HANOVER INSURANCE GROUP, INC.
Form 10-Q
August 09, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2007

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: 1-13754

THE HANOVER INSURANCE GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware	**04-3263626**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
440 Lincoln Street, Worcester, Massachusetts	**01653**
(Address of principal executive offices)	**(Zip Code)**

(508) 855-1000

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY

PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes ¨ No ¨

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 51,888,391 shares of common stock outstanding, as of August 1, 2007.

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PART I FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

THE HANOVER INSURANCE GROUP, INC.

CONSOLIDATED STATEMENTS OF INCOME

(In millions, except per share data)	(Unaudited) Quarter Ended June 30, 2007	2006	(Unaudited) Six Months Ended June 30, 2007	2006
REVENUES				
Premiums	**$ 595.5**	$ 554.8	**$ 1,197.7**	$ 1,114.2
Net investment income	**80.3**	79.2	**160.5**	159.5
Net realized investment gains	**0.8**	2.9	**3.1**	8.5
Fees and other income	**14.8**	16.9	**28.2**	36.2
Total revenues	**691.4**	653.8	**1,389.5**	1,318.4
BENEFITS, LOSSES AND EXPENSES				
Policy benefits, claims, losses and loss adjustment expenses	**382.2**	355.5	**767.7**	715.3
Policy acquisition expenses	**130.2**	117.5	**257.4**	231.1
Other operating expenses	**89.5**	102.4	**183.0**	208.3
Total benefits, losses and expenses	**601.9**	575.4	**1,208.1**	1,154.7
Income before federal income taxes	**89.5**	78.4	**181.4**	163.7
Federal income tax expense:				
Current	**13.8**	8.6	**35.8**	22.8
Deferred	**16.2**	16.1	**22.3**	27.2
Total federal income tax expense	**30.0**	24.7	**58.1**	50.0
Income from continuing operations	**59.5**	53.7	**123.3**	113.7
Discontinued operations (See Note 3):				
Gain (loss) on disposal of variable life insurance and annuity business (net of income tax (expense) benefit of $(0.1) and $3.6 for the quarters ended June 30, 2007 and 2006 and $0.1 and $7.8 for the six months ended June 30, 2007 and 2006)	**0.3**	(2.8)	**0.1**	(22.9)
Income before cumulative effect of change in accounting principle	**59.8**	50.9	**123.4**	90.8
Cumulative effect of change in accounting principle (net of income tax expense of $0.3)				0.6
Net income	**$ 59.8**	$ 50.9	**$ 123.4**	$ 91.4
PER SHARE DATA				
Basic				
Income from continuing operations	**$ 1.15**	$ 1.05	**$ 2.40**	$ 2.19
Discontinued operations:				
	0.01	(0.05)		(0.44)

Gain (loss) on disposal of variable life insurance and annuity business (net of income tax benefit of $0.07 and $0.15 for the quarter and six months ended June 30, 2006)								
Income before cumulative effect of change in accounting principle		**1.16**		1.00		**2.40**		1.75
Cumulative effect of change in accounting principle								0.01
Net income per share	**$**	**1.16**	$	1.00	**$**	**2.40**	$	1.76
Weighted average shares outstanding		**51.6**		51.0		**51.4**		52.0
Diluted								
Income from continuing operations	**$**	**1.14**	$	1.04	**$**	**2.37**	$	2.16
Discontinued operations:								
Loss on disposal of variable life insurance and annuity business (net of income tax benefit of $0.07 and $0.15 for the quarter and six months ended June 30, 2006)				(0.05)				(0.43)
Income before cumulative effect of change in accounting principle		**1.14**		0.99		**2.37**		1.73
Cumulative effect of change in accounting principle								0.01
Net income per share	**$**	**1.14**	$	0.99	**$**	**2.37**	$	1.74
Weighted average shares outstanding		**52.3**		51.6		**52.1**		52.6

The accompanying notes are an integral part of these consolidated financial statements.

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THE HANOVER INSURANCE GROUP, INC.

CONSOLIDATED BALANCE SHEETS

(In millions, except per share data)	(Unaudited) June 30, 2007	December 31, 2006
ASSETS		
Investments:		
Fixed maturities, at fair value (amortized cost of $5,685.6 and $5,643.2)	**$ 5,600.8**	$ 5,629.0
Equity securities, at fair value (cost of $17.8 and $11.6)	**25.5**	17.2
Mortgage loans	**46.7**	57.1
Policy loans	**120.8**	125.7
Other long-term investments	**33.3**	35.4
Total investments	**5,827.1**	5,864.4
Cash and cash equivalents	**301.0**	372.7
Accrued investment income	**72.6**	72.3
Premiums, accounts and notes receivable, net	**647.7**	584.7
Reinsurance receivable on paid and unpaid losses, benefits and unearned premiums	**1,337.0**	1,350.5
Deferred policy acquisition costs	**248.2**	233.5
Deferred federal income taxes	**410.7**	385.0
Goodwill	**121.4**	121.4
Other assets	**321.0**	328.5
Separate account assets	**519.0**	543.6
Total assets	**$ 9,805.7**	$ 9,856.6
LIABILITIES		
Policy liabilities and accruals:		
Future policy benefits	**$ 1,213.1**	$ 1,242.3
Outstanding claims, losses and loss adjustment expenses	**3,213.9**	3,247.2
Unearned premiums	**1,164.4**	1,101.4
Contractholder deposit funds and other policy liabilities	**169.6**	194.9
Total policy liabilities and accruals	**5,761.0**	5,785.8
Expenses and taxes payable	**817.7**	928.0
Reinsurance premiums payable	**60.4**	52.7
Trust instruments supported by funding obligations	**39.4**	38.5
Long-term debt	**508.8**	508.8
Separate account liabilities	**519.0**	543.6
Total liabilities	**7,706.3**	7,857.4
Commitments and contingencies (Note 11)		
SHAREHOLDERS' EQUITY		
Preferred stock, $0.01 par value, 20.0 million shares authorized, none issued		
Common stock, $0.01 par value, 300.0 million shares authorized 60.5 million shares issued	**0.6**	0.6
Additional paid-in capital	**1,814.8**	1,814.3

Accumulated other comprehensive loss	**(101.6)**	(39.9)
Retained earnings	**839.1**	712.0
Treasury stock at cost (8.7 million and 9.4 million shares)	**(453.5)**	(487.8)
Total shareholders' equity	**2,099.4**	1,999.2
Total liabilities and shareholders' equity	**$ 9,805.7**	$ 9,856.6

The accompanying notes are an integral part of these consolidated financial statements.

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THE HANOVER INSURANCE GROUP, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(In millions)	(Unaudited) Six Months Ended June 30, 2007	2006
PREFERRED STOCK		
Balance at beginning and end of period	**$**	$
COMMON STOCK		
Balance at beginning and end of period	**0.6**	0.6
ADDITIONAL PAID-IN CAPITAL		
Balance at beginning of period	**1,814.3**	1,785.1
Tax benefit from stock options and other	**2.2**	7.0
Employee and director stock-based awards	**(1.7)**	12.4
Balance at end of period	**1,814.8**	1,804.5
ACCUMULATED OTHER COMPREHENSIVE (LOSS) INCOME		
NET UNREALIZED (DEPRECIATION) APPRECIATION ON INVESTMENTS AND DERIVATIVE INSTRUMENTS:		
Balance at beginning of period	**(9.0)**	9.9
Depreciation during the period:		
Net depreciation on available-for-sale securities and derivative instruments	**(54.9)**	(128.7)
Benefit for deferred federal income taxes	**0.1**	0.2
	(54.8)	(128.5)
Balance at end of period	**(63.8)**	(118.6)
DEFINED BENEFIT PENSION AND POSTRETIREMENT PLANS:		
Balance at beginning of period	**(30.9)**	(69.4)
Amounts arising in the period	**(10.0)**	
Amortization during the period:		
Amount recognized as net periodic benefit cost	**(0.7)**	
Benefit for deferred federal income taxes	**3.8**	
	(6.9)	
Balance at end of period	**(37.8)**	(69.4)
Total accumulated other comprehensive loss	**(101.6)**	(188.0)
RETAINED EARNINGS		
Balance at beginning of period, before cumulative effect of accounting change, net of tax	**712.0**	589.8
Cumulative effect of accounting change, net of tax	**11.5**	

Balance at beginning of period, as adjusted	**723.5**	589.8
Net income	**123.4**	91.4
Treasury stock issued for less than cost	**(7.8)**	(28.5)
Balance at end of period	**839.1**	652.7
TREASURY STOCK		
Balance at beginning of period	**(487.8)**	(364.7)
Shares purchased at cost		(200.1)
Net shares reissued at cost under employee stock-based compensation plans	**34.3**	65.0
Balance at end of period	**(453.5)**	(499.8)
Total shareholders' equity	**$ 2,099.4**	$ 1,770.0

The accompanying notes are an integral part of these consolidated financial statements.

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THE HANOVER INSURANCE GROUP, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	(Unaudited) Quarter Ended June 30,		(Unaudited) Six Months Ended June 30,	
(In millions)	**2007**	**2006**	**2007**	**2006**
Net income	**$ 59.8**	$ 50.9	**$ 123.4**	$ 91.4
Other comprehensive (loss) income:				
Available-for-sale securities:				
Net depreciation during the period	**(78.9)**	(60.9)	**(54.6)**	(130.1)
Benefit (provision) for deferred federal income taxes	**4.8**	(0.9)		0.7
Total available-for-sale securities	**(74.1)**	(61.8)	**(54.6)**	(129.4)
Derivative instruments:				
Net (depreciation) appreciation during the period	**(0.1)**	0.1	**(0.3)**	1.4
(Provision) benefit for deferred federal income taxes		(0.1)	**0.1**	(0.5)
Total derivative instruments	**(0.1)**		**(0.2)**	0.9
	(74.2)	(61.8)	**(54.8)**	(128.5)
Pension and postretirement benefits:				
Amounts arising in the period:				
Net actuarial loss	**(10.0)**		**(10.0)**	
Amortization recognized as net periodic benefit costs:				
Net actuarial loss	**1.2**		**1.3**	
Prior service cost	**(0.6)**		**(1.2)**	
Transition asset	**(0.4)**		**(0.8)**	
	(9.8)		**(10.7)**	
Benefit for deferred federal income taxes	**3.5**		**3.8**	
Total pension and postretirement benefits	**(6.3)**		**(6.9)**	
Other comprehensive loss	**(80.5)**	(61.8)	**(61.7)**	(128.5)
Comprehensive (loss) income	**$ (20.7)**	$ (10.9)	**$ 61.7**	$ (37.1)

The accompanying notes are an integral part of these consolidated financial statements.

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THE HANOVER INSURANCE GROUP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)	(Unaudited) Six Months Ended June 30, 2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	**$ 123.4**	$ 91.4
Adjustments to reconcile net income to net cash used in operating activities:		
(Gain) loss on disposal of variable life insurance and annuity business	**(0.1)**	22.9
Net realized investment gains	**(3.1)**	(8.5)
Net amortization and depreciation	**9.5**	10.9
Stock-based compensation expense	**7.5**	8.6
Interest credited to contractholder deposit funds and trust instruments supported by funding obligations	**1.2**	5.3
Deferred federal income taxes	**22.3**	27.2
Change in deferred acquisition costs	**(14.7)**	(19.4)
Change in premiums and notes receivable, net of reinsurance premiums payable	**(22.8)**	(107.8)
Change in accrued investment income	**(0.3)**	4.3
Change in policy liabilities and accruals, net	**(13.0)**	(242.8)
Change in reinsurance receivable	**13.5**	238.9
Change in expenses and taxes payable	**(84.0)**	(75.8)
Other, net	**(1.4)**	2.2
Net cash provided by (used in) operating activities	**38.0**	(42.6)
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from disposals and maturities of available-for-sale fixed maturities	**751.6**	811.7
Proceeds from disposals of equity securities and other investments	**11.0**	10.5
Proceeds from mortgages matured or collected	**10.5**	24.7
Proceeds from collections of installment finance and notes receivable	**213.2**	169.3
Proceeds from sale of variable life insurance and annuity business		27.3
Purchase of available-for-sale fixed maturities	**(786.9)**	(596.9)
Purchase of equity securities and other investments	**(8.5)**	(4.1)
Capital expenditures	**(4.1)**	(4.3)
Net payments related to terminated swap agreements		(28.3)
Disbursements to fund installment finance and notes receivable	**(245.6)**	(183.3)
Net cash (used in) provided by investing activities	**(58.8)**	226.6
CASH FLOWS FROM FINANCING ACTIVITIES		
Withdrawals from contractholder deposit funds		(25.9)
Withdrawals from trust instruments supported by funding obligations		(251.6)
Exercise of options	**20.7**	37.0
Proceeds from excess tax benefits related to share-based payments	**1.2**	5.2
Change in collateral related to securities lending program	**(72.8)**	(56.7)
Treasury stock purchased at cost		(200.1)
Net cash used in financing activities	**(50.9)**	(492.1)
Net change in cash and cash equivalents	**(71.7)**	(308.1)

Cash and cash equivalents, beginning of period	**372.7**	701.5
Cash and cash equivalents, end of period	**$ 301.0**	$ 393.4

The accompanying notes are an integral part of these consolidated financial statements.

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THE HANOVER INSURANCE GROUP, INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation and Principles of Consolidation

The accompanying unaudited consolidated financial statements of The Hanover Insurance Group, Inc. (THG or the Company) have been prepared in accordance with generally accepted accounting principles for interim financial information and with the requirements of Form 10-Q.

The interim consolidated financial statements of THG include the accounts of The Hanover Insurance Company (Hanover Insurance) and Citizens Insurance Company of America (Citizens), THG s principal property and casualty companies; First Allmerica Financial Life Insurance Company (FAFLIC), THG s life insurance and annuity subsidiary; and certain other insurance and non-insurance subsidiaries. These legal entities conduct their operations through several business segments discussed in Note 8. All significant intercompany accounts and transactions have been eliminated.

The accompanying interim consolidated financial statements reflect, in the opinion of the Company's management, all adjustments necessary for a fair presentation of the financial position and results of operations. The results of operations for the six months ended June 30, 2007 are not necessarily indicative of the results to be expected for the full year. These financial statements should be read in conjunction with the Company s 2006 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

The preparation of financial statements in conformity with generally accepted accounting principles requires the Company 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 amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. New Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (Statement No. 159). Statement No. 159 permits a company to choose, at specified election dates, to measure at fair value certain eligible financial assets and liabilities that are not currently required to be measured at fair value. The specified election dates include, but are not limited to, the date when an entity first recognizes the item, when an entity enters into a firm commitment or when changes in the financial instrument causes it to no longer qualify for fair value accounting under a different accounting standard. An entity may elect the fair value option for eligible items that exist at the effective date. At that date, the difference between the carrying amounts and the fair values of eligible items for which the fair value option is elected should be recognized as a cumulative effect adjustment to the opening balance of retained earnings. The fair value option may be elected for each entire financial instrument, but need not be applied to all similar instruments. Once the fair value option has been elected, it is irrevocable. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. Statement No. 159 is effective as of the beginning of fiscal years that begin after November 15, 2007. The Company is currently assessing the effect of adopting Statement No. 159.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R)* (Statement No. 158). This statement requires an employer to recognize the funded status of its benefit plans in its statement of financial position and to recognize changes in that funded status through comprehensive income in the year in which they occur. The funded status of the plans should be measured as the difference between the fair value of plan assets and the benefit obligation. This statement also requires the recognition, as a component of other comprehensive income, net of taxes, of the gains or losses and prior service costs or credits that arise during the period but are not recognized as a component of net periodic benefit cost pursuant to Statement of Financial Accounting Standards No. 87, *Employers Accounting for Pensions* (Statement No. 87) or Statement of Financial Accounting Standards No. 106, *Employers Accounting for Postretirement Benefits Other Than Pensions* (Statement No. 106), as well as the balance of transition assets or obligations remaining from the initial application of Statement No. 87 and Statement No. 106. These balances in accumulated other comprehensive income shall be subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization requirements of Statement No. 87 and Statement No. 106. In addition, the statement requires an employer to measure the funded status of its plans as of the date of its year-end statement of financial position. The statement also provides for enhanced disclosures which include, among other items, the estimated amount of actuarial gains or losses, prior services costs or credits, and transition assets or obligations that are included in accumulated other comprehensive income to be recognized as components of net periodic benefit cost in the next fiscal year. The effective date for a company to recognize the funded status of its plans and the related disclosure requirements is

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as of the end of its fiscal year ending after December 15, 2006. Retrospective application of this statement is not permitted. The effective date for changing a company s measurement date for plan assets and benefit obligations to coincide with the date of its statement of financial position will be for fiscal years ending after December 15, 2008. The Company currently measures its funded status as of December 31. THG adopted Statement No. 158 effective December 31, 2006. The impact of adopting Statement No. 158 was not material to the Company s results of operations or financial position.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (Statement No. 157). This statement creates a common definition of fair value to be used throughout generally accepted accounting principles. Statement No. 157 will apply whenever another standard requires or permits assets or liabilities to be measured at fair value, with certain exceptions. The standard establishes a hierarchy for determining fair value which emphasizes the use of observable market data whenever available. The statement also requires expanded disclosures which include the extent to which assets and liabilities are measured at fair value, the methods and assumptions used to measure fair value and the effect of fair value measures on earnings. Statement No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The difference between the carrying amounts and fair values of those financial instruments held at the date this statement is initially applied should be recognized as a cumulative effect adjustment to the opening balance of retained earnings for the fiscal year in which this statement is initially applied. The Company is currently assessing the effect of adopting Statement No. 157.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48). The interpretation requires companies to recognize the tax benefits of uncertain tax positions only where the position is more likely than not to be sustained upon examination by tax authorities. The amount recognized would be the amount that represents the largest amount of tax benefit that is greater than 50% likely of being ultimately realized. A liability would be recognized for any benefit claimed, or expected to be claimed, in a tax return in excess of the benefit recorded in the financial statements, along with any interest and penalty on the excess. FIN 48 will require, among other items, a tabular reconciliation of the change during the reporting period, in the aggregate unrecognized tax benefits claimed or expected to be claimed in tax returns and disclosure relating to accrued interest and penalties for unrecognized tax benefits. Additional disclosure will also be required for those uncertain tax positions where it is reasonably possible that the estimate of the tax benefit will change significantly in the next twelve months. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company adopted FIN 48 as of January 1, 2007 which resulted in an increase to shareholders equity of $11.5 million. See Note 4 Federal Income Taxes.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets an amendment to FASB Statement No. 140* (Statement No. 156). Statement No. 156 amends Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* to require, among other things, that all separately recognized servicing assets and liabilities be initially measured at fair value, if practicable. It also permits an entity to choose a method for the subsequent measurement of separately recognized servicing assets and liabilities, either the amortization method or the fair value measurement method. The statement is effective as of the beginning of fiscal years that begin after September 15, 2006. The Company adopted Statement No. 156 effective January 1, 2007 with no material impact on its results of operations or financial position.

In September 2005, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts* (SOP 05-1). SOP 05-1 provides guidance on accounting by insurance companies for deferred acquisition costs on internal replacements of insurance and investment contracts other than those described in Statement of Financial Accounting Standards No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. This statement is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. The Company adopted SOP 05-1 effective January 1, 2007 with no material effect on the Company s results of operations or financial position.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (Statement No. 123(R)). This statement requires companies to measure and recognize the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value. Statement No. 123(R) replaces Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation,* and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB Opinion No. 25). The Company adopted Statement No. 123(R) effective January 1, 2006 using the modified prospective transition method. Prior to the adoption of Statement No. 123(R), the Company accounted for its stock-based compensation in accordance with APB Opinion No. 25; therefore, the Company had not previously recognized compensation expense for employee stock options in net income because the exercise price equaled the market value of the underlying common stock on the grant date. Upon adoption of Statement No. 123(R), the Company began recognizing expense related to employee stock options and modified its expense calculation associated with restricted shares and

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restricted share units. The cumulative effect adjustment of adopting Statement No. 123(R), net of tax, was a benefit of $0.6 million. In the fourth quarter 2006, the Company elected to adopt the alternate transition method described in FASB Staff Position No. FAS 123(R)-3, *Transition Election Related to Accounting for Tax Effects of Share-based Payment Awards*, for the purposes of calculating the pool of excess tax benefits available to absorb tax deficiencies recognized subsequent to the adoption of Statement No. 123(R). Electing the alternative method constitutes a change in accounting principle which requires retrospective application to the 2006 quarterly Consolidated Statements of Cash Flows. There was no impact to the Company s results of operations or financial position as a result of electing the alternative method.

3. Sale of Variable Life Insurance and Annuity Business

On December 30, 2005, the Company sold all of the outstanding shares of capital stock of Allmerica Financial Life Insurance and Annuity Company (AFLIAC), a life insurance subsidiary representing approximately 95% of the Company s run-off variable life insurance and annuity business to The Goldman Sachs Group, Inc. (Goldman Sachs). The transaction also included the reinsurance of 100% of the variable business of FAFLIC. In connection with these transactions, Allmerica Investment Trust agreed to transfer certain assets and liabilities of its funds to certain Goldman Sachs Variable Insurance Trust managed funds through a fund reorganization transaction. Finally, the Company agreed to sell to Goldman Sachs all of the outstanding shares of capital stock of Allmerica Financial Investment Management Services, Inc., its investment advisory subsidiary, concurrently with the consummation of a fund reorganization transaction. The fund reorganization transaction was consummated on January 9, 2006. Total proceeds from this transaction were $318.8 million, of which the Company has received $295.4 million as of June 30, 2007. The remaining $23.4 million will be received in equal installments in 2007 and 2008.

In connection with the sale, the Massachusetts Division of Insurance approved a cash dividend of $48.6 million from FAFLIC, including an $8.6 million ceding commission received related to the reinsurance of 100% of the variable business of FAFLIC, and for the distribution of other non-insurance subsidiaries, from which the holding company received $15.4 million of additional funds. These funds were paid to the holding company in the first quarter 2006.

The Company and Goldman Sachs have made various representations, warranties and covenants in connection with the transaction. The Company has agreed to indemnify Goldman Sachs for the breaches of the Company s representations, warranties and covenants. THG has also agreed to indemnify Goldman Sachs for certain litigation, regulatory matters and other liabilities relating to the pre-closing activities of the business that was sold. Additionally, the Company provided transition services to Goldman Sachs from December 30, 2005 through December 31, 2006. These services included policy and claims processing, accounting and reporting, and other administrative services.

The Company accounted for the disposal of AFLIAC as a discontinued operation in accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets*. The Company recognized a net gain of $0.3 million and a net loss of $2.8 million during the second quarter of 2007 and 2006, respectively, and a net gain of $0.1 million and a net loss of $22.9 million during the first six months of 2007 and 2006, respectively, which are presented in the Consolidated Statements of Income as Gain (Loss) on Disposal of Variable Life Insurance and Annuity Business, a component of discontinued operations.

Included in the loss in 2006 of $22.9 million was a $15.0 million provision related to the Company s estimated potential liability for certain contractual indemnities to Goldman Sachs relating to the pre-sale activities of the business sold recorded under FASB Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Others* (FIN 45). This provision relates to preliminary estimated expenses, reimbursements, penalties and other costs of remediating certain pre-closing processing errors relating to tax reporting to certain policyholders and others for a subset of the Company s former variable annuity business. This estimate is based on, among other things, the Company s review of affected policies, mathematical extrapolations derived from such review, and management s preliminary view of possible settlement ranges with the Internal Revenue Service and affected policyholders. The Company regularly reviews and updates its FIN 45 liability for legal and regulatory matter indemnities, including with respect to this matter. Although the Company believes its current estimate for its FIN 45 liability is appropriate, there can be no assurance that these estimates will not materially increase in the future. Adjustments to this reserve are recorded in the results of the Company in the period in which they are determined. The remaining charge of $2.8 million and $7.9 million in the second quarter and first six months of 2006, respectively, relates to after-tax net costs incurred for employee severance, transition services, operations conversion expenses and other litigation matters.

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4. Federal Income Taxes

Federal income tax expense for the six months ended June 30, 2007 and 2006 has been computed using estimated effective tax rates. These rates are revised, if necessary, at the end of each successive interim period to reflect the current estimates of the annual effective tax rates.

In the first six months of 2007, the Company increased its valuation allowance related to its deferred tax asset by $23.3 million. This increase resulted from unrealized depreciation of the Company s investment portfolio, which is reflected in Accumulated Other Comprehensive Loss in the Shareholders Equity section of the Consolidated Balance Sheets. Accordingly, the Company recorded this increase in the valuation allowance as an adjustment to Accumulated Other Comprehensive Loss. At June 30, 2007 and December 31, 2006, the deferred tax valuation allowance was $192.7 million and $169.4 million, respectively.