

PRINCIPAL FINANCIAL GROUP INC

Form 10-Q

October 31, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549



## **FORM 10-Q**

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

**For the quarterly period ended September 30, 2007**



**OR**





o

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

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1-16725

(Commission file number)



**PRINCIPAL FINANCIAL GROUP, INC.**

(Exact name of registrant as specified in its charter)



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**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)

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

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

Large Accelerated Filer ☒ Accelerated Filer ☐ Non-accelerated Filer ☐

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

The total number of shares of the registrant's Common Stock, \$0.01 par value, outstanding as of October 24, 2007 was 261,595,670.

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PRINCIPAL FINANCIAL GROUP, INC.

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**PART I FINANCIAL INFORMATION**



**Item 1. Financial Statements**



**Principal Financial Group, Inc.**  
**Consolidated Statements of Financial Position**

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	September 30, 2007 (Unaudited)	December 31, 2006
	(in millions)	
<b>Assets</b>		
Fixed maturities, available-for-sale	\$ 45,868.5	\$ 44,403.5
Fixed maturities, trading	485.4	323.4
Equity securities, available-for-sale	380.3	666.6
Equity securities, trading	244.0	181.0
Mortgage loans	12,290.8	11,663.9
Real estate	908.2	867.0
Policy loans	844.3	850.7
Other investments	1,879.7	1,410.7
Total investments	62,901.2	60,366.8
Cash and cash equivalents	2,558.7	1,590.8
Accrued investment income	761.5	723.5
Premiums due and other receivables	904.7	1,252.3
Deferred policy acquisition costs	2,687.7	2,418.9
Property and equipment	450.8	422.5
Goodwill	370.9	361.9
Other intangibles	1,013.3	981.0
Separate account assets	82,280.5	73,779.6
Other assets	1,688.6	1,760.8
Total assets	\$ 155,617.9	\$ 143,658.1
<b>Liabilities</b>		
Contractholder funds	\$ 39,086.3	\$ 36,799.0
Future policy benefits and claims	18,091.6	17,332.6
Other policyholder funds	537.4	619.4
Short-term debt	56.7	84.1
Long-term debt	1,523.3	1,553.8
Income taxes currently payable	2.0	4.2
Deferred income taxes	687.7	917.2
Separate account liabilities	82,280.5	73,779.6
Other liabilities	5,484.1	4,707.4
Total liabilities	147,749.6	135,797.3
<b>Stockholders' equity</b>		
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 2007 and 2006		
Series B preferred stock, par value \$.01 per share with liquidation preference of \$25 per share - 10.0 million shares authorized, issued and outstanding in 2007 and 2006	0.1	0.1
Common stock, par value \$.01 per share - 2,500.0 million shares authorized, 385.2 million and 383.6 million shares issued, and 262.5 million and 268.4 million shares outstanding in 2007 and 2006, respectively	3.8	3.8
Additional paid-in capital	8,250.8	8,141.8
Retained earnings	3,617.3	2,824.1
Accumulated other comprehensive income	388.4	846.9
Treasury stock, at cost (122.7 million and 115.2 million shares in 2007 and 2006, respectively)	(4,392.1)	(3,955.9)
Total stockholders' equity	7,868.3	7,860.8
Total liabilities and stockholders' equity	\$ 155,617.9	\$ 143,658.1

See accompanying notes.

**Principal Financial Group, Inc.**  
**Consolidated Statements of Operations**  
**(Unaudited)**

	For the three months ended		For the nine months ended	
	September 30,		September 30,	
	2007	2006	2007	2006
	(in millions, except per share data)			
Revenues				
Premiums and other considerations	\$ 1,171.4	\$ 1,060.0	\$ 3,456.0	\$ 3,206.4
Fees and other revenues	738.5	465.3	1,953.9	1,387.5
Net investment income	1,028.9	931.0	2,928.4	2,694.6
Net realized/unrealized capital gains (losses)	(89.3)	(6.7)	3.7	23.1
Total revenues	2,849.5	2,449.6	8,342.0	7,311.6
Expenses				
Benefits, claims, and settlement expenses	1,643.2	1,426.2	4,725.9	4,227.6
Dividends to policyholders	73.9	73.0	221.9	217.4
Operating expenses	800.9	619.5	2,316.0	1,865.8
Total expenses	2,518.0	2,118.7	7,263.8	6,310.8
Income from continuing operations before income taxes	331.5	330.9	1,078.2	1,000.8
Income taxes	91.0	72.1	260.3	229.4
Income from continuing operations, net of related income taxes	240.5	258.8	817.9	771.4
Income from discontinued operations, net of related income taxes		0.4		0.5
Net income	240.5	259.2	817.9	771.9
Preferred stock dividends	8.2	8.2	24.7	24.7
Net income available to common stockholders	\$ 232.3	\$ 251.0	\$ 793.2	\$ 747.2
Earnings per common share				
Basic earnings per common share:				
Income from continuing operations, net of related income taxes	\$ 0.88	\$ 0.93	\$ 2.97	\$ 2.73
Income from discontinued operations, net of related income taxes			—	—
Net income	\$ 0.88	\$ 0.93	\$ 2.97	\$ 2.73
Diluted earnings per common share:				
Income from continuing operations, net of related income taxes	\$ 0.87	\$ 0.92	\$ 2.94	\$ 2.70
Income from discontinued operations, net of related income taxes			—	—
Net income	\$ 0.87	\$ 0.92	\$ 2.94	\$ 2.70

See accompanying notes.



**Principal Financial Group, Inc.**  
**Consolidated Statements of Stockholders' Equity**  
**(Unaudited)**

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	Series A preferred stock	Series B preferred stock	Common stock	Additional paid-in capital	Retained earnings (in millions)	Accumulated other comprehensive income	Treasury stock	Total stockholders equity
<b>Balances at January 1, 2006</b>	\$	\$ 0.1	\$ 3.8	\$ 8,000.0	\$ 2,008.6	\$ 994.8	\$ (3,200.1)	\$ 7,807.2
Common stock issued				51.6				51.6
Capital transactions of equity method investee, net of related income taxes				1.4				1.4
Stock-based compensation and additional related tax benefits				53.6				53.6
Treasury stock acquired, common							(755.7)	(755.7)
Dividends to preferred stockholders					(24.7)			(24.7)
Comprehensive income:								
Net income					771.9			771.9
Net unrealized losses, net						(207.4)		(207.4)
Foreign currency translation adjustment, net of related income taxes						(9.8)		(9.8)
Comprehensive income								554.7
<b>Balances at September 30, 2006</b>	\$	\$ 0.1	\$ 3.8	\$ 8,106.6	\$ 2,755.8	\$ 777.6	\$ (3,955.8)	\$ 7,688.1
<b>Balances at January 1, 2007</b>	\$	\$ 0.1	\$ 3.8	\$ 8,141.8	\$ 2,824.1	\$ 846.9	\$ (3,955.9)	\$ 7,860.8
Common stock issued				49.5				49.5
Capital transactions of equity method investee, net of related income taxes				0.8				0.8
Stock-based compensation and additional related tax benefits				58.7				58.7
Treasury stock acquired, common							(436.2)	(436.2)
Dividends to preferred stockholders					(24.7)			(24.7)
Comprehensive income:								
Net income					817.9			817.9
Net unrealized losses, net						(492.3)		(492.3)
Foreign currency translation adjustment, net of related income taxes						35.2		35.2
Unrecognized post-retirement benefit obligation, net of related income taxes						(1.4)		(1.4)
Comprehensive income								359.4
<b>Balances at September 30, 2007</b>	\$	\$ 0.1	\$ 3.8	\$ 8,250.8	\$ 3,617.3	\$ 388.4	\$ (4,392.1)	\$ 7,868.3

See accompanying notes.



**Principal Financial Group, Inc.**  
**Consolidated Statements of Cash Flows**  
**(Unaudited)**

	For the nine months ended September 30,	
	2007	2006
	(in millions)	
<b>Operating activities</b>		
Net income	\$ 817.9	\$ 771.9
Adjustments to reconcile net income to net cash provided by operating activities:		
Income from discontinued operations, net of related income taxes		(0.5)
Amortization of deferred policy acquisition costs	292.2	184.6
Additions to deferred policy acquisition costs	(416.6)	(364.2)
Accrued investment income	(38.0)	(19.5)
Net cash flows from trading securities	(196.6)	(161.7)
Premiums due and other receivables	234.4	(40.9)
Contractholder and policyholder liabilities and dividends	1,681.4	1,311.5
Current and deferred income taxes	96.0	13.9
Net realized/unrealized capital gains	(3.7)	(23.1)
Depreciation and amortization expense	88.3	79.9
Mortgage loans held for sale, acquired or originated	(67.6)	(398.4)
Mortgage loans held for sale, sold or repaid, net of gain	142.7	706.9
Real estate acquired through operating activities	(36.7)	(19.7)
Real estate sold through operating activities	49.6	31.3
Stock-based compensation	52.5	52.6
Other	349.5	(74.7)
Net adjustments	2,227.4	1,278.0
Net cash provided by operating activities	3,045.3	2,049.9
<b>Investing activities</b>		
Available-for-sale securities:		
Purchases	(8,024.7)	(6,287.6)
Sales	2,727.2	1,101.0
Maturities	3,430.1	2,656.7
Mortgage loans acquired or originated	(2,119.3)	(1,798.7)
Mortgage loans sold or repaid	1,476.3	1,588.6
Real estate acquired	(89.1)	(21.4)
Real estate sold	6.2	22.9
Net purchases of property and equipment	(64.2)	(34.4)
Purchases of interest in subsidiaries, net of cash acquired	(69.1)	(37.2)
Net change in other investments	(106.6)	16.1
Net cash used in investing activities	\$ (2,833.2)	\$ (2,794.0)

**Principal Financial Group, Inc.**  
**Consolidated Statements of Cash Flows (continued)**  
**(Unaudited)**

	For the nine months ended, September 30,	
	2007	2006
	(in millions)	
<b>Financing activities</b>		
Issuance of common stock	\$ 49.5	\$ 51.6
Acquisition of treasury stock	(436.2)	(755.7)
Proceeds from financing element derivatives	122.7	126.3
Payments for financing element derivatives	(107.0)	(110.0)
Excess tax benefits from share-based payment arrangements	6.6	5.9
Dividends to preferred stockholders	(24.7)	(16.5)
Issuance of long-term debt	8.5	1.3
Principal repayments of long-term debt	(42.7)	(20.2)
Net repayments of short-term borrowings	(29.4)	(359.7)
Investment contract deposits	6,824.8	6,691.7
Investment contract withdrawals	(6,427.5)	(5,247.5)
Net banking operation deposits	811.2	131.7
Net cash provided by financing activities	755.8	498.9
<b>Discontinued operations</b>		
Net cash provided by operating activities		1.4
Net cash used in investing activities		(0.9)
Net cash provided by discontinued operations		0.5
Net increase (decrease) in cash and cash equivalents	967.9	(244.7)
Cash and cash equivalents at beginning of period	1,590.8	1,641.3
Cash and cash equivalents at end of period	\$ 2,558.7	\$ 1,396.6
<b>Cash and cash equivalents of discontinued operations included above</b>		
At beginning of period	\$	\$ 2.0
At end of period	\$	\$ 2.5

*See accompanying notes.*





**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements**  
**September 30, 2007**  
**(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 ( VIEs ), 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 nine months ended September 30, 2007, are not necessarily indicative of the results that may be expected for the year ended December 31, 2007. These interim unaudited consolidated financial statements should be read in conjunction with our annual audited financial statements as of December 31, 2006, included in our Form 10-K for the year ended December 31, 2006, filed with the United States Securities and Exchange Commission ( SEC ). The accompanying consolidated statement of financial position as of December 31, 2006, 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.

Reclassifications have been made to the September 30, 2006, financial statements to conform to the September 30, 2007, presentation.

**Recent Accounting Pronouncements**

On June 11, 2007, the American Institute of Certified Public Accountants (the AICPA ) issued Statement of Position ( SOP ) 07-1, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*. This SOP provides guidance for determining whether an entity is within the scope of the AICPA *Audit and Accounting Guide for Investment Companies* (the Guide ). This SOP also addresses whether the specialized industry accounting principles of the Guide should be retained by a parent company in consolidation or by an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the entity. In addition, this SOP includes certain disclosure requirements for parent companies and equity method investors in investment companies that retain investment company accounting in the parent company's consolidated financial statements or the financial statements of an equity method investor. The provisions of this SOP were effective for fiscal years beginning on or after December 15, 2007, with earlier application encouraged. On October 17, 2007, the Financial Accounting Standards Board (the FASB ) agreed to issue an exposure draft that would indefinitely delay the effective date of SOP 07-1 until the FASB can reassess its provisions.

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On February 15, 2007, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115* ( SFAS 159 ). SFAS 159 permits entities to choose, at specified election dates, to measure eligible financial instruments and certain other items at fair value that are not currently required to be reported at fair value. Unrealized gains and losses on items for which the fair value option is elected shall be reported in net income. The decision about whether to elect the fair value option (1) is applied instrument by instrument, with certain exceptions; (2) is irrevocable; and (3) is applied to an entire instrument and not only to specified risks, specific cash flows, or portions of that instrument. SFAS 159 also requires additional disclosures that are intended to facilitate comparisons between entities that choose different measurement attributes for similar assets and liabilities and between assets and liabilities in the financial statements of an entity that selects different measurement attributes for similar assets and liabilities. SFAS 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. At the effective date, the fair value option may be elected for eligible items that exist at that date and the effect of the first remeasurement to fair value for those items should be reported as a cumulative effect adjustment to retained earnings. We are currently evaluating the impact this guidance will have on our consolidated financial statements.

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2007**  
**(Unaudited)**

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

On July 13, 2006, the FASB issued FASB Interpretation ( FIN ) No. 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ). FIN 48, which is an interpretation of 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, or expected 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. We adopted FIN 48 on January 1, 2007, which did not have a material impact on our consolidated financial statements. See Note 3, Federal Income Taxes, for further details.

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 to recognize 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. We adopted SFAS 156 on January 1, 2007, and have not elected to subsequently measure any of our servicing rights at fair value or reclassify any AFS securities to trading. The prospective aspects of SFAS 156 are 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. We adopted SFAS 155 on January 1, 2007, and did not apply the fair value election to any existing hybrid financial instruments that had been bifurcated under SFAS 133 prior to adoption of SFAS 155. The prospective aspects of SFAS 155 are not expected to have a material impact on our consolidated financial statements.



**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2007**  
**(Unaudited)**

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

On September 19, 2005, the AICPA issued SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts* ( SOP 05-1 ). AICPA 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. An internal replacement that is determined to result in a replacement contract that is substantially unchanged from the replaced contract should be accounted for as a continuation of the replaced contract. Contract modifications resulting in a replacement contract that is substantially changed from the replaced contract should be accounted for as an extinguishment of the replaced contract and any unamortized deferred policy acquisition costs ( DPAC ), unearned revenue liabilities, and deferred sales inducement costs from the replaced contract should be written off and acquisition costs on the new contract capitalized as appropriate. This SOP is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. As of January 1, 2007, we adopted SOP 05-1, which did not have a material impact on our consolidated financial statements.

**Separate Accounts**



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As of September 30, 2007, and December 31, 2006, the separate accounts include a separate account valued at \$713.1 million and \$768.4 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 14, 2007, we invested \$100.0 million in a secured limited recourse note issued by a segregated portfolio company. The note represents Class B-1 notes. Class A notes are senior and Class C through Class E 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 \$100.0 million as of September 30, 2007.

### 3. Federal Income Taxes

The effective income tax rates for the three and nine months ended September 30, 2007, were lower than the corporate income tax rate of 35% primarily due to income tax deductions allowed for corporate dividends received. The effective income tax rate for the three months ended September 30, 2006, was lower than the corporate income tax rate of 35% primarily due to income tax deductions allowed for corporate dividends received, tax refinements in Mexico and interest exclusion from taxable income. The effective income tax rate for the nine months ended September 30, 2006, was lower than the prevailing corporate federal income tax rate due to income tax deductions allowed for corporate dividends received, a favorable court ruling on a contested Internal Revenue Service (the Service) issue for 1991 and later years and interest exclusion from taxable income.

We adopted the provisions of FIN 48 on January 1, 2007. The application of FIN 48 did not have a material impact on our consolidated financial statements. As of January 1, 2007, the total unrecognized benefits were \$60.0 million. Of this amount, \$20.3 million, if recognized, would reduce the 2007 effective tax rate.

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2007**  
**(Unaudited)**

**3. Federal Income Taxes (continued)**

We recognize interest and penalties related to uncertain tax positions in operating expenses. As of January 1, 2007, we had recognized \$15.7 million of accumulated pre-tax interest related to unrecognized tax benefits existing at the date of adoption.

The Service has completed examinations of the U.S. consolidated federal income tax returns for 2003 and prior years. The Service has commenced the audit of our federal income tax returns for the years 2004 and 2005. We do not expect the results of these audits to significantly increase or decrease the total amount of unrecognized tax benefits in the next twelve months, but the outcome of tax reviews is uncertain, and unforeseen results can occur.

**4. Employee and Agent Benefits**





**Components of net periodic benefit cost (income):**

	Pension benefits For the three months ended September 30,		Other postretirement benefits For the three months ended September 30,	
	2007	2006	2007	2006
	(in millions)			
Service cost	\$ 11.8	\$ 11.7	\$ 2.0	\$ 2.4
Interest cost	22.4	20.4	3.9	4.0
Expected return on plan assets	(28.6)	(26.3)	(8.4)	(8.1)
Amortization of prior service benefit	(2.1)	(2.2)	(0.7)	(0.7)
Recognized net actuarial loss (gain)	2.5	5.1	(0.5)	0.1
Net periodic benefit cost (income)	\$ 6.0	\$ 8.7	\$ (3.7)	\$ (2.3)

	Pension benefits For the nine months ended September 30,		Other postretirement benefits For the nine months ended September 30,	
	2007	2006	2007	2006
	(in millions)			
Service cost	\$ 35.3	\$ 35.2	\$ 6.0	\$ 7.1
Interest cost	67.1	61.2	11.6	12.1
Expected return on plan assets	(85.6)	(79.0)	(25.2)	(24.2)
Amortization of prior service benefit	(6.3)	(6.7)	(2.0)	(2.0)
Recognized net actuarial loss (gain)	7.5	15.3	(1.4)	0.2
Net periodic benefit cost (income)	\$ 18.0	\$ 26.0	\$ (11.0)	\$ (6.8)

## Contributions

Our funding policy for our qualified 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 2007 will be zero so we will not be required to fund our qualified pension plan during 2007. However, it is possible that we may fund the qualified and nonqualified pension plans in 2007 in the range of \$20.0 million to \$50.0 million, in total. During the three and nine months ended September 30, 2007, \$9.5 million and \$15.9 million were contributed to the nonqualified pension plan, respectively.

During the three months ended September 30, 2007, no contributions were made to the other postretirement benefit plans. We contributed \$0.7 million for the nine months ended September 30, 2007. We anticipate no additional contributions to the other postretirement benefit plans in 2007.

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2007**  
**(Unaudited)**

**5. Contingencies, Guarantees and Indemnifications**

**Litigation and Regulatory Contingencies**

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. To date, none of these Attorneys General investigations has resulted in any action against us. We are, however, engaged in discussions with the Connecticut and New York Attorneys General Offices with respect to broker payments relating to sales of our single premium group annuity products, which primarily fund terminating defined benefit plans. We do not anticipate any potential resolution of these discussions to materially affect net income in a particular quarter or annual period. We have received other requests from regulators and other governmental authorities relating to other industry issues and may receive additional such requests, including subpoenas and interrogatories, in the future.

On November 8, 2006, a trustee of Fairmount Park Inc. Retirement Savings Plan filed a putative class action lawsuit in the United States District Court for the Southern District of Illinois against Principal Life Insurance Company (Principal Life). The complaint alleges, among other things, that Principal Life breached its alleged fiduciary duties while performing services to 401(k) plans by failing to disclose, or adequately disclose, to employers or plan participants the fact that Principal Life receives revenue sharing fees from mutual funds that are included in its pre-packaged 401(k) plans and allegedly failed to use the revenue to defray the expenses of the services provided to the plans. Plaintiff further alleges that these acts constitute prohibited transactions under ERISA. Plaintiff seeks to certify a class of all retirement plans to which Principal Life was a service provider and for which Principal Life received and retained revenue sharing fees from mutual funds. Plaintiff seeks declaratory, injunctive and monetary relief. Principal Life's Motion to Transfer Venue to the Southern District of Iowa was granted and Principal Life is aggressively defending the lawsuit.

On August 28, 2007, two plaintiffs filed two putative class action lawsuits in the United States District Court for the Southern District of Iowa against us and Princor Financial Services Corporation (the Principal Defendants). One of the lawsuits alleges that the Principal Defendants breached alleged fiduciary duties to participants in employer-sponsored 401(k) plans who were retiring or leaving their respective plans, including providing misleading information and failing to act solely in the interests of the participants, resulting in alleged violations of ERISA. The second suit is based upon the same facts and alleges violations of the Securities Exchange Act of 1934 and the Securities Act of 1933. The

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allegations of the second suit include alleged omissions and misrepresentations by the Principal Defendants related to mutual fund shares purchased by plan participants rolling out of employer-sponsored retirement plans. The Principal Defendants are aggressively defending these lawsuits.

While the outcome of any pending or future litigation or regulatory matter cannot be predicted, management does not believe that any pending litigation or regulatory matter will have a material adverse effect on our business or financial position. The outcome of such matters 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.

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2007**  
**(Unaudited)**

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

**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 through 2019. The maximum exposure under these agreements as of September 30, 2007, was approximately \$191.0 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.

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 was determined to be insignificant.

**6. Stockholders' Equity**



**Reconciliation of Outstanding Shares**

	<b>Series A preferred stock</b>	<b>Series B preferred stock (in millions)</b>	<b>Common stock</b>
Outstanding shares at January 1, 2006	3.0	10.0	280.6
Shares issued			1.8
Treasury stock acquired			(12.8)
Outstanding shares at September 30, 2006	3.0	10.0	269.6
Outstanding shares at January 1, 2007	<b>3.0</b>	<b>10.0</b>	<b>268.4</b>
Shares issued			<b>1.6</b>
Treasury stock acquired			<b>(7.5)</b>
Outstanding shares at September 30, 2007	<b>3.0</b>	<b>10.0</b>	<b>262.5</b>



**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2007**  
**(Unaudited)**

**6. Stockholders' Equity (continued)**

**Comprehensive income**

	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
	(in millions)			
Net income	\$ 240.5	\$ 259.2	\$ 817.9	\$ 771.9
Net change in unrealized gains (losses) on fixed maturities, available-for-sale	(209.8)	975.1	(923.4)	(393.2)
Net change in unrealized losses on equity securities, available-for-sale	(2.8)	(0.3)	(8.2)	(9.9)
Net change in unrealized gains (losses) on equity method subsidiaries and minority interest adjustments	(43.4)	(6.1)	53.2	12.2
Adjustments for assumed changes in amortization patterns	11.3	(151.3)	129.8	29.9
Net change in unrealized gains (losses) on derivative instruments	(20.2)	(33.3)	8.6	(1.6)
Adjustments to unrealized gains for Closed Block policyholder dividend obligation				33.7
Change in net foreign currency translation adjustment	(2.2)	24.5	36.1	(5.7)
Change in unrecognized post-retirement benefit obligation	(0.8)		(2.2)	
Provision for deferred income tax benefits (taxes)	102.3	(249.5)	247.6	117.4
Comprehensive income	\$ 74.9	\$ 818.3	\$ 359.4	\$ 554.7

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2007**  
**(Unaudited)**

**7. 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 Brazil, Chile, China, Hong Kong, India, Malaysia and Mexico. 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 in goal setting, as a basis in determining employee compensation and in 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 DPAC and sales inducements, recognition of deferred front-end fee revenues for sales charges on retirement products and services, net realized capital gains and losses distributed, minority interest capital gains and losses and certain market value adjustments to fee revenues. Net realized/unrealized capital gains (losses), as adjusted, exclude periodic settlements and accruals on non-hedge derivative instruments. Segment operating revenues exclude net realized/unrealized capital gains (except periodic settlements and accruals on non-hedge derivatives) 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. While these items may be significant components in understanding and assessing 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 the positions we took on tax returns. The Corporate and Other segment results reflect any differences between the tax returns and the estimated resolution of any disputes.

Principal Financial Group, Inc.  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2007**  
**(Unaudited)**

**7. Segment Information (continued)**

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

	September 30, 2007	December 31, 2006
	(in millions)	
<b>Assets:</b>		
U.S. Asset Management and Accumulation	\$ 129,120.8	\$ 117,950.0
International Asset Management and Accumulation	9,021.3	8,101.0
Life and Health Insurance	14,910.1	14,364.5
Corporate and Other	2,565.7	3,242.6
Total consolidated assets	\$ 155,617.9	\$ 143,658.1

	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
	(in millions)			
<b>Operating revenues by segment:</b>				
U.S. Asset Management and Accumulation	\$ 1,509.8	\$ 1,111.3	\$ 4,178.0	\$ 3,299.4
International Asset Management and Accumulation	224.6	169.2	540.9	476.8
Life and Health Insurance	1,211.6	1,183.4	3,635.5	3,526.1
Corporate and Other	(7.2)	(7.6)	(6.4)	(13.5)
Total segment operating revenues	2,938.8	2,456.3	8,348.0	7,288.8
Add:				
Net realized/unrealized capital gains (losses) (except periodic settlements and accruals on non-hedge derivatives), including recognition of front-end fee revenues and certain market value adjustments to fee revenues	(89.3)	(6.1)	(6.0)	23.6
Subtract:				
Operating revenues from a discontinued real estate investment		0.6		0.8
Total revenues per consolidated statements of operations	\$ 2,849.5	\$ 2,449.6	\$ 8,342.0	\$ 7,311.6
<b>Operating earnings (loss) by segment, net of related income taxes:</b>				
U.S. Asset Management and Accumulation	\$ 211.9	\$ 157.4	\$ 587.0	\$ 466.4
International Asset Management and Accumulation	39.3	23.2	85.3	56.9
Life and Health Insurance	73.4	82.0	179.0	217.6
Corporate and Other	(11.7)	(7.9)	(18.7)	(20.8)
Total segment operating earnings, net of related income taxes	312.9	254.7	832.6	720.1
Net realized/unrealized capital gains (losses), as adjusted	(59.4)	(3.7)	(18.2)	8.3
Other after-tax adjustments (1)	(21.2)		(21.2)	18.8
Net income available to common stockholders per consolidated statements of operations	\$ 232.3	\$ 251.0	\$ 793.2	\$ 747.2

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(1) For the three and nine months ended September 30, 2007, other after-tax adjustments of \$21.2 million included the negative effect of tax refinements related to prior years.

For the nine months ended September 30, 2006, other after-tax adjustments of \$18.8 million included the positive effect of a favorable court ruling on a contested Internal Revenue Service ("IRS") issue for 1991 and later years.

**Principal Financial Group, Inc.**  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2007**  
**(Unaudited)**

**8. Stock-Based Compensation Plans**

As of September 30, 2007, 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 ( Stock-Based Compensation Plans ). 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.

As of September 30, 2007, 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 19.2 million.

The compensation cost that was charged against income for the Stock-Based Compensation Plans is as follows:

	<b>For the nine months ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in millions)</b>	
Compensation cost	\$ 48.2	\$ 47.3
Related income tax benefit	15.7	15.3
Capitalized as part of an asset	2.8	2.4

**Nonqualified Stock Options**

Nonqualified stock options were granted to certain employees under the 2005 Stock Incentive Plan. Total options granted were 1.8 million for the nine months ended September 30, 2007. The fair value of these options was determined assuming a weighted average dividend yield of 1.3 percent, a weighted average expected volatility of 23.6 percent, a weighted average risk-free interest rate of 4.6 percent, and a weighted average expected life of 6 years. Using the Black-Scholes option valuation model, the weighted-average estimated fair value of stock options granted during the nine months ended September 30, 2007, was \$17.98 per share.

We previously determined expected volatility for stock options granted based on, among other factors, historical volatility using monthly price observations. Beginning with stock options granted in 2007, we determine expected volatility based on, among other factors, historical volatility using daily price observations. We believe that daily price observations provide a better estimate of expected fluctuations in our stock price over the expected term of stock options granted.

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As of September 30, 2007, there were \$20.1 million of total unrecognized compensation costs related to nonvested stock options. The costs are expected to be recognized over a weighted-average service period of approximately 2.1 years.

### **Performance Share Awards**

Performance share awards were granted to certain employees under the 2005 Stock Incentive Plan. Total performance share awards granted were 0.3 million for the nine months ended September 30, 2007. The performance share awards granted represent initial target awards and do not reflect potential increases or decreases resulting from the final performance objectives to be determined at the end of the respective performance period. The actual number of shares to be awarded at the end of each performance period will range between 0% and 200% of the initial target awards. 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 these performance share awards granted was \$62.61 per common share.

As of September 30, 2007, there were \$19.7 million of total unrecognized compensation costs related to nonvested performance share awards granted. The costs are expected to be recognized over a weighted-average service period of approximately 1.5 years.



**Principal Financial Group, Inc.**

Notes to Consolidated Financial Statements (continued)

September 30, 2007

(Unaudited)



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

**Restricted Stock Units**

Restricted stock units were issued to certain employees and agents pursuant to the 2005 Stock Incentive Plan. Total restricted stock units granted were 0.3 million for the nine months ended September 30, 2007. The fair value of restricted stock units is determined based on the closing stock price of our common shares on the grant date. The weighted-average grant date fair value of these restricted stock units granted was \$61.01 per share.

As of September 30, 2007, there were \$17.0 million of total unrecognized compensation costs related to nonvested restricted stock unit awards granted. The costs are expected to be recognized over a weighted-average period of approximately 2.0 years.

**Employee Stock Purchase Plan**

Under the Employee Stock Purchase Plan, employees purchased 0.5 million shares for the nine months ended September 30, 2007. The weighted-average fair value of the discount on the stock purchased was \$9.79 per share.

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 September 30, 2007, a total of 2.8 million of new shares are available to be made issuable by us for this plan.

**9. Earnings Per Common Share**



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

	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
	(in millions, except per share data)			
Income from continuing operations, net of related income taxes	\$ 240.5	\$ 258.8	\$ 817.9	\$ 771.4
Subtract:				
Preferred stock dividends	8.2	8.2	24.7	24.7
Income from continuing operations available to common stockholders, net of related income taxes	\$ 232.3	\$ 250.6	\$ 793.2	\$ 746.7
Weighted-average shares outstanding				
Basic	264.7	269.5	266.8	274.1
Dilutive effects:				
Stock options	2.1	2.0	2.2	2.0
Restricted stock units	0.5	0.6	0.5	0.6
Diluted	267.3	272.1	269.5	276.7
Income from continuing operations per common share:				
Basic	\$ 0.88	\$ 0.93	\$ 2.97	\$ 2.73
Diluted	\$ 0.87	\$ 0.92	\$ 2.94	\$ 2.70

**Principal Financial Group, Inc.**

Notes to Consolidated Financial Statements (continued)

September 30, 2007

(Unaudited)



**10. 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 PFG. 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.

The following tables set forth condensed consolidating financial information of Principal Life and PFG as of September 30, 2007, and December 31, 2006, and for the nine months ended September 30, 2007 and 2006.



Principal Financial Group, Inc.  
**Notes to Consolidated Financial Statements (continued)**  
**September 30, 2007**  
**(Unaudited)**

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

**Condensed Consolidating Statements of Financial Position**  
**September 30, 2007**

	Principal Financial Group, Inc. Parent Only	Principal Life Insurance Company Only	Principal Financial Services, Inc. and Other Subsidiaries Combined (in millions)	Eliminations	Principal Financial Group, Inc. Consolidated
<b>Assets</b>					
Fixed maturities, available-for-sale	\$	\$ 41,355.7	\$ 5,299.5	\$ (786.7)	\$ 45,868.5
Fixed maturities, trading		261.1	224.3	—	485.4
Equity securities, available-for-sale		360.5	19.8	—	380.3
Equity securities, trading		10.5	233.5	—	244.0
Mortgage loans		9,979.1	2,608.8	(297.1)	12,290.8
Real estate		15.8	892.4		908.2
Policy loans		844.3			844.3
Investment in unconsolidated entities	8,167.3	646.6	3,827.0	(12,204.4)	436.5
Other investments	8.6	3,608.0	343.1	(2,516.5)	1,443.2
Cash and cash equivalents	111.3	1,377.6	1,473.5	(403.7)	2,558.7
Accrued investment income		706.2	61.5	(6.2)	761.5
Premiums due and other receivables	—	717.7	176.7	10.3	904.7
Deferred policy acquisition costs		2,514.1	173.6		2,687.7
Property and equipment		405.3	45.5		450.8
Goodwill		77.2	293.7		370.9
Other intangibles		36.3	977.0		1,013.3
Separate account assets		77,600.8	4,679.7		82,280.5
Other assets	206.2	1,215.1	432.2	(164.9)	1,688.6
Total assets	\$ 8,493.4	\$ 141,731.9	\$ 21,761.8	\$ (16,369.2)	\$ 155,617.9
<b>Liabilities</b>					
Contractholder funds	\$	\$ 39,301.2	\$ 19.5	\$ (234.4)	\$ 39,086.3
Future policy benefits and claims		15,456.0	2,641.4	(5.8)	18,091.6
Other policyholder funds		524.5	12.9		537.4
Short-term debt			138.9	(82.2)	56.7
Long-term debt	601.8	99.2	1,461.5	(639.2)	1,523.3
Income taxes currently payable (receivable)	(5.8)	(201.9)	39.1	170.6	2.0
Deferred income taxes	2.7	376.3	318.4	(9.7)	687.7
Separate account liabilities		77,600.8	4,679.7	—	82,280.5
Other liabilities	26.4	1,973.2	4,283.1	(798.6)	5,484.1
Total liabilities	625.1	135,129.3	13,594.5	(1,599.3)	147,749.6
<b>Stockholders' equity</b>					
Series A preferred stock					
Series B preferred stock	0.1				0.1
Common stock	3.8	2.5		(2.5)	3.8

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Additional paid-in capital	8,250.8	5,558.7	7,740.6	(13,299.3)	8,250.8
Retained earnings	3,617.3	941.8	46.0	(987.8)	3,617.3
Accumulated other comprehensive income	388.4	99.6	380.7	(480.3)	388.4
Treasury stock, at cost	(4,392.1)				(4,392.1)
Total stockholders' equity	7,868.3	6,602.6	8,167.3	(14,769.9)	7,868.3
Total liabilities and stockholders' equity \$	8,493.4	\$ 141,731.9	\$ 21,761.8	\$ (16,369.2)	\$ 155,617.9