans to adopt this guidance effective January 1, 2008. The Company is currently assessing the impact of SFAS No. 157 on the Company s consolidated financial position and results of operations.

In September 2006, the staff of the SEC issued Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements.

The interpretations in this SAB express the staff s views regarding the process of quantifying financial statement misstatements. Specifically, the SEC staff believes that registrants must quantify the impact on current period financial statements of correcting all misstatements, including both those occurring in the current period and the effect of reversing those that have accumulated from prior periods. This SAB should be applied beginning with the first fiscal year ending after November 15, 2006, with early adoption encouraged. Since the Company s method for quantifying financial statement misstatements already considers those occurring in the current period and the effect of reversing those that have accumulated from prior periods, the adoption of SAB No. 108 should have no effect to the financial position and result of operations of the Company.

In July 2006, the FASB issued FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. This Interpretation prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that a company has taken or expects to take on a tax return. This Interpretation is effective for fiscal years beginning after December 15, 2006. The Company will adopt FIN No. 48 on January 1, 2007. The Company is currently assessing the impact of FIN No. 48 on the Company s consolidated financial position, results of operations and notes to the consolidated financial statements.

In July 2006, the FASB issued FSP No. 13-2, Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction an amendment of FASB Statement No. 13. This Staff Position indicates that a change or projected change in the timing of cash flows relating to income taxes generated by a leveraged lease would require a recalculation of cumulative and prospective income recognition associated with the transaction. The FSP is effective for fiscal years beginning after December 15, 2006. The Company will adopt FSP No. 13-2 on January 1, 2007. The Company currently estimates that the impact of adopting FSP No. 13-2 will be a net after-tax reduction to retained earnings of $75 million, as of January 1, 2007.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets. This statement requires that servicing assets or liabilities are to be initially measured at fair value, with subsequent changes in value reported based on either a fair value or amortized cost approach. Under the previous guidance,

PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements (Continued)

such servicing assets or liabilities were initially measured at historical cost and the amortized cost method was required for subsequent reporting. The Company plans to adopt this guidance effective January 1, 2007. The Company is currently assessing the impact of SFAS No. 156 on the Company s consolidated financial position and results of operations.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Instruments. This statement provides an election, on an instrument by instrument basis, to measure at fair value an entire hybrid financial instrument that contains an embedded derivative requiring bifurcation, rather than measuring only the embedded derivative on a fair value basis. This statement also removes an exception from the requirement to bifurcate an embedded derivative feature from a beneficial interest in securitized financial assets. The Company has used this exception for investments the Company has made in securitized financial assets in the normal course of operations, and thus has not previously had to consider whether such investments contain an embedded derivative. The new requirement to identify embedded derivatives in beneficial interests will be applied on a prospective basis only to beneficial interests acquired, issued, or subject to certain remeasurement conditions after the adoption date of the new guidance. The Company plans to adopt this guidance effective January 1, 2007. The Company is in the process of determining whether there are any hybrid instruments for which the Company will elect the fair value option.

In September 2005, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants issued Statement of Position (SOP) 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts. SOP 05-1 provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in SFAS No. 97. SOP 05-1 defines an internal replacement as a modification in product benefits, features, rights, or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement, or rider to a contract, or by the election of a feature or coverage within a contract, and is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. The Company will adopt SOP 05-1 on January 1, 2007. The Company is currently assessing the impact of SOP 05-1 on the Company s consolidated financial position and results of operations.

3. ACQUISITIONS AND DISPOSITIONS

Acquisition of The Allstate Corporation s Variable Annuity Business

On June 1, 2006 (the date of acquisition), the Company acquired the variable annuity business of The Allstate Corporation (Allstate) through a reinsurance transaction for $635 million of total consideration, consisting primarily of a $628 million ceding commission. The reinsurance arrangements with Allstate include a coinsurance arrangement associated with the general account liabilities assumed and a modified coinsurance arrangement associated with the separate account liabilities assumed. The assets acquired and liabilities assumed have been included in the Company s consolidated financial statements as of the date of acquisition. The Company s results of operations include the results of the acquired variable annuity business beginning from the date of acquisition. The assets acquired included primarily cash of $1.4 billion that was subsequently used to purchase investments; valuation of business acquired (VOBA) of $648 million that represents the present value of future profits embedded in the acquired contracts; and $97 million of goodwill. The liabilities assumed consisted primarily of variable annuity contractholders account balances of $1.5 billion associated with the coinsurance agreement. The assets acquired and liabilities assumed also included a reinsurance receivable from Allstate and a reinsurance payable to Allstate, each in the amount of $14.8 billion. The reinsurance payable, which represents the Company s obligation under the modified coinsurance arrangement, is netted with the

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reinsurance receivable in the Company s Statement of Financial Position. Pro forma information for this acquisition is omitted as the impact is not material.

Acquisition of CIGNA Corporation s (CIGNA) Retirement Business

The Company acquired the retirement business of CIGNA for cash consideration of $2.1 billion on April 1, 2004 and the results of this business have been included in the Company s consolidated results since the date of acquisition. As an element of the acquisition, the Company had the right, beginning two years after the acquisition, to commute the modified-coinsurance-with-assumption arrangement related to the acquired defined benefit guaranteed-cost contracts in exchange for cash consideration from CIGNA. Effective April 1, 2006, the Company reached an agreement with CIGNA to convert the modified-coinsurance-with-assumption arrangement to an indemnity coinsurance arrangement, effectively retaining the economics of the defined benefit guaranteed-cost contracts for the life of the block of business. Upon conversion, the Company extinguished its reinsurance receivable and payable with CIGNA related to the modified-coinsurance-with-assumption arrangement. Concurrently, the Company assumed $1.7 billion of liabilities from CIGNA under the indemnity coinsurance arrangement and received the related assets.

Discontinued Operations

Income (loss) from discontinued businesses, including charges upon disposition, are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(in millions)			
Sold real estate investments	$ 96	$	$ 96	$
Canadian IWP and IH operations	(5)	(1)	(11)	2
Philippine insurance operations	2		(13)	
Dryden Wealth Management	1	(16)	(3)	(66)
International securities operations	(4)	(1)	(9)	(13)
Healthcare operations	10		10	18
Income (loss) from discontinued operations before income taxes	100	(18)	70	(59)
Income tax expense (benefit)	32	(3)	24	(6)
Income (loss) from discontinued operations, net of taxes	$ 68	$ (15)	$ 46	$ (53)

The Company s Unaudited Interim Consolidated Statements of Financial Position include total assets and total liabilities related to discontinued businesses of $290 million and $125 million, respectively, as of September 30, 2006 and $699 million and $436 million, respectively, as of December 31, 2005. Charges recorded in connection with the disposals of businesses include estimates that are subject to subsequent adjustment. It is possible that such adjustments might be material to future net results of operations of a particular quarterly or annual period.

Discontinued operations activity includes a gain on the sale of a wholly-owned real estate property; the completion of the sale of the Company s Philippine insurance operations; and the completion of a reinsurance transaction related to the Company s Canadian Intermediate Weekly Premium (IWP) and Individual Health (IH) operations, all of which occurred during the third quarter of 2006.

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4. CLOSED BLOCK

On the date of demutualization, Prudential Insurance established a Closed Block for certain individual life insurance policies and annuities issued by Prudential Insurance in the U.S. The recorded assets and liabilities were allocated to the Closed Block at their historical carrying amounts. The Closed Block forms the principal component of the Closed Block Business.

The policies included in the Closed Block are specified individual life insurance policies and individual annuity contracts that were in force on the effective date of the Plan of Reorganization and for which Prudential Insurance is currently paying or expects to pay experience-based policy dividends. Assets have been allocated to the Closed Block in an amount that has been determined to produce cash flows which, together with revenues from policies included in the Closed Block, are expected to be sufficient to support obligations and liabilities relating to these policies, including provision for payment of benefits, certain expenses, and taxes and to provide for continuation of the policyholder dividend scales in effect in 2000, assuming experience underlying such scales continues. To the extent that, over time, cash flows from the assets allocated to the Closed Block and claims and other experience related to the Closed Block are, in the aggregate, more or less favorable than what was assumed when the Closed Block was established, total dividends paid to Closed Block policyholders in the future may be greater than or less than the total dividends that would have been paid to these policyholders if the policyholder dividend scales in effect in 2000 had been continued. Any cash flows in excess of amounts assumed will be available for distribution over time to Closed Block policyholders and will not be available to stockholders. If the Closed Block has insufficient funds to make guaranteed policy benefit payments, such payments will be made from assets outside of the Closed Block. The Closed Block will continue in effect as long as any policy in the Closed Block remains in force unless, with the consent of the New Jersey insurance regulator, it is terminated earlier.

The excess of Closed Block Liabilities over Closed Block Assets at the date of the demutualization (adjusted to eliminate the impact of related amounts in Accumulated other comprehensive income (loss)) represented the estimated maximum future earnings at that date from the Closed Block expected to result from operations attributed to the Closed Block after income taxes. In establishing the Closed Block, the Company developed an actuarial calculation of the timing of such maximum future earnings. If actual cumulative earnings of the Closed Block from inception through the end of any given period are greater than the expected cumulative earnings, only the expected earnings will be recognized in income. Any excess of actual cumulative earnings over expected cumulative earnings will represent undistributed accumulated earnings attributable to policyholders, which are recorded as a policyholder dividend obligation. The policyholder dividend obligation represents amounts to be paid to Closed Block policyholders as an additional policyholder dividend unless otherwise offset by future Closed Block performance that is less favorable than originally expected. If the actual cumulative earnings of the Closed Block from its inception through the end of any given period are less than the expected cumulative earnings of the Closed Block, the Company will recognize only the actual earnings in income. However, the Company may reduce policyholder dividend scales in the future, which would be intended to increase future actual earnings until the actual cumulative earnings equaled the expected cumulative earnings. At September 30, 2006, the Company recognized a policyholder dividend obligation of $360 million to Closed Block policyholders for the excess of actual cumulative earnings over the expected cumulative earnings. Additionally, net unrealized investment gains that have arisen subsequent to the establishment of the Closed Block were reflected as a policyholder dividend obligation of $1.809 billion at September 30, 2006 to be paid to Closed Block policyholders unless otherwise offset by future experience, with an offsetting amount reported in Accumulated other comprehensive income (loss).

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Notes to Unaudited Interim Consolidated Financial Statements (Continued)

Closed Block Liabilities and Assets designated to the Closed Block, as well as maximum future earnings to be recognized from Closed Block Liabilities and Closed Block Assets, are as follows:

	September 30, 2006	December 31, 2005
	(in millions)	
Closed Block Liabilities		
Future policy benefits	$ 50,448	$ 50,112
Policyholders dividends payable	1,175	1,089
Policyholder dividend obligation	2,169	2,628
Policyholders account balances	5,559	5,568
Other Closed Block liabilities	10,770	9,676
Total Closed Block Liabilities	70,121	69,073
Closed Block Assets		
Fixed maturities, available for sale, at fair value	45,749	45,403
Equity securities, available for sale, at fair value	3,432	3,128
Commercial loans	6,731	6,750
Policy loans	5,407	5,403
Other long-term investments	888	923
Short-term investments	1,701	1,340
Total investments	63,908	62,947
Cash and cash equivalents	2,078	2,167
Accrued investment income	713	658
Other Closed Block assets	406	286
Total Closed Block Assets	67,105	66,058
Excess of reported Closed Block Liabilities over Closed Block Assets	3,016	3,015
Portion of above representing accumulated other comprehensive income:		
Net unrealized investment gains	1,859	2,402
Allocated to policyholder dividend obligation	(1,809)	(2,302)
Future earnings to be recognized from Closed Block Assets and Closed Block Liabilities	$ 3,066	$ 3,115

Information regarding the policyholder dividend obligation is as follows:

		Nine Months Ended September 30, 2006
		(in millions)
Balance, January 1, 2006	$	2,628
Impact on income before gains allocable to policyholder dividend obligation		34
Change in unrealized investment gains		(493)
Balance, September 30, 2006	$	2,169

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PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements (Continued)

Closed Block revenues and benefits and expenses were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
	(in millions)			
Revenues				
Premiums	$ 814	$ 822	$ 2,617	$ 2,631
Net investment income	844	864	2,544	2,575
Realized investment gains (losses), net	160	87	196	499
Other income	11	15	38	41
Total Closed Block revenues	1,829	1,788	5,395	5,746
Benefits and Expenses				
Policyholders benefits	894	912	2,898	2,930
Interest credited to policyholders account balances	34	35	105	103
Dividends to policyholders	697	666	1,803	1,856
General and administrative expenses	176	176	545	538
Total Closed Block benefits and expenses	1,801	1,789	5,351	5,427
Closed Block revenues, net of Closed Block benefits and expenses, before income taxes	28	(1)	44	319
Income tax expense (benefit)	28	(18)	(5)	101
Closed Block revenues, net of Closed Block benefits and expenses and income taxes	$	$ 17	$ 49	$ 218

5. STOCKHOLDERS EQUITY

The Company has outstanding two classes of common stock: the Common Stock and the Class B Stock. The changes in the number of shares issued, held in treasury and outstanding are as follows for the periods indicated:

	Common Stock			Class B Stock
	Issued	Held In Treasury	Outstanding	Issued and Outstanding
		(in millions)		
Balance, December 31, 2005	604.9	107.4	497.5	2.0
Common Stock issued				
Common Stock acquired		24.7	(24.7)	
Stock-based compensation programs(1)		(4.5)	4.5	
Balance, September 30, 2006	604.9	127.6	477.3	2.0

(1) Represents net shares issued from treasury pursuant to the Company s stock-based compensation program.

Common Stock Held in Treasury

In November 2005, Prudential Financial s Board of Directors authorized the Company to repurchase up to $2.5 billion of its outstanding Common Stock in calendar year 2006. The timing and amount of any repurchases

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under this authorization are determined by management based upon market conditions and other considerations, and the repurchases may be effected in the open market or through negotiated transactions. The 2006 stock repurchase program supersedes all previous repurchase programs. During the first nine months of 2006, the Company acquired 24.7 million shares of its Common Stock at a total cost of $1.873 billion.

Comprehensive Income

The components of comprehensive income are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
	(in millions)			
Net income	$ 1,205	$ 1,364	$ 2,391	$ 3,176
Other comprehensive income (loss), net of taxes:				
Change in foreign currency translation adjustments	(59)	(81)	139	(231)
Change in net unrealized investments gains (losses)(1)	1,101	(653)	(472)	(421)
Additional pension liability adjustment	(3)		(7)	1
Other comprehensive income (loss)(2)	1,039	(734)	(340)	(651)
Comprehensive income	$ 2,244	$ 630	$ 2,051	$ 2,525

(1) Includes cash flow hedges of $7 million and $(13) million for the three months ended September 30, 2006 and 2005, respectively, and $(34) million and $(30) million for the nine months ended September 30, 2006 and 2005, respectively.

(2) Amounts are net of taxes of $517 million and $(352) million for the three months ended September 30, 2006 and 2005, respectively, and $(280) million and $(271) million for the nine months ended September 30, 2006 and 2005, respectively.

The balance of and changes in each component of Accumulated other comprehensive income for the nine months ended September 30, 2006 are as follows (net of taxes):

	Accumulated Other Comprehensive Income (Loss)			
	Foreign Currency	**Net**	**Pension Liability**	**Total**

	Translation Adjustments	Unrealized Investment Gains (Losses)(1)	Adjustment	Accumulated Other Comprehensive Income (Loss)
		(in millions)		
Balance, December 31, 2005	$ (75)	$ 1,576	$ (267)	$ 1,234
Change in component during period	139	(472)	(7)	(340)
Balance, September 30, 2006	$ 64	$ 1,104	$ (274)	$ 894

(1) Includes cash flow hedges of $(112) million and $(78) million at September 30, 2006 and December 31, 2005, respectively.

6. EARNINGS PER SHARE

The Company has outstanding two separate classes of common stock. The Common Stock reflects the performance of the Financial Services Businesses and the Class B Stock reflects the performance of the Closed

PRUDENTIAL FINANCIAL, INC.

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Block Business. Accordingly, earnings per share is calculated separately for each of these two classes of common stock.

Net income for the Financial Services Businesses and the Closed Block Business is determined in accordance with U.S. GAAP and includes general and administrative expenses charged to each of the respective businesses based on the Company s methodology for the allocation of such expenses. Cash flows between the Financial Services Businesses and the Closed Block Business related to administrative expenses are determined by a policy servicing fee arrangement that is based upon insurance and policies in force and statutory cash premiums. To the extent reported administrative expenses vary from these cash flow amounts, the differences are recorded, on an after tax basis, as direct equity adjustments to the equity balances of the businesses. The direct equity adjustments modify the earnings available to each of the classes of common stock for earnings per share purposes.

Common Stock

A reconciliation of the numerators and denominators of the basic and diluted per share computations is as follows:

	Three Months Ended September 30,					
	2006			2005		
	Income	Weighted Average Shares	Per Share Amount	Income	Weighted Average Shares	Per Share Amount
	(in millions, except per share amounts)					
Basic earnings per share						
Income from continuing operations attributable to the Financial Services Businesses	$ 1,084			$ 1,337		
Direct equity adjustment	16			19		
Income from continuing operations attributable to the Financial Services Businesses available to holders of Common Stock after direct equity adjustment	$ 1,100	480.8	$ 2.29	$ 1,356	509.1	$ 2.66