

PRUDENTIAL FINANCIAL INC  
Form 10-K/A  
February 15, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-K/A**  
**AMENDMENT NO. 1**

(MARK ONE)

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2004

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

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**Prudential Financial, Inc.**

(Exact Name of Registrant as Specified in its Charter)

New Jersey

22-3703799

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(State or Other Jurisdiction  
of Incorporation or Organization)

(I.R.S. Employer  
Identification Number)

751 Broad Street  
Newark, New Jersey 07102  
(973) 802-6000

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

**SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:**

<u>Title of Each Class</u>	<u>Name of Each Exchange on Which Registered</u>
Common Stock, Par Value \$.01  (including Shareholder Protection Rights)	New York Stock Exchange

**SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT: NONE**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Exchange Act. Yes x No "

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes " No x

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. "

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 Act). Yes " No x

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As of June 30, 2004, the aggregate market value of the registrant's Common Stock (par value \$0.01) held by non-affiliates of the registrant was \$24.21 billion and 521 million shares of the Common Stock were outstanding. As of February 28, 2005, 524 million shares of the registrant's Common Stock (par value \$0.01) were outstanding. As of June 30, 2004, and February 28, 2005, 2 million shares of the registrant's Class B Stock, for which there is no established public trading market, were outstanding and held by non-affiliates of the registrant.

### DOCUMENTS INCORPORATED BY REFERENCE

**THE INFORMATION REQUIRED TO BE FURNISHED PURSUANT TO PART III OF THIS FORM 10-K IS SET FORTH IN, AND IS HEREBY INCORPORATED BY REFERENCE HEREIN FROM, THE REGISTRANT'S DEFINITIVE PROXY STATEMENT FOR THE ANNUAL MEETING OF SHAREHOLDERS TO BE HELD ON JUNE 7, 2005, TO BE FILED BY THE REGISTRANT WITH THE SECURITIES AND EXCHANGE COMMISSION PURSUANT TO REGULATION 14A NOT LATER THAN 120 DAYS AFTER THE YEAR ENDED DECEMBER 31, 2004.**

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**EXPLANATORY NOTE**

This Amendment No. 1 on Form 10-K/A is being filed for the purpose of amending Items 8 and 9A of Part II of the Annual Report on Form 10-K for the year ended December 31, 2004 of Prudential Financial, Inc. ( Prudential Financial ) to reflect the restatement of Prudential Financial s Consolidated Statements of Cash Flows for the years ended December 31, 2004, 2003 and 2002, as described in Footnote 2 to the Consolidated Financial Statements included in this Form 10-K/A. All other Items of the original filing on Form 10-K made on March 9, 2005 are unaffected by the changes to the Consolidated Statements of Cash Flows and such Items have not been included in this Amendment. Information in this Form 10-K/A is generally stated as of December 31, 2004 and does not reflect any subsequent information or events other than the restatement of the Consolidated Statements of Cash Flows. More current information with respect to Prudential Financial is contained within its Quarterly Report on Form 10-Q for the quarter ended September 30, 2005, and other filings with the Securities and Exchange Commission.

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*Throughout this Annual Report on Form 10-K/A, 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.*

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**PART II**

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**CONSOLIDATED FINANCIAL STATEMENTS**

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**Management's Annual Report on Internal Control Over Financial Reporting**

Management of Prudential Financial, Inc. (together with its consolidated subsidiaries, the Company) is responsible for establishing and maintaining adequate internal control over financial reporting. Management conducted an assessment of the effectiveness, as of December 31, 2004, of the Company's internal control over financial reporting, based on the framework established in *Internal Control - Integrated Framework Issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*. Based on our assessment under that framework, management concluded that the Company's internal control over financial reporting was effective as of December 31, 2004.

Our internal control over financial reporting is a process designed by or under the supervision of our principal executive and principal financial officers to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of management and the directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on our financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements.

Management has excluded from the scope of its assessment the business of Aoba Life Insurance Company, Ltd., which the Company acquired during the fourth quarter of 2004. A discussion of this business, including its significance to the Company, is included in Note 3 to the consolidated financial statements of the Company included in this Annual Report.

Management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2004 has been audited by PricewaterhouseCoopers LLP, an independent registered accounting firm, as stated in their report accompanying the consolidated financial statements of the Company included in this Annual Report, which expresses unqualified opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting as of December 31, 2004.

March 8, 2005

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of

Prudential Financial, Inc.:

We have completed an integrated audit of Prudential Financial, Inc.'s 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2004 and audits of its 2003 and 2002 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

*Consolidated financial statements and financial statement schedules*

In our opinion, the consolidated financial statements, appearing under Item 8, present fairly, in all material respects, the financial position of Prudential Financial, Inc. and its subsidiaries at December 31, 2004 and 2003 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the index appearing under Item 15(a)(2) present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The accompanying supplemental combining financial information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position and results of operations of the individual components. Such supplemental information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

As discussed in Notes 2 and 6 to the consolidated financial statements, the Company adopted American Institute of Certified Public Accountants Statement of Position 03-1 Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts as of January 1, 2004, Financial Accounting Standards Board revised Interpretation No. 46, Consolidation of Variable Interest Entities as of December 31, 2003, and the fair value recognition provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation as of January 1, 2003.

As discussed in Note 2 to the consolidated financial statements, the Company has restated its 2004, 2003, and 2002 consolidated financial statements.



*Internal control over financial reporting*

Also, in our opinion, management's assessment, included in Management's Annual Report on Internal Control Over Financial Reporting, appearing under Item 8, that the Company maintained effective internal control over financial reporting as of December 31, 2004 based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control - Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our

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responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As described in Management's Annual Report on Internal Control Over Financial Reporting, management has excluded Aoba Life Insurance Company, Ltd. (Aoba Life) from its assessment of internal control over financial reporting as of December 31, 2004 because it was acquired by the Company in a purchase business combination during the fourth quarter of 2004. We have also excluded Aoba Life from our audit of internal control over financial reporting. Aoba Life is a wholly-owned subsidiary of the Company whose total assets represent less than 2% of the Company's consolidated total assets as of December 31, 2004.

/s/ PricewaterhouseCoopers LLP

New York, New York

March 8, 2005, except with respect to our opinion on the Consolidated Financial Statements insofar as it relates to Note 2 as to which the date is February 15, 2006.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Consolidated Statements of Financial Position****December 31, 2004 and 2003 (in millions, except share amounts)**

	<u>2004</u>	<u>2003</u>
<b>ASSETS</b>		
Fixed maturities:		
Available for sale, at fair value (amortized cost: 2004 \$143,156; 2003 \$121,193)	\$ 150,968	\$ 128,943
Held to maturity, at amortized cost (fair value: 2004 \$2,765; 2003 \$3,084)	2,747	3,068
Trading account assets supporting insurance liabilities, at fair value	12,964	88
Other trading account assets, at fair value	1,547	3,214
Equity securities, available for sale, at fair value (cost: 2004 \$3,589; 2003 \$2,799)	4,283	3,401
Commercial loans	24,389	19,469
Policy loans	8,373	8,152
Securities purchased under agreements to resell	127	1,464
Other long-term investments	5,981	5,609
Short-term investments	5,245	7,633
	<u>216,624</u>	<u>181,041</u>
Total investments	216,624	181,041
Cash and cash equivalents	8,072	7,949
Accrued investment income	2,028	1,797
Reinsurance recoverables	32,790	633
Deferred policy acquisition costs	8,847	7,826
Other assets	17,129	15,348
Separate account assets	115,568	106,680
	<u>\$ 401,058</u>	<u>\$ 321,274</u>
<b>TOTAL ASSETS</b>	<b>\$ 401,058</b>	<b>\$ 321,274</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>LIABILITIES</b>		
Future policy benefits	\$ 102,305	\$ 94,845
Policyholders' account balances	75,225	49,691
Unpaid claims and claim adjustment expenses	1,807	1,687
Policyholders' dividends	5,350	4,688
Reinsurance payables	32,386	180
Securities sold under agreements to repurchase	8,958	9,654
Cash collateral for loaned securities	7,269	5,786
Income taxes payable	2,681	2,282
Securities sold but not yet purchased	427	1,598
Short-term debt	4,044	4,739
Long-term debt	7,627	5,610
Other liabilities	15,067	12,542
Separate account liabilities	115,568	106,680
	<u>378,714</u>	<u>299,982</u>
Total liabilities	378,714	299,982
<b>COMMITMENTS AND CONTINGENCIES (See Note 21)</b>		
<b>STOCKHOLDERS EQUITY</b>		
Preferred Stock (\$.01 par value; 10,000,000 shares authorized; none issued)		
Common Stock (\$.01 par value; 1,500,000,000 shares authorized; 604,894,558 and 584,590,320 shares issued at December 31, 2004 and 2003, respectively)	6	6

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Class B Stock (\$.01 par value; 10,000,000 shares authorized; 2,000,000 shares issued and outstanding at December 31, 2004 and 2003, respectively)		
	20,354	19,560
Additional paid-in capital	(2,967)	(1,632)
Common Stock held in treasury, at cost (77,549,848 and 49,736,520 shares at December 31, 2004 and 2003, respectively)	(91)	(48)
Deferred compensation	2,191	2,446
Accumulated other comprehensive income	2,851	960
Retained earnings	<u>22,344</u>	<u>21,292</u>
Total stockholders' equity	<u>22,344</u>	<u>21,292</u>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b><u>\$ 401,058</u></b>	<b><u>\$ 321,274</u></b>

*See Notes to Consolidated Financial Statements*

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Consolidated Statements of Operations**

Years Ended December 31, 2004, 2003 and 2002 (in millions, except per share amounts)

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<b>REVENUES</b>			
Premiums	\$ 12,580	\$ 13,233	\$ 13,053
Policy charges and fee income	2,317	2,001	1,780
Net investment income	9,079	8,680	8,818
Realized investment gains (losses), net	726	270	(1,365)
Commissions and other income	3,646	3,704	3,992
	<u>28,348</u>	<u>27,888</u>	<u>26,278</u>
<b>BENEFITS AND EXPENSES</b>			
Policyholders' benefits	12,896	13,424	13,378
Interest credited to policyholders' account balances	2,334	1,830	1,846
Dividends to policyholders	2,485	2,602	2,644
General and administrative expenses	7,346	7,562	8,328
Loss on disposition of property and casualty insurance operations		491	
	<u>25,061</u>	<u>25,909</u>	<u>26,196</u>
<b>INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES, EXTRAORDINARY GAIN ON ACQUISITION AND CUMULATIVE EFFECT OF ACCOUNTING CHANGE</b>			
	<u>3,287</u>	<u>1,979</u>	<u>82</u>
Income taxes:			
Current	601	169	(90)
Deferred	354	488	(98)
	<u>955</u>	<u>657</u>	<u>(188)</u>
<b>INCOME FROM CONTINUING OPERATIONS BEFORE EXTRAORDINARY GAIN ON ACQUISITION AND CUMULATIVE EFFECT OF ACCOUNTING CHANGE</b>			
	<u>2,332</u>	<u>1,322</u>	<u>270</u>
Loss from discontinued operations, net of taxes	(18)	(58)	(76)
Extraordinary gain on acquisition, net of taxes	21		
Cumulative effect of accounting change, net of taxes	(79)		
	<u>2,265</u>	<u>1,264</u>	<u>194</u>
<b>NET INCOME</b>	<b>\$ 2,256</b>	<b>\$ 1,264</b>	<b>\$ 194</b>
<b>EARNINGS PER SHARE (See Note 14)</b>			
<b>Financial Services Businesses</b>			
<b>Basic:</b>			
Income from continuing operations before extraordinary gain on acquisition and cumulative effect of accounting change per share of Common Stock	\$ 3.52	\$ 2.10	\$ 1.38
Loss from discontinued operations	(0.03)	(0.11)	(0.13)
Extraordinary gain on acquisition, net of taxes	0.04		
Cumulative effect of accounting change, net of taxes	(0.15)		

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Net income per share of Common Stock	\$ 3.38	\$ 1.99	\$ 1.25
<b>Diluted:</b>			
Income from continuing operations before extraordinary gain on acquisition and cumulative effect of accounting change per share of Common Stock	\$ 3.45	\$ 2.08	\$ 1.38
Loss from discontinued operations	(0.03)	(0.10)	(0.13)
Extraordinary gain on acquisition, net of taxes	0.04		
Cumulative effect of accounting change, net of taxes	(0.15)		
Net income per share of Common Stock	\$ 3.31	\$ 1.98	\$ 1.25
Dividends declared per share of Common Stock	\$ 0.625	\$ 0.50	\$ 0.40
<b>Closed Block Business</b>			
Net income (loss) per share of Class B Stock basic and diluted	\$ 249.00	\$ 89.50	\$ (264.00)
Dividends declared per share of Class B Stock	\$ 9.625	\$ 9.625	\$ 9.625

*See Notes to Consolidated Financial Statements*

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## PRUDENTIAL FINANCIAL, INC.

## Consolidated Statements of Stockholders Equity

Years Ended December 31, 2004, 2003 and 2002 (in millions)

	Common Stock		Class B Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Common Stock Held in Treasury	Deferred Compensation	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
	Shares	Amount							
<b>Balance, December 31, 2001</b>	583.6	\$ 6	\$	\$ 19,462	\$ 41	\$	\$	\$ 944	\$ 20,453
Common Stock acquired	(26.0)					(800)			(800)
Stock-based compensation programs	1.7			4		57	(21)		40
Adjustments to policy credits issued and cash payments to eligible policyholders	0.9			47					47
Dividends declared on Common Stock					(226)				(226)
Dividends declared on Class B Stock					(19)				(19)
Comprehensive income:									
Net income					194				194
Other comprehensive income, net of tax								1,641	1,641
<b>Total comprehensive income</b>									1,835
<b>Balance, December 31, 2002</b>	560.2	6		19,513	(10)	(743)	(21)	2,585	21,330
Common Stock acquired	(29.1)					(1,001)			(1,001)
Stock-based compensation programs	3.7			40	(6)	112	(27)		119
Adjustments to policy credits issued and cash payments to eligible policyholders	0.1			7					7
Dividends declared on Common Stock					(269)				(269)
Dividends declared on Class B Stock					(19)				(19)
Comprehensive income:									
Net income					1,264				1,264
Other comprehensive loss, net of tax								(139)	(139)
<b>Total comprehensive income</b>									1,125
<b>Balance, December 31, 2003</b>	534.9	6		19,560	960	(1,632)	(48)	2,446	21,292
Common Stock issued	20.3			690					690
Common Stock acquired	(32.5)					(1,499)			(1,499)
Stock-based compensation programs	4.6			104	(14)	164	(43)		211
Dividends declared on Common Stock					(332)				(332)
Dividends declared on Class B Stock					(19)				(19)
Comprehensive income:									
Net income					2,256				2,256
Other comprehensive loss, net of tax								(255)	(255)
<b>Total comprehensive income</b>									2,001
<b>Balance, December 31, 2004</b>	527.3	\$ 6	\$	\$ 20,354	\$ 2,851	\$ (2,967)	\$ (91)	\$ 2,191	\$ 22,344

*See Notes to Consolidated Financial Statements*



**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Consolidated Statements of Cash Flows****Years Ended December 31, 2004, 2003 and 2002 (in millions)**

	2004	2003	2002
	(Restated)	(Restated)	(Restated)
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net income	\$ 2,256	\$ 1,264	\$ 194
Adjustments to reconcile net income to net cash provided by operating activities:			
Realized investment (gains) losses, net	(726)	(270)	1,365
Policy charges and fee income	(822)	(528)	(563)
Interest credited to policyholders' account balances	2,359	1,857	1,846
Depreciation and amortization, including premiums and discounts	537	716	580
Net loss on business dispositions		510	
Change in:			
Deferred policy acquisition costs	(665)	(606)	(211)
Future policy benefits and other insurance liabilities	2,291	2,088	1,975
Trading account assets supporting insurance liabilities and other trading account assets	(1,794)	(2,342)	(1,277)
Income taxes payable	470	263	(205)
Securities sold but not yet purchased	485	1,373	1,442
Other, net	192	(2,919)	(2,628)
<b>Cash flows from operating activities</b>	<b>4,583</b>	<b>1,406</b>	<b>2,518</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Proceeds from the sale/maturity/prepayment of:			
Fixed maturities, available for sale	70,173	46,905	58,750
Fixed maturities, held to maturity	610	1,418	418
Equity securities, available for sale	2,262	1,412	2,050
Commercial loans	5,663	3,206	3,682
Other long-term investments	1,530	1,146	1,019
Short-term investments	22,154	20,132	15,434
Payments for the purchase of:			
Fixed maturities, available for sale	(80,896)	(50,433)	(67,482)
Fixed maturities, held to maturity	(211)	(1,816)	(2,701)
Equity securities, available for sale	(2,498)	(1,394)	(2,830)
Commercial loans	(4,263)	(2,762)	(2,747)
Other long-term investments	(1,081)	(1,185)	(1,590)
Short-term investments	(18,789)	(22,646)	(16,050)
Acquisition of subsidiaries, net of cash acquired.	(1,082)	(1,109)	
Cash of operations contributed to Wachovia Securities Financial Holdings, LLC		(229)	
Proceeds from sale of subsidiaries, net of cash disposed	(76)	91	
Net change in policy loans	306	1,070	(230)
<b>Cash flows used in investing activities</b>	<b>(6,198)</b>	<b>(6,194)</b>	<b>(12,277)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Policyholders' account deposits	14,627	10,235	9,148
Policyholders' account withdrawals	(14,584)	(9,471)	(7,511)
Net change in securities sold under agreements to repurchase and cash collateral for loaned securities	2,064	(124)	6,079
Proceeds from issuance of Common Stock	690		
Cash dividends paid on Common Stock	(322)	(256)	(173)
Cash dividends paid on Class B Stock	(19)	(19)	(19)

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Net change in financing arrangements (maturities 90 days or less)	(419)	3,603	(1,666)
Proceeds from deferred compensation program			56
Common Stock acquired	(1,493)	(1,007)	(782)
Common Stock reissued for exercise of stock options	107	53	1
Proceeds from the issuance of debt (maturities longer than 90 days)	4,212	3,607	1,536
Repayments of debt (maturities longer than 90 days)	(2,652)	(3,380)	(2,570)
Cash payments to or in respect of eligible policyholders	(327)	(147)	(2,569)
Other, net	(77)	(438)	(61)
<b>Cash flows from (used in) financing activities</b>	<b>1,807</b>	<b>2,656</b>	<b>1,469</b>
Effect of foreign exchange rate changes on cash balances	(69)	183	(348)
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>123</b>	<b>(1,949)</b>	<b>(8,638)</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR</b>	<b>7,949</b>	<b>9,898</b>	<b>18,536</b>
<b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>	<b>\$ 8,072</b>	<b>\$ 7,949</b>	<b>\$ 9,898</b>
<b>SUPPLEMENTAL CASH FLOW INFORMATION</b>			
Income taxes paid (received)	\$ (24)	\$ (84)	\$ 57
Interest paid	\$ 494	\$ 399	\$ 482

*See Notes to Consolidated Financial Statements*

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**1. BUSINESS**

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. 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 9), 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.

***Demutualization***

On December 18, 2001 (the date of demutualization ), the Prudential Insurance Company of America ( Prudential Insurance ) converted from a mutual life insurance company to a stock life insurance company and became an indirect, wholly owned subsidiary of Prudential Financial. At the time of demutualization Prudential Financial issued two classes of common stock both of which remain outstanding. The Common Stock, which is publicly traded, reflects the performance of the Financial Services Businesses and the Class B Stock, which was issued through a private placement, reflects the performance of the Closed Block Business.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Restatement of Consolidated Statements of Cash Flows***

The Consolidated Statements of Cash Flows for the years ended December 31, 2004, 2003 and 2002 have been restated to reflect the following:

1. Changes in the net receivable/payable from unsettled investment purchases and sales, previously classified within adjustments to reconcile net income to cash provided by operating activities, have been reclassified to cash flows from investing activities, to the extent such balances pertained to investments classified as either available for sale or held to maturity.

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2. The deconsolidations of three previously consolidated subsidiaries are now reported as having no impact to cash flows from operating activities or cash flows from (used in) financing activities. Previously, the deconsolidations were reflected in the Consolidated Statements of Cash Flows as adjustments to cash flows of operating activities and cash flows of financing activities.
3. The net change in the policy loans receivable, previously reported in cash flows from operating activities, is now reported as a component of cash flows of investing activities.
4. Changes in the presentation of bank overdrafts, certain commercial loans, proprietary investments, certain variable product investments, and various other items.

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As a result of the restatements, previously reported cash flows from operating activities, cash flows used in investing activities and cash flows from (used in) financing activities were increased or reduced for the years ended December 31, 2004, 2003 and 2002 as follows:

	Year-Ended December 31,		
	2004	2003	2002
<b>Cash flows from operating activities:</b>			
As originally reported	\$ 7,119	\$ 784	\$ 6,884
Impact of restatements	(2,536)	622	(4,366)
<b>Revised for restatements</b>	<b>\$ 4,583</b>	<b>\$ 1,406</b>	<b>\$ 2,518</b>
<b>Cash flows used in investing activities:</b>			
As originally reported	\$ (7,423)	\$ (4,401)	\$ (14,361)
Impact of restatements	1,225	(1,793)	2,084
<b>Revised for restatements</b>	<b>\$ (6,198)</b>	<b>\$ (6,194)</b>	<b>\$ (12,277)</b>
<b>Cash flows from (used in) financing activities:</b>			
As originally reported	\$ 506	\$ 1,511	\$ (794)
Impact of restatements	1,301	1,145	2,263
<b>Revised for restatements</b>	<b>\$ 1,807</b>	<b>\$ 2,656</b>	<b>\$ 1,469</b>

The restatements had no impact on the total change in cash and cash equivalents within the Consolidated Statements of Cash Flows or on the Consolidated Statements of Operations or Consolidated Statements of Financial Position.

***Basis of Presentation***

The consolidated financial statements include the accounts of Prudential Financial, its majority-owned subsidiaries, as well as variable interest entities in which the Company is considered the primary beneficiary, and those partnerships and joint ventures in which the Company has a majority financial interest, except for those partnerships and joint ventures where the Company cannot exercise control because the minority owners have substantive participating rights in the operating and capital decisions of the entity. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ). Intercompany balances and transactions have been eliminated.

The Company's Gibraltar Life Insurance Company, Ltd. ( Gibraltar Life ) operations adopted a November 30 fiscal year end for purposes of inclusion in the Company's Consolidated Financial Statements. Therefore the Consolidated Financial Statements as of December 31, 2004, and 2003, include Gibraltar Life's assets and liabilities as of November 30, 2004 and 2003, respectively, and for the years ended December 31, 2004, 2003 and 2002, include Gibraltar life's results of operations for the twelve months ended November 30, 2004, 2003 and 2002, respectively.

*Use of Estimates*

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, in particular deferred policy acquisition costs, valuation of business acquired, investments, future policy benefits, provision for income taxes, disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from those estimates.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)***Earnings Per Share*

As discussed in Note 1, the Company has outstanding two separate classes of common stock. Basic earnings per share is computed by dividing available income attributable to each of the two groups of common shareholders by the respective weighted average number of common shares outstanding for the period. Diluted earnings per share includes the effect of all dilutive potential common shares that were outstanding during the period.

*Stock Options*

Effective January 1, 2003, the Company changed its accounting for employee stock options to adopt the fair value recognition provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123, Accounting for Stock-Based Compensation, as amended, prospectively for all new awards 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 accounting method of SFAS No. 123 for the years ended December 31, 2004, 2003 and 2002, net income and earnings per share would have been as follows:

	Year ended		Year ended		Year ended	
	December 31, 2004		December 31, 2003		December 31, 2002	
	Closed					
	Financial Services Businesses	Block Business	Financial Services Businesses	Closed Block Business	Financial Services Businesses	Closed Block Business
	(in millions, except per share amounts)					
Net income (loss), as reported	\$ 1,674	\$ 582	\$ 1,025	\$ 239	\$ 679	\$ (485)
Add: Total employee stock option compensation expense included in reported net income, net of tax	19		10			
Deduct: Total employee stock option compensation expense determined under the fair value based method for all awards, net of tax	45	1	45	1	30	
Pro forma net income (loss)	\$ 1,648	\$ 581	\$ 990	\$ 238	\$ 649	\$ (485)

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Earnings per share:						
Basic as reported	3.38	249.00	1.99	89.50	1.25	(264.00)
Basic pro forma	3.33	249.00	1.93	89.50	1.20	(264.00)
Diluted as reported	3.31	249.00	1.98	89.50	1.25	(264.00)
Diluted pro forma	3.26	249.00	1.91	89.50	1.20	(264.00)

The Company accounts for non-employee stock options using the fair value method of SFAS No. 123 in accordance with Emerging Issues Task Force Issue ( EITF ) No. 96-18 Accounting for Equity Instruments That Are Issued to Other Than Employees and related interpretations in accounting for its non-employee stock options.

In December 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 123R, Share-Based Payment, which replaces FASB Statement No. 123, Accounting for Stock-Based Compensation. SFAS 123R 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. Under this method, compensation costs of awards to employees, such as stock options, are measured at fair value



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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

and expensed over the period during which an employee is required to provide service in exchange for the award (the vesting period). The Company had previously adopted the fair value recognition provisions of the original SFAS 123, prospectively for all new stock options issued to employees on or after January 1, 2003. SFAS 123R is effective for interim and annual periods beginning after June 15, 2005. The Company will adopt the fair value recognition provisions of this statement on July 1, 2005 for those awards issued prior to January 1, 2003. By that date, the unvested stock options issued prior to January 1, 2003 will have a compensation cost estimated to be \$2.8 million, which will be recognized over the remaining vesting period of approximately six months.

***Investments***

Fixed maturities are comprised of bonds, notes and redeemable preferred stock. Fixed maturities classified as available for sale are carried at fair value. Fixed maturities that the Company has both the positive intent and ability to hold to maturity are stated at amortized cost and classified as held to maturity. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion is included in Net investment income. The amortized cost of fixed maturities is written down to fair value when a decline in value is considered to be other than temporary. See the discussion below on realized investment gains and losses for a description of the accounting for impairments. Unrealized gains and losses on fixed maturities classified as available for sale, net of tax and the effect on deferred policy acquisition costs, valuation of business acquired, future policy benefits and policyholders' dividends that would result from the realization of unrealized gains and losses, are included in a separate component of equity, Accumulated other comprehensive income (loss).

Investments for which fair value changes result in changes in experience-rated contractholder liabilities are classified as trading and included in Trading account assets supporting insurance liabilities, at fair value. All investment results, which include realized and unrealized gains and losses, as well as net investment income for these investments are reported in Commissions and other income.

Other trading account assets, at fair value and Securities sold but not yet purchased consist primarily of investments and derivatives used by the Company either in its capacity as a broker-dealer, its operation of hedge portfolios or its use of derivatives for asset and liability management activities. These instruments are carried at fair value. Realized and unrealized gains and losses on other trading account assets, securities sold but not yet purchased and the Company's investments in its own separate accounts are included in Commissions and other income.

Equity securities, available for sale are comprised of common and non-redeemable preferred stock and are carried at fair value. The associated unrealized gains and losses, net of tax and the effect on deferred policy acquisition costs, valuation of business acquired, future policy benefits and policyholders' dividends that would result from the realization of unrealized gains and losses, are included in Accumulated other comprehensive income (loss). The cost of equity securities is written down to fair value when a decline in value is considered to be other than temporary. See the discussion below on realized investment gains and losses for a description of the accounting for impairments.

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Originated commercial loans are stated at unpaid principal balances, net of unamortized discounts and an allowance for losses. Interest income, including the amortization of the related discounts, is included in Net investment income. In connection with the acquisition of various businesses, commercial loans are recorded at fair value when acquired, with any premium or discount amortized over the remaining lives of the loans and included in Net investment income. The allowance for losses includes a loan specific reserve for non-performing loans and a portfolio reserve for probable incurred but not specifically identified losses. Non-performing loans include those loans for which it is probable that amounts due according to the contractual terms of the loan agreement will not all be collected. These loans are measured at the present value of expected future cash flows discounted at the loan's effective interest rate, or at the fair value of the collateral if the loan is

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** *(continued)*

collateral dependent. Interest received on non-performing loans, including loans that were previously modified in a troubled debt restructuring, is either applied against the principal or reported as revenue, according to management's judgment as to the collectibility of principal. Management discontinues accruing interest on non-performing loans after the loans are 90 days delinquent as to principal or interest, or earlier when management has serious doubts about collectibility. When a loan is recognized as non-performing, any accrued but uncollectible interest is charged to interest income in the period the loan is deemed non-performing. Generally, a loan is restored to accrual status only after all delinquent interest and principal are brought current and, in the case of loans where the payment of interest has been interrupted for a substantial period, a regular payment performance has been established. The portfolio reserve for incurred but not specifically identified losses considers the Company's past loan loss experience, the current credit composition of the portfolio, historical credit migration, property type diversification, default and loss severity statistics and other relevant factors.

Policy loans are carried at unpaid principal balances.

Securities repurchase and resale agreements and securities borrowed and loaned transactions are used to generate income, to borrow funds, or to facilitate trading activity. Securities repurchase and resale agreements are generally short-term in nature, and therefore, the carrying amounts of these instruments approximate fair value. Securities repurchase and resale agreements are collateralized principally by U.S. government and government agency securities. Securities borrowed or loaned are collateralized principally by cash or U.S. government securities. For securities repurchase agreements and securities loaned transactions used to generate income, the cash received is typically invested in cash equivalents, short-term investments or fixed maturities.

Securities repurchase and resale agreements that satisfy certain criteria are treated as collateralized financing arrangements. These agreements are carried at the amounts at which the securities will be subsequently resold or reacquired, as specified in the respective agreements. For securities purchased under agreements to resell, the Company's policy is to take possession or control of the securities and to value the securities daily. Securities to be resold are the same, or substantially the same, as the securities received. For securities sold under agreements to repurchase, the market value of the securities to be repurchased is monitored, and additional collateral is obtained where appropriate, to protect against credit exposure. Securities to be repurchased are the same, or substantially the same, as those sold. Income and expenses related to these transactions executed within the general account, insurance and broker-dealer subsidiaries used to generate income are reported as Net investment income; however, for transactions used to borrow funds, the associated borrowing cost is reported as interest expense (included in

General and administrative expenses). Income and expenses related to these transactions executed within our mortgage banking, derivative dealer and hedge portfolio operations are reported in Commissions and other income.

Securities borrowed and securities loaned transactions are treated as financing arrangements and are recorded at the amount of cash advanced or received. With respect to securities loaned transactions, the Company obtains collateral in an amount equal to 102% and 105% of the fair value of the domestic and foreign securities, respectively. The Company monitors the market value of the securities borrowed and loaned on a daily basis with additional collateral obtained or provided as necessary. Substantially all of the Company's securities borrowed transactions are with brokers and dealers, commercial banks and institutional clients. Substantially all of the Company's securities loaned transactions are with large brokerage firms. Income and expenses associated with securities borrowed transactions are reported as Net investment income. Income and

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expenses associated with securities loaned transactions used to generate income are generally reported as Net investment income; however, for securities loaned transactions used for funding purposes the associated rebate is reported as interest expense (included in General and administrative expenses ).

Other long-term investments consist of the Company's investments in joint ventures and limited partnerships in which the Company does not exercise control, other than our investment in Wachovia Securities Financial Holdings, LLC ( Wachovia Securities ), as well as investments in the Company's own separate

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)***

accounts, which are carried at estimated fair value, and investment real estate. Joint venture and partnership interests are generally accounted for using the equity method of accounting, except in instances in which the Company's interest is so minor that it exercises virtually no influence over operating and financial policies. In such instances, the Company applies the cost method of accounting. The Company's net income from investments in joint ventures and partnerships, other than our investment in Wachovia Securities, is generally included in Net investment income.

Real estate which the Company has the intent to hold for the production of income is carried at depreciated cost less any write-downs to fair value for impairment losses and is reviewed for impairment whenever events or circumstances indicate that the carrying value may not be recoverable. Real estate held for disposal is carried at the lower of depreciated cost or fair value less estimated selling costs and is not further depreciated once classified as such. An impairment loss is recognized when the carrying value of the investment real estate exceeds the estimated undiscounted future cash flows (excluding interest charges) from the investment. At that time, the carrying value of the investment real estate is written down to fair value. Decreases in the carrying value of investment real estate and impairments are recorded in Realized investment gains (losses), net. Depreciation on real estate held for the production of income is computed using the straight-line method over the estimated lives of the properties, and is included in Net investment income.

Short-term investments consists of highly liquid debt instruments with a maturity of greater than three months and less than twelve months when purchased. These investments are carried at amortized cost which, because of their short term, approximates fair value.

Realized investment gains (losses), net are computed using the specific identification method. Costs of fixed maturities and equity securities are adjusted for impairments, which are declines in value that are considered to be other than temporary. Impairment adjustments are included in

Realized investment gains (losses), net. In evaluating whether a decline in value is other than temporary, the Company considers several factors including, but not limited to the following: (1) the extent (generally if greater than 20%) and the duration (generally if greater than six months) of the decline; (2) the reasons for the decline in value (credit event, interest related or market fluctuation); (3) the Company's ability and intent to hold the investment for a period of time to allow for a recovery of value; and (4) the financial condition of and near-term prospects of the issuer. Provisions for losses on commercial loans are included in Realized investment gains (losses), net.

***Cash and Cash Equivalents***

Cash and cash equivalents include cash on hand, amounts due from banks, money market instruments and other debt instruments with maturities of three months or less when purchased.

***Reinsurance Recoverables and Payables***

Reinsurance recoverables and payables primarily include receivables and corresponding payables associated with the modified coinsurance arrangements used to effect the Company's acquisition of the retirement businesses of CIGNA Corporation ( CIGNA ). The reinsurance recoverables and the reinsurance payables associated with this acquisition are each \$32.2 billion at December 31, 2004. See Note 3 for additional information about these arrangements. The remaining amounts relate to reinsurance ceded and assumed arrangements entered into by the Company.

***Deferred Policy Acquisition Costs***

The costs that vary with and that are related primarily to the production of new insurance and annuity business are deferred to the extent such costs are deemed recoverable from future profits. Such costs include

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** *(continued)*

commissions, costs of policy issuance and underwriting, and variable field office expenses. Deferred policy acquisition costs ( DAC ) are subject to recoverability testing at the end of each accounting period. DAC, for applicable products, is adjusted for the impact of unrealized gains or losses on investments as if these gains or losses had been realized, with corresponding credits or charges included in Accumulated other comprehensive income (loss).

For participating life insurance included in the Closed Block, DAC is amortized over the expected life of the contracts (up to 45 years) in proportion to estimated gross margins based on historical and anticipated future experience, which is evaluated regularly. The average rate per annum of assumed future investment yield used in estimating expected gross margins was 7.35% at December 31, 2004 and gradually increases to 8.06% for periods after December 31, 2031. The effect of changes in estimated gross margins on unamortized deferred acquisition costs is reflected in General and administrative expenses in the period such estimated gross margins are revised. Policy acquisition costs related to interest-sensitive and variable life products and certain investment-type products are deferred and amortized over the expected life of the contracts (periods ranging from 7 to 30 years) in proportion to estimated gross profits arising principally from investment results, mortality and expense margins, and surrender charges based on historical and anticipated future experience, which is updated periodically. The effect of changes to estimated gross profits on unamortized deferred acquisition costs is reflected in General and administrative expenses in the period such estimated gross profits are revised. DAC related to non-participating traditional individual life insurance is amortized over the expected life of the contracts in proportion to gross premiums.

The Company has offered programs under which policyholders, for a selected product or group of products, can exchange an existing policy or contract issued by the Company for another form of policy or contract. These transactions are known as internal replacements. If policyholders surrender traditional life insurance policies in exchange for life insurance policies that do not have fixed and guaranteed terms, the Company immediately charges to expense an estimate of the remaining unamortized DAC on the surrendered policies. For other internal replacement transactions, the unamortized DAC on the surrendered policies is immediately charged to expense if the terms of the new policies are not substantially similar to those of the former policies. If the new policies have terms that are substantially similar to those of the earlier policies, the DAC is retained with respect to the new policies and amortized over the expected life of the new policies.

For group annuity defined contribution contracts and funding agreement notes, acquisition expenses are deferred and amortized over the expected life of the contracts in proportion to estimated gross profits. For group and individual long-term care contracts, acquisition expenses are deferred and amortized over the expected life of the contracts in proportion to gross premiums. For other group life and disability insurance, group annuities and guaranteed investment contracts, acquisition costs are expensed as incurred.

***Separate Account Assets and Liabilities***

Separate account assets and liabilities are reported at fair value and represent segregated funds which are invested for certain policyholders, pension funds and other customers. The assets consist of common stocks, fixed maturities, real estate related investments, real estate mortgage

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loans and short-term investments. The assets of each account are legally segregated and are generally not subject to claims that arise out of any other business of the Company. Investment risks associated with market value changes are borne by the customers, except to the extent of minimum guarantees made by the Company with respect to certain accounts. See Note 8 for additional information regarding separate account arrangements with contractual guarantees. The investment income and gains or losses for separate accounts generally accrue to the policyholders and are not included in the Consolidated Statements of Operations. Mortality, policy administration and surrender charges assessed against the accounts are included in Policy charges and fee income. Asset management fees charged to the accounts are included in Commissions and other income.



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**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** *(continued)**Other Assets and Other Liabilities*

Other assets consist primarily of prepaid benefit costs, certain restricted assets, broker-dealer related receivables, trade receivables, valuation of business acquired (described below), goodwill and other intangible assets, the Company's investment in Wachovia Securities, mortgage brokerage-loan inventory, property and equipment, and receivables resulting from sales of securities that had not yet settled at the balance sheet date. Commercial mortgage loans and other securities sold by the Company in securitization transactions for the years ended December 31, 2004, 2003 and 2002, were \$1,793 million, \$1,179 million and \$615 million, respectively. In some of the commercial loan securitizations, the Company retained servicing responsibilities, but did not retain any material ownership interest in the financial assets that were transferred. The Company recognized pre-tax gains of \$35 million, \$19 million and \$18 million for the years ended December 31, 2004, 2003 and 2002, respectively, in connection with securitization transactions, which are recorded in Commissions and other income. Property and equipment are carried at cost less accumulated depreciation. Depreciation is determined using the straight-line method over the estimated useful lives of the related assets which generally range from 3 to 40 years. Other liabilities consist primarily of trade payables, broker-dealer related payables, employee benefit liabilities, demutualization consideration not yet paid to policyholders and payables resulting from purchases of securities that had not yet settled at the balance sheet date.

As a result of certain acquisitions and the application of purchase accounting, the Company reports a financial asset representing the valuation of business acquired (VOBA). VOBA represents the present value of future profits embedded in acquired insurance, annuity and investment-type contracts. VOBA is determined by estimating the net present value of future cash flows from the contracts in force at the date of acquisition. For acquired traditional insurance contracts, future positive cash flows generally include premiums while future negative cash flows include policyholders' benefits and certain maintenance expenses. For acquired annuity contracts, future positive cash flows generally include fees and other charges assessed to the contracts as long as they remain in force as well as fees collected upon surrender, if applicable, while future negative cash flows include costs to administer contracts and benefit payments. Future cash flows with respect to the acquired Skandia U.S. business include the impact of future cash flows expected from the guaranteed minimum death benefit provisions of the acquired contracts. For acquired investment-type contracts, future positive cash flows include investment spreads, and fees and other charges assessed to the contracts for as long as they remain in force, while future negative cash flows include costs to administer the contracts and taxes. Contract balances, from which the cash flows arise, are projected using assumptions for add-on deposits, participant withdrawals, contract surrenders, and investment returns. VOBA is further explicitly adjusted to reflect the cost associated with the capital invested in the business. The Company amortizes VOBA over the effective life of the acquired contracts. For acquired traditional insurance contracts, VOBA is amortized in proportion to gross premiums or in proportion to the face amount of insurance in force, as applicable. For acquired annuity contracts, VOBA is amortized in proportion to estimated gross profits arising from the contracts and anticipated future experience, which is evaluated regularly. For acquired investment-type contracts, VOBA is amortized in proportion to estimated gross profits arising principally from fees in excess of actual expense based upon historical and estimated future experience, which is updated periodically. The effect of changes in estimated gross profits on unamortized VOBA is reflected in General and administrative expenses in the period such estimates of expected future profits are revised.

*Future Policy Benefits*

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The Company's liability for future policy benefits is primarily comprised of the present value of estimated future payments to or on behalf of policyholders, where the timing and amount of payment depends on policyholder mortality, less the present value of future net premiums. For traditional participating life insurance products, the mortality and interest rate assumptions applied are those used to calculate the policies guaranteed cash surrender values. For life insurance, other than traditional participating life insurance, and annuity products, expected mortality is generally based on the Company's historical experience or standard industry tables. Interest rate assumptions are based on factors such as market conditions and expected investment returns. Although

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

mortality and interest rate assumptions are locked-in upon the issuance of new insurance or annuity business with fixed and guaranteed terms, significant changes in experience or assumptions may require the Company to provide for expected future losses on a product by establishing premium deficiency reserves. The Company's liability for future policy benefits is also inclusive of liabilities for guarantee benefits related to certain nontraditional long-duration life and annuity contracts, which are discussed more fully in Note 8.

***Policyholders' Account Balances***

The Company's liability for policyholders' account balances represents the contract value that has accrued to the benefit of the policyholder as of the balance sheet date. This liability is generally equal to the accumulated account deposits, plus interest credited, less policyholder withdrawals and other charges assessed against the account balance. These policyholders' account balances also include provision for benefits under non-life contingent payout annuities.

***Unpaid Claims and Claims Adjustments Expenses***

The Company does not establish loss reserves until a loss has occurred. However, unpaid claims and claim adjustment expenses includes estimates of claims that the Company believes have been incurred but have not yet been reported (IBNR) as of the balance sheet date. These IBNR estimates, and estimates of the amounts of loss the Company will ultimately incur on reported claims, which are based in part on historical experience, are adjusted as appropriate to reflect actual claims experience. When actual experience differs from the previous estimate, the resulting difference will be included in the reported results for the period of the change in estimate in the Policyholders' benefits caption. On an ongoing basis, trends in actual experience are a significant factor in the determination of claim reserve levels.

***Policyholders' Dividends***

The Company's liability for policyholders' dividends includes its dividends payable to policyholders and its policyholder dividend obligation associated with the participating policies included in the Closed Block established in connection with the Company's demutualization. The dividends payable for participating policies included in the Closed Block are determined at the end of each year for the following year by the Board of Directors of Prudential Insurance based on its statutory results, capital position, ratings, and the emerging experience of the Closed Block. The policyholder dividend obligation represents net unrealized investment gains that have arisen subsequent to the establishment of the Closed Block. The dividends payable for policies other than the participating policies included in the Closed Block include extraordinary dividends to certain policyholders of Gibraltar Life, a Japanese insurance company acquired in April 2001 and dividends payable in accordance with certain group insurance policies. The extraordinary dividends payable to the policyholders of Gibraltar Life are based on 70% of net

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realized investment gains, if any, over the value of real estate and loans included in Gibraltar Life's reorganization plan, net of transaction costs and taxes. As of December 31, 2004, this dividend liability is \$975 million.

### *Contingencies*

Amounts related to contingencies are accrued if it is probable that a liability has been incurred and an amount is reasonably estimable. Management evaluates whether there are incremental legal or other costs directly associated with the ultimate resolution of the matter that are reasonably estimable and, if so, they are included in the accrual.

### *Insurance Revenue and Expense Recognition*

Premiums from life insurance policies, excluding interest-sensitive life contracts, are recognized when due. When premiums are due over a significantly shorter period than the period over which benefits are provided, any

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** *(continued)*

excess profit is deferred and recognized into income in a constant relationship to insurance in force. Benefits are recorded as an expense when they are incurred. A liability for future policy benefits is recorded when premiums are recognized using the net level premium method.

Premiums from non-participating group annuities with life contingencies, structured settlements with life contingencies and single premium immediate annuities with life contingencies are recognized when received. Benefits are recorded as an expense when they are incurred. When premiums are due over a significantly shorter period than the period over which benefits are provided, a liability for future policy benefits is recorded when premiums are recognized using the net level premium method and any gross premium in excess of the net premium is deferred and recognized into income in a constant relationship to the amount of expected future policy benefit payments.

Certain annuity contracts provide the holder a guarantee that the benefit received upon death will be no less than a minimum prescribed amount that is based upon a combination of net deposits to the contract, net deposits to the contract accumulated at a specified rate or the highest historical account value on a contract anniversary. These contracts are discussed in further detail in Note 8. Also, as more fully discussed in Note 8, the liability for the guaranteed minimum death benefit under these contracts is determined each period end by estimating the accumulated value of a percentage of the total assessments to date less the accumulated value of death benefits in excess of the account balance.

Amounts received as payment for interest-sensitive life contracts, deferred annuities, structured settlements and other contracts without life contingencies, and participating group annuities are reported as deposits to Policyholders' account balances. Revenues from these contracts are reflected in Policy charges and fee income, or as a reduction of Interest credited to policyholders' account balances, and consist primarily of fees assessed during the period against the policyholders' account balances for mortality charges, policy administration charges and surrender charges. Benefits and expenses for these products include claims in excess of related account balances, expenses of contract administration, interest credited and amortization of DAC.

For group life and disability insurance, and property and casualty insurance, premiums are recognized over the period to which the premiums relate in proportion to the amount of insurance protection provided. Claim and claim adjustment expenses are recognized when incurred.

Premiums, benefits and expenses are stated net of reinsurance ceded to other companies. Estimated reinsurance recoverables and the cost of reinsurance are recognized over the life of the reinsured policies using assumptions consistent with those used to account for the underlying policies.

***Foreign Currency Translation Adjustments***

Assets and liabilities of foreign operations and subsidiaries reported in currencies other than U.S. dollars are translated at the exchange rate in effect at the end of the period. Revenues, benefits and other expenses are translated at the average rate prevailing during the period. The effects of translating the statements of financial position of non-U.S. entities with functional currencies other than the U.S. dollar are included, net of related hedge gains and losses and income taxes, in Accumulated other comprehensive income (loss).

*Commissions and Other Income*

Commissions and other income principally include asset management fees and securities and commodities commission revenues which are recognized in the period in which the services are performed, as well as earnings from our investment in Wachovia Securities. Realized and unrealized gains and net investment income from investments classified as Trading account assets supporting insurance liabilities and Other trading account assets are also included in Commissions and other income.

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

***Derivative Financial Instruments***

Derivatives are financial instruments whose values are derived from interest rates, foreign exchange rates, financial indices or the values of securities or commodities. Derivative financial instruments generally used by the Company include swaps, futures, forwards and options and may be exchange-traded or contracted in the over-the-counter market. Derivative positions are carried at fair value, generally by obtaining quoted market prices or through the use of pricing models. Values can be affected by changes in interest rates, foreign exchange rates, financial indices, values of securities or commodities, credit spreads, market volatility and liquidity. Values can also be affected by changes in estimates and assumptions used in pricing models.

Derivatives are used in a non-dealer capacity in our insurance, investment and international businesses as well as our treasury operations to manage the characteristics of the Company's asset/liability mix, manage the interest rate and currency characteristics of assets or liabilities and to mitigate the risk of a diminution, upon translation to U.S. dollars, of expected non-U.S. earnings and net investments in foreign operations resulting from unfavorable changes in currency exchange rates. Additionally, derivatives may be used to seek to reduce exposure to interest rate and foreign currency risks associated with assets held or expected to be purchased or sold, and liabilities incurred or expected to be incurred.

Derivatives are also used in a derivative dealer or broker capacity in the Company's securities operations to meet the needs of clients by structuring transactions that allow clients to manage their exposure to interest rates, foreign exchange rates, indices or prices of securities and commodities and similarly in a dealer or broker capacity through the operation of hedge portfolios in a limited-purpose subsidiary. Realized and unrealized changes in fair value of derivatives used in these dealer related operations as well as derivatives used in the mortgage banking business are included in Commissions and other income in the periods in which the changes occur. Cash flows from such derivatives are reported in the operating activities section of the Consolidated Statements of Cash Flows.

Derivatives are recorded either as assets, within Other trading account assets, Other assets, or Other long-term investments, or as liabilities, within Other liabilities. As discussed in detail below and in Note 19, all realized and unrealized changes in fair value of non-dealer related derivatives, with the exception of the effective unrealized portion of cash flow hedges and effective hedges of net investments in foreign operations, are recorded in current earnings. Cash flows from these derivatives are reported in the operating or investing activities section in the Consolidated Statements of Cash Flows.

For non-dealer related derivatives the Company designates derivatives as either (1) a hedge of the fair value of a recognized asset or liability or unrecognized firm commitment ( fair value hedge); (2) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability ( cash flow hedge); (3) a foreign-currency fair value or cash flow hedge ( foreign currency hedge); (4) a hedge of a net investment in a foreign operation; or (5) a derivative that does not qualify for hedge accounting.

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To qualify for hedge accounting treatment, a derivative must be highly effective in mitigating the designated risk of the hedged item. Effectiveness of the hedge is formally assessed at inception and throughout the life of the hedging relationship. Even if a derivative qualifies for hedge accounting treatment, there may be an element of ineffectiveness of the hedge. Under such circumstances, the ineffective portion of adjusting the derivative to fair value is recorded in Realized investment gains (losses), net.

The Company formally documents all relationships between hedging instruments and hedged items, as well as its risk-management objective and strategy for undertaking various hedge transactions. This process includes linking all derivatives designated as fair value, cash flow, or foreign currency, hedges to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. Hedges of a net investment in a foreign operation are linked to the specific foreign operation.



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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

When a derivative is designated as a fair value hedge and is determined to be highly effective, changes in its fair value, along with changes in the fair value of the hedged asset or liability (including losses or gains on firm commitments), are reported on a net basis in the income statement, generally in Realized investment gains (losses), net. When swaps are used in hedge accounting relationships, periodic settlements are recorded in the same income statement line as the related settlements of the hedged items.

When a derivative is designated as a cash flow hedge and is determined to be highly effective, changes in its fair value are recorded in Accumulated other comprehensive income (loss) until earnings are affected by the variability of cash flows being hedged (e.g., when periodic settlements on a variable-rate asset or liability are recorded in earnings). At that time, the related portion of deferred gains or losses on the derivative instrument is reclassified and reported in the income statement line item associated with the hedged item.

When a derivative is designated as a foreign currency hedge and is determined to be highly effective, changes in its fair value are recorded in either current period earnings or Accumulated other comprehensive income (loss), depending on whether the hedge transaction is a fair value hedge (e.g., a hedge of a firm commitment that is to be settled in a foreign currency) or a cash flow hedge (e.g., a foreign currency denominated forecasted transaction). When a derivative is used as a hedge of a net investment in a foreign operation, its change in fair value, to the extent effective as a hedge, is recorded in the cumulative translation adjustment account within Accumulated other comprehensive income (loss).

If a derivative does not qualify for hedge accounting, all changes in its fair value, including net receipts and payments, are included in Realized investment gains (losses), net without considering changes in the fair value of the economically associated assets or liabilities.

The Company is a party to financial instruments that may contain derivative instruments that are embedded in the financial instruments. At inception, the Company assesses whether the economic characteristics of the embedded derivative are clearly and closely related to the economic characteristics of the remaining component of the financial instrument (i.e., the host contract) and whether a separate instrument with the same terms as the embedded instrument would meet the definition of a derivative instrument. When it is determined that (1) the embedded derivative possesses economic characteristics that are not clearly and closely related to the economic characteristics of the host contract, and (2) a separate instrument with the same terms would qualify as a derivative instrument, the embedded derivative is separated from the host contract, carried at fair value, and changes in its fair value are included in Realized investment gains (losses), net.

If it is determined that a derivative no longer qualifies as an effective fair value or cash flow hedge or management removes the hedge designation, the derivative will continue to be carried on the balance sheet at its fair value, with changes in fair value recognized currently in Realized investment gains (losses), net. The asset or liability under a fair value hedge will no longer be adjusted for changes in fair value and the existing basis adjustment is amortized to the income statement line associated with the asset or liability. The component of Accumulated other comprehensive income (loss) related to discontinued cash flow hedges is amortized to the income statement line associated with the hedged cash flows consistent with the earnings impact of the original hedged cash flows.

When hedge accounting is discontinued because the hedged item no longer meets the definition of a firm commitment, or because it is probable that the forecasted transaction will not occur by the end of the specified time period, the derivative will continue to be carried on the balance sheet at its fair value, with changes in fair value recognized currently in Realized investment gains (losses), net. Any asset or liability that was recorded pursuant to recognition of the firm commitment is removed from the balance sheet and recognized currently in Realized investment gains (losses), net. Gains and losses that were in Accumulated other comprehensive income (loss) pursuant to the hedge of a forecasted transaction are recognized immediately in Realized investment gains (losses), net.

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

In its mortgage operations, the Company enters into commitments to fund commercial mortgage loans at specified interest rates and other applicable terms within specified periods of time. These commitments are legally binding agreements to extend credit to a counterparty. Loan commitments for loans that will be held for sale, are recognized as derivatives and recorded at fair value. Beginning in 2004, as a result of Securities and Exchange Commission Staff Accounting Bulletin 105 ( SAB 105 ), Application of Accounting Principles to Loan Commitments, in recording such commitments at fair value the Company no longer recognizes: 1) the initial fair value for those loan commitments where the Company does not have a corresponding investor purchase commitment for the resulting loan; and 2) the fair value of the future mortgage servicing right ( MSR ) related to the resulting loan. However, subsequent changes in fair value on loan commitments for loans that will be held for sale, exclusive of MSR value, are included in Commissions and Other Income, and recognized as derivative assets or liabilities. Upon funding of the related loan, the carrying amount of the loan commitment is included in the initial basis of the loan. The impact of adopting the provisions of SAB 105 did not have a material impact on the Company's financial condition or results of operations. The determination of the estimated fair value of loan commitments accounted for as derivatives considers various factors including, among others, terms of the related loan, the intended exit strategy for the loans based upon either a securitization pricing model or investor purchase commitments, prevailing interest rates, and origination income or expense. Loan commitments that relate to the origination of mortgage loans that will be held for investment are not accounted for as derivatives and accordingly are not recognized in the Company's financial statements.

***Income Taxes***

The Company and its eligible domestic subsidiaries file a consolidated federal income tax return that includes both life insurance companies and non-life insurance companies. Subsidiaries operating outside the U.S. are taxed, and income tax expense is recorded, based on applicable foreign statutes. See Note 17 for a discussion of certain non-U.S. jurisdictions for which the Company assumes repatriation of earnings to the U.S.

Deferred income taxes are recognized, based on enacted rates, when assets and liabilities have different values for financial statement and tax reporting purposes. A valuation allowance is recorded to reduce a deferred tax asset to the amount expected to be realized.

***New Accounting Pronouncements***

In March 2004, the EITF of the FASB reached a final consensus on Issue 03-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments. This Issue establishes impairment models for determining whether to record impairment losses associated with investments in certain equity and debt securities. 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's policy is generally to record income only as cash is received following an impairment of a debt security. In September 2004, the FASB issued FASB Staff Position ( FSP ) EITF 03-1-1, which defers the effective date of a substantial portion of EITF 03-1, from the third quarter of 2004, as originally required by the EITF, until such time as FASB issues further implementation guidance, which is expected sometime in 2005. The Company will continue to monitor developments concerning this Issue and is currently unable to estimate the potential effects of implementing EITF 03-1 on the

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Company's consolidated financial position or results of operations.

In January 2004 and May 2004, the FASB issued FSP 106-1 and 106-2, each of which is entitled Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, respectively. See Note 16 for details regarding the adoption of these pronouncements.

In December 2003, the FASB issued FIN No. 46(R), Consolidation of Variable Interest Entities, which revised the original FIN No. 46 guidance issued in January 2003. FIN No. 46(R) addresses whether certain types

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

of entities, referred to as variable interest entities ( VIEs ), should be consolidated in a company s financial statements. A VIE is an entity that either (1) has equity investors that lack certain essential characteristics of a controlling financial interest (including the ability to control the entity, the obligation to absorb the entity s expected losses and the right to receive the entity s expected residual returns) or (2) lacks sufficient equity to finance its own activities without financial support provided by other entities, which in turn would be expected to absorb at least some of the expected losses of the VIE. An entity should consolidate a VIE if, as the primary beneficiary, it stands to absorb a majority of the VIE s expected losses or to receive a majority of the VIE s expected residual returns. On December 31, 2003, the Company adopted FIN No. 46(R) for all special purpose entities ( SPEs ) and for relationships with all VIEs that began on or after February 1, 2003. On March 31, 2004, the Company implemented FIN No. 46(R) for relationships with potential VIEs that are not SPEs. The transition to FIN No. 46(R) did not have a material effect on the Company s consolidated financial position or results of operations.

In July 2003, the Accounting Standards Executive Committee ( AcSEC ) of the American Institute of Certified Public Accountants ( AICPA ) issued Statement of Position ( SOP ) 03-1, Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts. AcSEC issued this SOP to address the need for interpretive guidance in three areas: separate account presentation and valuation; the classification and valuation of certain long-duration contract liabilities; and the accounting recognition given sales inducements (bonus interest, bonus credits and persistency bonuses).

The Company adopted SOP 03-1 effective January 1, 2004. One element of this guidance addressed the accounting for liabilities related to insurance products that provide contractholders with a return based on a contractually referenced pool of investments. Effective with the adoption of SOP 03-1, the contractholder liabilities associated with these products are required to be adjusted for changes in the fair value of the related pool of investments. These products pass the economics related to the referenced pool of investments to the contractholder.

The effect of adopting SOP 03-1 was a charge of \$79 million, net of \$44 million of taxes, which was reported as a Cumulative effect of accounting change, net of taxes in the results of operations for the year ended December 31, 2004. This charge reflects the net impact of converting large group annuity contracts and certain individual market value adjusted annuity contracts from separate account accounting treatment to general account accounting treatment, including carrying the related liabilities at accreted value, and the effect of establishing reserves for guaranteed minimum death benefit provisions of the Company s variable annuity and variable life contracts. The Company also recognized a cumulative effect of accounting change related to unrealized investment gains within Other comprehensive income, net of taxes of \$73 million, net of \$42 million of taxes, for the year ended December 31, 2004. Upon adoption of SOP 03-1, \$3.3 billion in Separate account assets were reclassified resulting in a \$2.8 billion increase in Fixed maturities, available for sale and a \$0.6 billion increase in Trading account assets supporting insurance liabilities, at fair value, as well as changes in other non-separate account assets. Similarly, upon adoption, \$3.3 billion in Separate account liabilities were reclassified resulting in increases in Policyholders account balances and Future policy benefits, as well as changes in other non-separate account liabilities.

In June 2004, the FASB issued FSP No. 97-1, Situations in Which Paragraphs 17(b) and 20 of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, Permit or Require Accrual of an Unearned Revenue Liability. FSP 97-1 clarifies the accounting for unearned revenue liabilities of certain

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universal-life type contracts under SOP 03-1. The Company's adoption of FSP 97-1 on July 1, 2004 did not change the accounting for unearned revenue liabilities and, therefore, had no impact on the Company's consolidated financial position or results of operations. In September 2004, the AICPA SOP 03-1 Implementation Task Force issued a Technical Practice Aid ( TPA ) to clarify certain aspects of SOP 03-1. The Company is currently evaluating the effect of the implementation of this TPA in its international insurance operations on the Company's consolidated financial position or results of operations.

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)***

In April 2003, the FASB issued Statement No. 133 Implementation Issue No. B36, *Embedded Derivatives: Modified Coinsurance Arrangements and Debt Instruments That Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor Under Those Instruments*. Implementation Issue No. B36 indicates that a modified coinsurance arrangement ( *modco* ), in which funds are withheld by the ceding insurer and a return on those withheld funds is paid based on the ceding company's return on certain of its investments, generally contains an embedded derivative feature that is not clearly and closely related to the host contract and should be bifurcated in accordance with the provisions of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Effective October 1, 2003, the Company adopted the guidance prospectively for existing contracts and all future transactions. As permitted by SFAS No. 133, all contracts entered into prior to January 1, 1999, were grandfathered and are exempt from the provisions of SFAS No. 133 that relate to embedded derivatives. The application of Implementation Issue No. B36 in 2003 had no impact on the consolidated financial position or results of operations of the Company.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. SFAS No. 150 generally applies to instruments that are mandatorily redeemable, that represent obligations that will be settled with a variable number of company shares, or that represent an obligation to purchase a fixed number of company shares. For instruments within its scope, the statement requires classification as a liability with initial measurement at fair value. Subsequent measurement depends upon the certainty of the terms of the settlement (such as amount and timing) and whether the obligation will be settled by a transfer of assets or by issuance of a fixed or variable number of equity shares. The Company's adoption of SFAS No. 150, as of July 1, 2003, did not have a material effect on the Company's consolidated financial position or results of operations.

In July 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 requires that a liability for costs associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. Prior to the adoption of SFAS No. 146, such amounts were recorded upon the Company's commitment to a restructuring plan. The Company has adopted this statement for applicable transactions occurring on or after January 1, 2003.

In November 2002, the FASB issued FIN No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN No. 45 expands existing accounting guidance and disclosure requirements for certain guarantees and requires the recognition of a liability for the fair value of certain types of guarantees issued or modified after December 31, 2002. The January 1, 2003 adoption of the Interpretation's guidance did not have a material effect on the Company's financial position.

***Reclassifications***

Certain amounts in prior years have been reclassified to conform to the current year presentation.

### 3. ACQUISITIONS AND DISPOSITIONS

#### *Acquisition of Aoba Life Insurance Company, Ltd.*

On November 1, 2004, the Company acquired Aoba Life Insurance Company, Ltd. ( Aoba Life ) for \$191 million of total consideration from Tawa S.A., a subsidiary of Artemis S.A. Aoba Life is a Japanese life insurer with a run-off book of insurance and is not selling new policies. The Company is in the process of integrating this business into its existing international insurance operations. The Statement of Financial Position of the Company as of December 31, 2004, includes assets and liabilities of \$6.4 billion and \$6.2 billion, respectively, from the acquisition of Aoba Life. Pro forma information for this acquisition is omitted as the impact is not material.



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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**3. ACQUISITIONS AND DISPOSITIONS (continued)**

*Acquisition of CIGNA Corporation's Retirement Business*

On April 1, 2004, the Company purchased the retirement business of CIGNA for \$2.123 billion, including \$2.103 billion of cash consideration and \$20 million of transaction costs. The assets acquired and liabilities assumed and the results of operations have been included in the Company's consolidated financial statements as of that date. The acquisition of this business included the purchase by the Company of all the shares of CIGNA Life Insurance Company (CIGNA Life), which became an indirect wholly owned subsidiary of the Company. Prior to the acquisition, CIGNA Life entered into reinsurance arrangements with CIGNA to effect the transfer of the retirement business included in the transaction to CIGNA Life. Subsequent to its acquisition, the Company changed the name of CIGNA Life to Prudential Retirement Insurance and Annuity Company (PRIAC).

The reinsurance arrangements between PRIAC and CIGNA include coinsurance-with-assumption, modified-coinsurance-with-assumption, and modified-coinsurance-without-assumption.

The coinsurance-with-assumption arrangement applies to the acquired general account defined contribution and defined benefit plan contracts. Prior to the acquisition, CIGNA Life assumed from CIGNA all of the insurance liabilities associated with these contracts, totaling \$15.9 billion, and received from CIGNA the related investments. PRIAC has established a trust account for the benefit of CIGNA to secure its obligations to CIGNA under the coinsurance agreement. The Company is in the process of requesting the pension plan customers to agree to substitute PRIAC for CIGNA in their respective contracts, and expects this process to be substantially complete by the end of 2005.

The modified-coinsurance-with-assumption arrangements apply to the majority of separate account contracts, and the general account defined benefit guaranteed-cost contracts acquired. Under the modified coinsurance arrangement associated with the separate account contracts, CIGNA retains the separate account and other assets as well as the related separate account and other liabilities until the agreed upon dates of asset transfer but, beginning on the date of acquisition, cedes all of the net profits or losses and related net cash flows associated with the contracts to PRIAC. At the date of acquisition, the statement of financial position for PRIAC includes a reinsurance receivable of \$32.4 billion and reinsurance payable of \$32.4 billion established under these modified coinsurance arrangements and reflected in Reinsurance recoverables and Reinsurance payables, respectively. At the agreed upon dates of asset transfer, PRIAC will assume the separate account and other insurance liabilities and concurrently will receive from CIGNA the associated separate account and other assets. The Company expects the assumption of these liabilities and the concurrent asset transfer to be substantially complete by early 2005.

The modified-coinsurance-with-assumption arrangement associated with the general account defined benefit guaranteed-cost contracts is similar to the arrangement associated with the separate account contracts; however, beginning two years after the acquisition, the Company may commute this modified coinsurance arrangement in exchange for cash consideration from CIGNA, at which time PRIAC would no longer have a related liability and the defined benefit guaranteed cost contracts would remain with CIGNA. If PRIAC does not commute the modified coinsurance arrangement, this arrangement will convert to a coinsurance-with-assumption arrangement. After the conversion, this coinsurance

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arrangement will be similar to the arrangement associated with the defined contribution and defined benefit pension plan contracts described above. At the date of acquisition, PRIAC established a reinsurance receivable of \$1.8 billion and a reinsurance payable of \$1.8 billion under the modified coinsurance arrangement, which are reflected in Reinsurance recoverables and Reinsurance payables, respectively. The net profits earned by PRIAC during the two-year period that the modified coinsurance arrangement is in effect are included in Commissions and other income.

The modified-coinsurance-without-assumption arrangement applies to the remaining separate account contracts acquired and is similar to the modified coinsurance arrangement associated with the separate account contracts described above; however, CIGNA will retain the separate account and other assets and the related

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****3. ACQUISITIONS AND DISPOSITIONS (continued)**

liabilities while ceding the net profits or losses and the associated net cash flows to PRIAC for the remaining lives of the contracts. At the date of acquisition, PRIAC established a reinsurance receivable of \$1.0 billion and a reinsurance payable of \$1.0 billion for this modified coinsurance arrangement, which are reflected in Reinsurance recoverables and Reinsurance payables, respectively.

The following table presents an allocation of the purchase price to assets acquired and liabilities assumed:

	<b>(in millions)</b>
Total invested assets at fair value(1)	\$ 17,103
Cash and cash equivalents	45
Accrued investment income	181
Valuation of business acquired ( VOBA )	423
Goodwill	564
Reinsurance recoverable(2)	35,184
Other assets	202
Separate account assets	25
	<hr/>
Total assets acquired	53,727
	<hr/>
Future policy benefits assumed	(9)
Policyholders' account balances assumed	(15,871)
Reinsurance payable(2)	(35,184)
Other liabilities	(515)
Separate account liabilities	(25)
	<hr/>
Total liabilities assumed	(51,604)
	<hr/>
Net assets acquired	\$ 2,123
	<hr/>

(1) Total invested assets include \$11.1 billion of Trading account assets supporting insurance liabilities, which is primarily comprised of fixed maturities.

(2) The reinsurance recoverable and reinsurance payable amounts represent amounts receivable and payable under the modified coinsurance arrangements described above.

Goodwill is the excess of the cost of an acquired entity over the net amounts assigned to assets acquired and liabilities assumed. Goodwill resulting from the acquisition of CIGNA's retirement business amounted to \$564 million, of which the Company currently estimates 100% to be deductible for tax purposes. In accordance with GAAP, goodwill will not be amortized but rather will be tested at least annually for impairment. The goodwill associated with this acquisition is reflected as \$445 million in the Retirement segment, and as \$119 million in the Asset Management segment.



**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****3. ACQUISITIONS AND DISPOSITIONS (continued)**

The following supplemental information presents selected unaudited pro forma information for the Company assuming the acquisition had occurred as of January 1, 2003. This pro forma information does not purport to represent what the Company's actual results of operations would have been if the acquisition had occurred as of the dates indicated or what such results would be for any future periods.

	Years ended December 31,	
	2004	2003
	(in millions, except per share data, unaudited)	
Total revenues	\$ 28,888	\$ 29,534
Income from continuing operations before extraordinary gain on acquisition and cumulative effect of accounting change	2,356	1,547
Net income	2,145	1,489
<b>Earnings per share:</b>		
<b>Financial Services Businesses:</b>		
Income from continuing operations before extraordinary gain on acquisition and cumulative effect of accounting change per share of Common Stock		
Basic	\$ 3.57	\$ 2.51
Diluted	3.50	2.49
Net income per share of Common Stock		
Basic	\$ 3.16	\$ 2.41
Diluted	3.10	2.39
<b>Closed Block Business:</b>		
Income from continuing operations before extraordinary gain on acquisition and cumulative effect of accounting change per share of Class B Stock		
Basic and diluted	\$ 249.00	\$ 89.50
Net income per share of Class B Stock		
Basic and diluted	\$ 249.00	\$ 89.50

**Acquisition of Hyundai Investment and Securities Co., Ltd.**

On February 27, 2004, the Company completed the acquisition of an 80% interest in Hyundai Investment and Securities Co., Ltd. and its subsidiary Hyundai Investment Trust Management Co., Ltd. (together Hyundai) from the Korean Deposit Insurance Corporation (KDIC), an agency of the Korean government for \$301 million in cash, including \$210 million used to repay debt assumed. The Company may choose to acquire, or be required to acquire, from the KDIC the remaining 20% of Hyundai three to six years after closing. Subsequent to the acquisition, the Company was renamed Prudential Investment & Securities Co., Ltd. Pro forma information for this acquisition is omitted as the impact is not material.

The Company has completed its purchase accounting for the transaction, which resulted in a \$21 million extraordinary gain as the fair value of the assets acquired of \$2.4 billion less the fair value of liabilities assumed of \$2.3 billion exceeded the purchase price. In addition, at the date of acquisition the Company recorded approximately \$1.5 billion of Other trading account assets and approximately \$1.5 billion of Other liabilities associated with certain special purposes entities related to Hyundai (the Hyundai SPEs), that the Company consolidated in accordance with FIN No. 46(R). In the fourth quarter of 2004 the Company stopped consolidating the Hyundai SPEs, as the KDIC assumed all the rights and obligations of the Hyundai SPEs. There are no income taxes associated with the extraordinary gain based on the assumption that foreign investment and subsequent earnings are not to be repatriated to the U.S. The Company's Consolidated Statement of Operations for the year ended December 31, 2004, includes the operating results of Hyundai from the date of acquisition. Commissions and other income for 2004 include \$20 million of fees due from the Korean government under the terms of the transaction.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****3. ACQUISITIONS AND DISPOSITIONS (continued)***Acquisition of Skandia U.S. Inc.*

On May 1, 2003, the Company acquired Skandia U.S. Inc. ( Skandia U.S. ), a wholly owned subsidiary of Skandia Insurance Company Ltd. ( Skandia ). The Company purchased newly issued shares of common stock representing 90% of the outstanding common stock of Skandia U.S. and one share of a newly issued class of preferred stock (collectively the Shares ) and entered into an agreement at the date of acquisition whereby the Company had the right to acquire, and Skandia had the right to require the Company to acquire, the remaining 10% of outstanding common stock. This agreement was accounted for as a financing transaction until the Company purchased the remaining 10% in the third quarter of 2003. The Company's acquisition of Skandia U.S. included American Skandia, Inc. ( American Skandia ), which is one of the largest distributors of variable annuities through independent financial planners in the U.S. The acquisition also included a mutual fund business.

Effective May 1, 2003, 100% of the assets acquired and liabilities assumed and the results of operations have been included in the Company's consolidated financial statements. The total purchase price was as follows:

	(in millions)
Purchase price paid for the Shares(a)	\$ 646
Assumption of collateralized notes held by third parties	248
Purchase price for the remaining 10% equity of Skandia U.S.	165
Other payments to Skandia(b)	115
Transaction costs	10
	<hr/>
Total purchase price(c)	\$ 1,184
	<hr/>

The following table represents an allocation of the purchase price to assets acquired and liabilities assumed:

	(in millions)
Total investments at market value	\$ 486
Cash and cash equivalents	238
Valuation of business acquired ( VOBA )	425
Other assets at fair value	408
Separate account assets	22,311
	<hr/>
Total assets acquired	23,868
	<hr/>
Policyholders' account balances	(168)

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Other liabilities at fair value	(205)
Separate account liabilities	(22,311)
	<hr/>
Total liabilities assumed	(22,684)
	<hr/>
Net assets acquired(c)	\$ 1,184
	<hr/>

- 
- (a) The proceeds were used by Skandia U.S. to retire an aggregate of \$646 million of unsecured debt and collateralized notes held by Skandia.
- (b) Prior to the Company's acquisition of Skandia U.S., Skandia acquired certain subsidiaries of Skandia U.S. The cash Skandia paid to Skandia U.S. for these subsidiaries has been repaid to Skandia and is considered a component of the purchase price.
- (c) In May 2003, subsequent to the Company's acquisition of Skandia U.S., Skandia U.S. paid a dividend to Prudential Financial of approximately \$108 million, reducing the equity of Skandia U.S. by that amount.



**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****3. ACQUISITIONS AND DISPOSITIONS (continued)**

The following table presents selected unaudited pro forma financial information of the Company for the periods ended December 31, 2003 and 2002, assuming that the Skandia U.S. acquisition had occurred January 1, 2002. This pro forma information does not purport to represent what the Company's actual results of operations would have been if the acquisition had occurred as of the date indicated or what such results would be for any future periods.

	Years ended December 31,	
	2003	2002
(in millions, except		
per share data, unaudited)		
Total revenues	\$ 28,030	\$ 26,843
Income from continuing operations before extraordinary gain on acquisition and cumulative effect of accounting change	1,335	387
Net income	1,277	311
Earnings per share:		
Financial Services Businesses:		
Income from continuing operations before extraordinary gain on acquisition and cumulative effect of accounting change per share of Common Stock		
Basic	\$ 2.12	\$ 1.58
Diluted	2.11	1.58
Net income per share of Common Stock		
Basic	\$ 2.02	\$ 1.45
Diluted	2.00	1.45
Closed Block Business:		
Income (loss) from continuing operations before extraordinary gain on acquisition and cumulative effect of accounting change per share of Common Stock		
Basic and diluted	\$ 89.50	\$ (264.00)
Net income (loss) per share of Class B Stock		
Basic and diluted	\$ 89.50	\$ (264.00)

**Investment in Wachovia Securities**

On July 1, 2003, the Company completed the combination of its retail securities brokerage and clearing operations with those of Wachovia Corporation ( Wachovia ) to form a joint venture, Wachovia Securities. The Company has a 38% ownership interest in the joint venture, while Wachovia owns the remaining 62%. The transaction included certain assets and liabilities of the Company's securities brokerage operations but did not include its equity sales, trading and research operations. As part of the transaction, the Company retained certain assets and liabilities related to the contributed businesses, including liabilities for certain litigation and regulatory matters. The Company and Wachovia have each

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agreed to indemnify the other for certain losses, including losses resulting from litigation and regulatory matters relating to certain events arising from the operations of their respective contributed businesses prior to March 31, 2004. The Company accounts for its 38% ownership of the joint venture under the equity method of accounting; periods prior to July 1, 2003, continue to reflect the results of the Company's previously wholly owned securities brokerage operations on a fully consolidated basis.

At any time after July 1, 2005 and on or prior to July 1, 2008, the Company may, subject to certain limitations, require Wachovia to purchase its interests in Wachovia Securities for a price generally equal to the Company's initial \$1.0 billion equity contribution plus its share of transition costs, as adjusted to reflect additional investments made by the Company. At any time after July 1, 2008, the Company may, subject to certain limitations, require Wachovia to purchase its interests in Wachovia Securities for a price generally equal to the Company's share of the then appraised value of the common equity of the organization, determined as if it were a public company and including a control premium such as would apply in the case of a sale of 100% of its common equity. The agreement between Prudential Financial and Wachovia also gives the Company put rights, and Wachovia call rights, in certain other specified circumstances, at prices determined in accordance with the agreement.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****3. ACQUISITIONS AND DISPOSITIONS (continued)**

Results for the year ended December 31, 2003, include a pre-tax gain of \$22 million from the combination of the businesses.

The Company recognized pre-tax equity earnings from Wachovia Securities of \$58 million and \$56 million for the years ended December 31, 2004 and 2003, respectively. The pre-tax equity earnings from Wachovia Securities are included in Commissions and other income. The Company's investment in Wachovia Securities was \$1.1 billion as of December 31, 2004 and 2003, and is included in Other assets.

In connection with the combination, the Company entered into various agreements with Wachovia and Wachovia Securities, including one associated with certain money market mutual fund balances of brokerage clients of Wachovia Securities, for which our results of operations include revenues of \$28 million and \$79 million for the years ended December 31, 2004 and 2003, respectively. These balances were essentially eliminated as of September 30, 2004 due to the replacement of those funds with other investment alternatives for those brokerage clients. The resulting reduction in asset management fees has been offset by payments from Wachovia under an agreement dated as of July 30, 2004 implementing arrangements with respect to money market mutual funds in connection with the combination. The agreement extends for ten years after termination of the joint venture with Wachovia. The revenue from Wachovia under this agreement was \$35 million in 2004.

**Discontinued Operations**

Income (loss) from discontinued businesses, including charges upon disposition, for the years ended December 31, are as follows:

	<b>2004</b>	<b>2003</b>	<b>2002</b>
	_____	_____	_____
	<b>(in millions)</b>		
International securities operations(a)	\$ (42)	\$ (97)	\$ (71)
Web-based workplace distribution of voluntary benefits(b)			(58)
Healthcare operations(c)	6	11	71
Property and casualty operations(d)	(2)	(28)	(32)
Other(e)	(7)	(13)	3
	_____	_____	_____
Loss from discontinued operations before income taxes	(45)	(127)	(87)
Income tax benefit	(27)	(69)	(11)
	_____	_____	_____
Loss from discontinued operations, net of taxes	\$ (18)	\$ (58)	\$ (76)
	_____	_____	_____

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The Company's Consolidated Statements of Financial Position include total assets and total liabilities related to discontinued businesses of \$141 million and \$114 million, respectively, at December 31, 2004 and \$1,531 million and \$1,209 million, respectively, at December 31, 2003.

- 
- (a) International securities operations include the European retail transaction-oriented stockbrokerage and related activities of Prudential Securities Group Inc. The loss for the discontinued businesses for the years ended December 31, 2004, 2003 and 2002 include pre-tax charges of \$6 million, \$40 million and \$43 million, respectively, relating primarily to severance and termination benefits and office closure costs.
  - (b) In the third quarter of 2002, the Company discontinued its web-based business for the workplace distribution of voluntary benefits. The loss for the year ended December 31, 2002 includes a pre-tax impairment charge of \$32 million on the Company's investment in a vendor of that distribution platform, as well as a pre-tax charge of \$7 million related to severance and contract termination costs.
  - (c) The sale of the Company's healthcare business to Aetna was completed in 1999. The loss the Company previously recorded upon the disposal of its healthcare business was reduced in each of the years ended December 31, 2004, 2003 and 2002. The reductions were primarily the result of favorable resolution of certain legal, regulatory and contractual matters. Although the Company no longer issues or renews healthcare policies, it was required to issue and renew policies for specified periods of time after the closing date, in order to provide for uninterrupted operation and growth of the business that Aetna acquired. All such policies were 100% coinsured by Aetna.
  - (d) This includes the results of the Company's specialty automobile and work-place distribution property and casualty insurance operations, which the Company sold in 2003 and 2004, respectively.
  - (e) Other includes the results of consumer banking operations, which the Company exited in 2004, and retail broker-dealer operations in Tokyo, which the Company decided to sell in the fourth quarter of 2002.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****3. ACQUISITIONS AND DISPOSITIONS (continued)**

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 results of operations of a particular quarterly or annual period.

***Disposition of Other Property and Casualty Insurance Operations***

In the fourth quarter of 2003, the Company completed the sale of its property and casualty insurance companies that operated nationally in 48 states outside of New Jersey, and the District of Columbia, to Liberty Mutual Group, as well as its New Jersey property and casualty insurance companies to Palisades Group. Results of these businesses are included in Income from continuing operations before income taxes, extraordinary gain on acquisition and cumulative effect of accounting change for all periods. For the year ended December 31, 2003, the Company recognized a loss on disposition of \$491 million (\$319 million after taxes), recorded within Loss from disposition of property and casualty insurance operations, which also includes management's best estimate of the cost of retained liabilities, including litigation pertaining to events before the closing and the estimated value of indemnification coverage provided in connection with potential adverse claim experience and a \$57 million abandonment and impairment loss recorded in connection with certain long-lived assets.

**4. INVESTMENTS*****Fixed Maturities and Equity Securities***

The following tables provide information relating to fixed maturities and equity securities (excluding investments classified as trading) at December 31,

	2004			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(in millions)			
<b>Fixed maturities, available for sale</b>				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 6,143	\$ 619	\$ 3	\$ 6,759

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Obligations of U.S. states and their political subdivisions	2,241	247	4	2,484
Foreign government bonds	26,556	1,069	146	27,479
Corporate securities	98,234	6,252	401	104,085
Mortgage-backed securities	9,982	191	12	10,161
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total fixed maturities, available for sale	\$ 143,156	\$ 8,378	\$ 566	\$ 150,968
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Equity securities, available for sale	\$ 3,589	\$ 776	\$ 82	\$ 4,283
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

2004

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
	(in millions)			
<b>Fixed maturities, held to maturity</b>				
Foreign government bonds	\$ 109	\$	\$ 4	\$ 105
Corporate securities	593	19		612
Mortgage-backed securities	2,045	20	17	2,048
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total fixed maturities, held to maturity	\$ 2,747	\$ 39	\$ 21	\$ 2,765
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****4. INVESTMENTS (continued)**

	2003			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(in millions)			
<b>Fixed maturities, available for sale</b>				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 7,023	\$ 439	\$ 30	\$ 7,432
Obligations of U.S. states and their political subdivisions	1,815	178	8	1,985
Foreign government bonds	24,167	1,072	91	25,148
Corporate securities	84,443	6,412	331	90,524
Mortgage-backed securities	3,745	116	7	3,854
<b>Total fixed maturities, available for sale</b>	<b>\$ 121,193</b>	<b>\$ 8,217</b>	<b>\$ 467</b>	<b>\$ 128,943</b>
<b>Equity securities, available for sale</b>	<b>\$ 2,799</b>	<b>\$ 691</b>	<b>\$ 89</b>	<b>\$ 3,401</b>
	2003			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(in millions)			
<b>Fixed maturities, held to maturity</b>				
Foreign government bonds	\$ 163	\$ 2	\$ 3	\$ 162
Corporate securities	312	12		324
Mortgage-backed securities	2,593	28	23	2,598
<b>Total fixed maturities, held to maturity</b>	<b>\$ 3,068</b>	<b>\$ 42</b>	<b>\$ 26</b>	<b>\$ 3,084</b>

The amortized cost and fair value of fixed maturities by contractual maturities at December 31, 2004, is as follows:

Available for Sale	Held to Maturity
--------------------	------------------

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	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(in millions)		(in millions)	
Due in one year or less	\$ 8,780	\$ 8,859	\$ 29	\$ 29
Due after one year through five years	41,524	43,154	141	145
Due after five years through ten years	37,071	39,440	48	53
Due after ten years	45,799	49,354	484	490
Mortgage-backed securities	9,982	10,161	2,045	2,048
<b>Total</b>	<b>\$ 143,156</b>	<b>\$ 150,968</b>	<b>\$ 2,747</b>	<b>\$ 2,765</b>

Actual maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.



**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****4. INVESTMENTS (continued)**

The following table depicts the source of fixed maturity proceeds and related gross investment gains (losses) on trades and prepayments and losses on impairments of both fixed maturities and equity securities:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(in millions)		
<b>Fixed maturities, available for sale:</b>			
Proceeds from sales	\$ 57,870	\$ 34,489	\$ 47,341
Proceeds from maturities/repayments	12,525	12,106	13,188
Gross investment gains from sales and prepayments	906	933	1,267
Gross investment losses from sales	(305)	(306)	(1,300)
<b>Fixed maturities, held to maturity:</b>			
Proceeds from maturities/repayments	\$ 610	\$ 1,418	\$ 418
Gross investment gains from prepayments			
<b>Fixed maturity and equity security impairments:</b>			
Write-downs for impairments of fixed maturities	\$ (183)	\$ (389)	\$ (687)
Write-downs for impairments of equity securities	(18)	(160)	(309)

**Trading Account Assets Supporting Insurance Liabilities**

Trading account assets supporting insurance liabilities is comprised of investments that support experience-rated contracts of the Company's Retirement and International Insurance segments. These assets are classified as trading and are carried at fair value. All investment results, which include realized and unrealized gains and losses, as well as net investment income, for these investments are reported in Commissions and other income. The following table sets forth the composition of Trading account assets supporting insurance liabilities at December 31,

	<u>2004</u>		<u>2003</u>	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(in millions)		(in millions)	
Short-term investments, cash and cash equivalents	\$ 951	\$ 951	\$	\$
Fixed maturities:				
U.S. government corporations and agencies and obligations of U.S. states	311	306	3	3
Foreign government bonds	387	390	37	38
Corporate securities	9,483	9,378	17	15

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Mortgage-backed securities	1,494	1,492	—	—
<b>Total fixed maturities</b>	<b>11,675</b>	<b>11,566</b>	<b>57</b>	<b>56</b>
Equity securities	378	447	32	32
<b>Total trading account assets supporting insurance liabilities</b>	<b>\$ 13,004</b>	<b>\$ 12,964</b>	<b>\$ 89</b>	<b>\$ 88</b>

At December 31, 2004, 67% of the portfolio was comprised of publicly traded securities, versus 100% of the portfolio as of December 31, 2003. As of December 31, 2004, 98% of the fixed maturity portion of the portfolio was investment grade investments, versus 100% of the fixed maturity portion of the portfolio as of December 31, 2003. The change in the net holding gain or loss on these securities during the years ended December 31, 2004 and 2003 was a loss of \$108 million and \$1 million, respectively.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****4. INVESTMENTS (continued)****Commercial Loans**

The Company's commercial loans are as follows at December 31,

	2004		2003	
	Amount (in millions)	% of Total	Amount (in millions)	% of Total
<b>Collateralized loans by property type</b>				
Office buildings	\$ 5,013	22.3%	\$ 3,355	18.8%
Retail stores	2,904	12.9%	1,739	9.8%
Residential properties	1,311	5.8%	2,058	11.5%
Apartment complexes	5,169	22.9%	4,642	26.1%
Industrial buildings	4,790	21.2%	3,379	19.0%
Agricultural properties	1,786	7.9%	1,864	10.5%
Other	1,581	7.0%	764	4.3%
Subtotal of collateralized loans	22,554	100.0%	17,801	100.0%
Valuation allowance	(159)		(160)	
Total collateralized loans	22,395		17,641	
<b>Uncollateralized loans</b>				
Uncollateralized loans	2,329		2,160	
Valuation allowance	(335)		(332)	
Total uncollateralized loans	1,994		1,828	
Net carrying value	\$ 24,389		\$ 19,469	

The commercial loans are geographically dispersed throughout the United States, Canada and Asia with the largest concentrations in California (23%) and Asia (14%) at December 31, 2004.

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Activity in the allowance for losses for all commercial loans, for the years ended December 31, is as follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(in millions)		
Allowance for losses, beginning of year	\$ 492	\$ 496	\$ 550
Release of allowance for losses	(12)	(34)	(33)
Charge-offs, net of recoveries	(8)	(7)	(39)
Change in foreign exchange	22	37	18
	<u>          </u>	<u>          </u>	<u>          </u>
Allowance for losses, end of year	<u>\$ 494</u>	<u>\$ 492</u>	<u>\$ 496</u>

Non-performing commercial loans identified in management's specific review of probable loan losses and the related allowance for losses at December 31, are as follows:

	<u>2004</u>	<u>2003</u>
	(in millions)	
Non-performing commercial loans with allowance for losses	\$ 429	\$ 369
Non-performing commercial loans with no allowance for losses	120	120
Allowance for losses, end of year	(352)	(318)
	<u>          </u>	<u>          </u>
Net carrying value of non-performing commercial loans	<u>\$ 197</u>	<u>\$ 171</u>

Non-performing commercial loans with no allowance for losses are loans in which the fair value of the collateral or the net present value of the loans' expected future cash flows equals or exceeds the recorded

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****4. INVESTMENTS (continued)**

investment. The average recorded investment in non-performing loans before allowance for losses was \$523 million, \$542 million and \$631 million for 2004, 2003 and 2002, respectively. Net investment income recognized on these loans totaled \$18 million, \$14 million and \$27 million for the years ended December 31, 2004, 2003 and 2002, respectively.

**Other Long-term Investments**

Other long-term investments are comprised as follows:

	<u>2004</u>	<u>2003</u>
	(in millions)	
Joint venture and limited partnerships:		
Real estate related	\$ 509	\$ 368
Non real estate related	1,383	1,245
	<u>1,892</u>	<u>1,613</u>
Total joint venture and limited partnerships	1,892	1,613
Real estate held through direct ownership	1,435	1,204
Separate accounts	1,361	1,273
Other	1,293	1,519
	<u>5,981</u>	<u>5,609</u>
Total other long-term investments	<u>\$ 5,981</u>	<u>\$ 5,609</u>

**Equity Method Investments**

Summarized combined financial information for joint ventures and limited partnership interests accounted for under the equity method, including our investment in Wachovia Securities, in which the Company has an investment of \$10 million or greater and an equity interest of 10% or greater, is as follows:

At December 31,

	<u>2004</u>	<u>2003</u>
	(in millions)	
<b>STATEMENTS OF FINANCIAL POSITION</b>		
Investments in real estate	\$ 2,755	\$ 2,540
Investments in securities	14,106	11,544
Cash and cash equivalents	928	878
Other assets	23,305	17,832
	<u>          </u>	<u>          </u>
<b>Total assets</b>	<b>\$ 41,094</b>	<b>\$ 32,794</b>
	<u>          </u>	<u>          </u>
Borrowed funds-third party	\$ 1,012	\$ 1,617
Borrowed funds-Prudential	532	460
Other liabilities	30,014	22,827
	<u>          </u>	<u>          </u>
<b>Total liabilities</b>	<b>31,558</b>	<b>24,904</b>
<b>Partners' capital</b>	<b>9,536</b>	<b>7,890</b>
	<u>          </u>	<u>          </u>
<b>Total liabilities and partners' capital</b>	<b>\$ 41,094</b>	<b>\$ 32,794</b>
	<u>          </u>	<u>          </u>
Equity in partners' capital included above	\$ 2,764	\$ 2,486
Equity in limited partnership interests not included above	612	548
	<u>          </u>	<u>          </u>
<b>Carrying value</b>	<b>\$ 3,376</b>	<b>\$ 3,034</b>
	<u>          </u>	<u>          </u>

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****4. INVESTMENTS (continued)**

	Years ended December 31,		
	2004	2003	2002
	(in millions)		
<b>STATEMENTS OF OPERATIONS</b>			
Income from real estate investments	\$ 409	\$ 313	\$ 140
Income from securities investments	2,875	2,732	140
Interest expense-third party	(103)	(151)	(63)
Other expenses	(2,668)	(2,381)	(159)
<b>Net earnings</b>	<b>\$ 513</b>	<b>\$ 513</b>	<b>\$ 58</b>
Equity in net earnings included above	\$ 162	\$ 141	\$ 12
Equity in net earnings of limited partnership interests not included above	158	60	16
<b>Total equity in net earnings</b>	<b>\$ 320</b>	<b>\$ 201</b>	<b>\$ 28</b>

**Net Investment Income**

Net investment income for the years ended December 31, was from the following sources:

	2004	2003	2002
	(in millions)		
Fixed maturities, available for sale	\$ 6,647	\$ 6,308	\$ 6,344
Fixed maturities, held to maturity	110	117	80
Equity securities, available for sale	88	54	73
Commercial loans	1,507	1,368	1,416
Policy loans	463	497	529
Broker-dealer related receivables	52	95	259
Short-term investments and cash equivalents	179	182	312
Other investment income	646	606	504
<b>Gross investment income</b>	<b>9,692</b>	<b>9,227</b>	<b>9,517</b>
Less investment expenses	(613)	(547)	(699)

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Net investment income	\$ 9,079	\$ 8,680	\$ 8,818
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Based on the carrying value, assets categorized as non-income producing at December 31, 2004 included in fixed maturities, commercial loans and other long-term investments totaled \$80 million, \$7 million and \$201 million, respectively.

**Realized Investment Gains (Losses), Net**

Realized investment gains (losses), net, for the years ended December 31, were from the following sources:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(in millions)		
Fixed maturities	\$ 418	\$ 238	\$ (720)
Equity securities, available for sale	430	(10)	(335)
Commercial loans	11	81	48
Investment real estate	62	(22)	(7)
Joint ventures and limited partnerships	68	65	24
Derivatives	(264)	(167)	(400)
Other	1	85	25
	<u>          </u>	<u>          </u>	<u>          </u>
Realized investment gains (losses), net	\$ 726	\$ 270	\$ (1,365)



**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****4. INVESTMENTS (continued)****Net Unrealized Investment Gains (Losses)**

Net unrealized investment gains and losses on securities classified as available for sale and certain other long-term investments are included in the Consolidated Statements of Financial Position as a component of Accumulated other comprehensive income (loss). Changes in these amounts include reclassification adjustments to exclude from Other comprehensive income (loss) those items that are included as part of Net income for a period that had been part of Other comprehensive income (loss) in earlier periods. The amounts for the years ended December 31, are as follows:

	Net Unrealized Gains  (Losses) On Investments	Deferred Policy Acquisition Costs and Valuation of Business Acquired	Future Policy Benefits	Policyholders Dividends	Deferred Income Tax (Liability) Benefit	Accumulated Other Comprehensive Income (Loss) Related To Net Unrealized Investment Gains (Losses)
	(in millions)					
Balance, December 31, 2001	\$ 2,372	\$ (320)	\$ (77)	\$	\$ (747)	\$ 1,228
Net investment gains (losses) on investments arising during the period	4,019				(1,434)	2,585
Reclassification adjustment for (gains) losses included in net income	1,055				(376)	679
Impact of net unrealized investment (gains) losses on deferred policy acquisition costs		(216)			78	(138)
Impact of net unrealized investment (gains) losses on future policy benefits			(769)		276	(493)
Impact of net unrealized investment (gains) losses on policyholders dividends				(1,606)	579	(1,027)
Balance, December 31, 2002	7,446	(536)	(846)	(1,606)	(1,624)	2,834
Net investment gains (losses) on investments arising during the period	1,164				(439)	725
Reclassification adjustment for (gains) losses included in net income	(368)				139	(229)
Impact of net unrealized investment (gains) losses on deferred policy acquisition costs		103			(37)	66
Impact of net unrealized investment (gains) losses on future policy benefits			(446)		161	(285)
				(837)	301	(536)

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Impact of net unrealized investment (gains) losses  
on policyholders' dividends

Balance, December 31, 2003	8,242	(433)	(1,292)	(2,443)	(1,499)	2,575
Net investment gains (losses) on investments arising during the period	791				(127)	664
Reclassification adjustment for (gains) losses included in net income	(805)				282	(523)
Impact of net unrealized investment (gains) losses on deferred policy acquisition costs and valuation of business acquired		83			(33)	50
Impact of net unrealized investment (gains) losses on future policy benefits			(502)		162	(340)
Impact of net unrealized investment (gains) losses on policyholders' dividends				(698)	220	(478)
Cumulative effect of accounting change	137	(22)			(42)	73
Balance, December 31, 2004	\$ 8,365	\$ (372)	\$ (1,794)	\$ (3,141)	\$ (1,037)	\$ 2,021

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****4. INVESTMENTS (continued)**

The table below presents unrealized gains (losses) on investments by asset class at December 31,

	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(in millions)		
Fixed maturities	\$ 7,812	\$ 7,750	\$ 7,594
Equity securities	694	602	(42)
Other investments	(141)	(110)	(106)
	<u>          </u>	<u>          </u>	<u>          </u>
Net unrealized gains on investments	\$ 8,365	\$ 8,242	\$ 7,446
	<u>          </u>	<u>          </u>	<u>          </u>

**Duration of Gross Unrealized Loss Positions for Fixed Maturities**

The following table shows the fair value and gross unrealized losses aggregated by investment category and length of time that individual fixed maturity securities have been in a continuous unrealized loss position, at December 31:

	2004					
	<u>Less than twelve months</u>		<u>Twelve months or more</u>		<u>Total</u>	
	Unrealized		Unrealized		Unrealized	
	<u>Fair Value</u>	<u>Losses</u>	<u>Fair Value</u>	<u>Losses</u>	<u>Fair Value</u>	<u>Losses</u>
	(in millions)					
<b>Fixed maturities(1)</b>						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 771	\$ 3	\$ 4	\$	\$ 775	\$ 3
Obligations of U.S. states and their political subdivisions	394	1	86	2	480	3
Foreign government bonds	2,852	37	1,355	113	4,207	150
Corporate securities	14,079	230	2,017	172	16,096	402
Mortgage-backed securities	2,503	15	621	14	3,124	29
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

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Total	\$ 20,599	\$ 286	\$ 4,083	\$ 301	\$ 24,682	\$ 587
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- (1) Includes \$1,259 million of fair value and \$21 million of gross unrealized losses at December 31, 2004 on securities classified as held to maturity, which are not reflected in accumulated other comprehensive income.

2003

	Less than twelve months		Twelve months or more		Total	
	Unrealized		Unrealized		Unrealized	
	Fair Value	Losses	Fair Value	Losses	Fair Value	Losses
	(in millions)					
<b>Fixed maturities(1)</b>						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 1,642	\$ 34	\$	\$	\$ 1,642	\$ 34
Obligations of U.S. states and their political subdivisions	235	8	3		238	8
Foreign government bonds	2,703	91	54	2	2,757	93
Corporate securities	8,802	250	1,498	79	10,300	329
Mortgage-backed securities	2,309	29			2,309	29
<b>Total</b>	<b>\$ 15,691</b>	<b>\$ 412</b>	<b>\$ 1,555</b>	<b>\$ 81</b>	<b>\$ 17,246</b>	<b>\$ 493</b>

- (1) Includes \$1,617 million of fair value and \$26 million of gross unrealized losses at December 31, 2003 on securities classified as held to maturity, which are not reflected in accumulated other comprehensive income.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****4. INVESTMENTS (continued)**

At December 31, 2004, gross unrealized losses on fixed maturities were \$587 million, compared to \$493 million at December 31, 2003. The gross unrealized losses at December 31, 2004 and 2003, are comprised of \$490 million and \$396 million related to investment grade securities and \$97 million and \$97 million related to below investment grade securities, respectively. At December 31, 2004, \$3 million of the gross unrealized losses represented declines in value of greater than 20%, none of which had been in that position for twelve months or more, as compared to \$39 million at December 31, 2003 that represented declines in value of greater than 20%, substantially all of which had been in that position for less than six months. At December 31, 2004, the \$301 million of gross unrealized losses of twelve months or more were concentrated in the foreign government, finance and manufacturing sectors. At December 31, 2003, the \$81 million of gross unrealized losses of twelve months or more were concentrated in the retail, finance and manufacturing sectors. In accordance with its policy described in Note 2, the Company concluded that an adjustment for other than temporary impairments for these securities was not warranted at December 31, 2004 or 2003.

*Duration of Gross Unrealized Loss Positions for Equity Securities*

The following table shows the fair value and gross unrealized losses aggregated by length of time that individual equity securities have been in a continuous unrealized loss position, at December 31:

	2004					
	Less than twelve months		Twelve months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	_____	_____	_____	_____	_____	_____
	(in millions)					
Equity securities, available for sale	\$ 735	\$ 66	\$ 66	\$ 16	\$ 801	\$ 82
	_____	_____	_____	_____	_____	_____
	2003					
	Less than twelve months		Twelve months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	_____	_____	_____	_____	_____	_____

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	_____	_____	_____	_____	_____	_____
	(in millions)					
Equity securities, available for sale	\$ 548	\$ 65	\$ 123	\$ 24	\$ 671	\$ 89
	_____	_____	_____	_____	_____	_____

At December 31, 2004, gross unrealized losses on equity securities were \$82 million, compared to \$89 million at December 31, 2003. At December 31, 2004, \$18 million of the gross unrealized losses represented declines of greater than 20%, substantially all of which had been in that position for less than six months. At December 31, 2003, \$8 million of the gross unrealized losses represented declines of greater than 20%, substantially all of which had been in that position for less than six months. In accordance with its policy described in Note 2, the Company concluded that an adjustment for other than temporary impairments for these securities was not warranted at December 31, 2004 or 2003.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****4. INVESTMENTS (continued)***Duration of Gross Unrealized Loss Positions for Cost Method Investments*

The following table shows the fair value and gross unrealized losses aggregated by length of time that individual cost method investments have been in a continuous unrealized loss position, at December 31:

	2004					
	Less than twelve months		Twelve months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	—	—	—	—	—	—
	(in millions)					
Cost Method Investments	\$ 2	\$ —	\$ 10	\$ 2	\$ 12	\$ 2
	—	—	—	—	—	—
	2003					
	Less than twelve months		Twelve months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	—	—	—	—	—	—
	(in millions)					
Cost Method Investments	\$ —	\$ —	\$ 20	\$ 8	\$ 20	\$ 8
	—	—	—	—	—	—

The aggregate cost of the Company's cost method investments included in Other long-term investments totaled \$80 million at both December 31, 2004 and 2003. At December 31, 2004, gross unrealized losses on cost method investments were \$2 million, compared to \$8 million at December 31, 2003. In accordance with its policy described in Note 2, the Company concluded that an adjustment for other than temporary impairments for these securities was not warranted at December 31, 2004 or 2003.

*Securities Pledged, Restricted Assets and Special Deposits*

The Company pledges investment securities it owns to unaffiliated parties through certain transactions, including securities lending, securities sold under agreements to repurchase and futures contracts. At December 31, the carrying value of investments pledged to third parties as reported in the Consolidated Statements of Financial Position included the following:

	<u>2004</u>	<u>2003</u>
	(in millions)	
Fixed maturities, available for sale	\$ 16,037	\$ 13,537
Other trading account assets	340	1,927
Separate account assets	3,467	3,196
	<u>          </u>	<u>          </u>
Total securities pledged	<u>\$ 19,844</u>	<u>\$ 18,660</u>

In the normal course of its business activities, the Company accepts collateral that can be sold or repledged. The primary sources of this collateral are securities in customer accounts, securities purchased under agreements to resell and securities borrowed transactions. The fair value of this collateral was approximately \$369 million and \$1,628 million at December 31, 2004 and 2003, respectively, of which \$369 million in 2004 and \$1,478 million in 2003 had either been sold or repledged.

Assets of \$528 million and \$419 million at December 31, 2004 and 2003, respectively, were on deposit with governmental authorities or trustees. Additionally, assets valued at \$706 million and \$601 million at December 31, 2004 and 2003, respectively, were held in voluntary trusts established primarily to fund guaranteed dividends to certain policyholders and to fund certain employee benefits. Assets valued at \$22 million and \$2 million at December 31, 2004 and 2003, respectively, were held as collateral. Letter stock or other securities restricted as to



**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****4. INVESTMENTS (continued)**

sale amounted to \$2 million and \$11 million at December 31, 2004 and 2003, respectively. Restricted cash and securities of \$2,512 million and \$1,908 million at December 31, 2004 and 2003, respectively, were included in Other assets. The restricted cash and securities primarily represent funds deposited by clients and funds accruing to clients as a result of trades or contracts.

**5. DEFERRED POLICY ACQUISITION COSTS**

The balances of and changes in deferred policy acquisition costs as of and for the years ended December 31, are as follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(in millions)		
Balance, beginning of year	\$ 7,826	\$ 7,031	\$ 6,868
Capitalization of commissions, sales and issue expenses	1,537	1,584	1,478
Amortization	(873)	(978)	(1,267)
Change in unrealized investment gains and losses	82	103	(216)
Impact of adoption of SOP 03-1	2		
Disposition of subsidiaries	(1)	(118)	
Foreign currency translation and other	274	204	168
	<u>          </u>	<u>          </u>	<u>          </u>
Balance, end of year	<u>\$ 8,847</u>	<u>\$ 7,826</u>	<u>\$ 7,031</u>

**6. VALUATION OF BUSINESS ACQUIRED AND GOODWILL AND OTHER INTANGIBLES***Valuation of Business Acquired*

The balance of and changes in VOBA as of and for the years ended December 31, are as follows:

<u>2004</u>	<u>2003</u>
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	(in millions)	
Balance, beginning of year	\$ 489	\$ 117
Acquisitions	713	440
Amortization(1)	(93)	(90)
Interest(2)	41	17
Foreign currency translation	5	5
Impact of adoption of SOP 03-1	(130)	
Opening balance sheet adjustment	(14)	
	<hr/>	<hr/>
Balance, end of year	\$ 1,011	\$ 489
	<hr/>	<hr/>

- (1) The average expected life of VOBA varies by product. The average expected lives were approximately 25, 10, 7 and 9 years from the date of acquisition for the VOBA related to the businesses acquired from CIGNA and the acquired American Skandia, Aoba Life and Gibraltar Life businesses, respectively.
- (2) The interest accrual rates vary by product. The interest rates were 6.32% to 7.76%, 5.90%, 1.35% to 1.50% and .5% to 1.88% for the VOBA related to the businesses acquired from CIGNA and the acquired American Skandia, Aoba Life and Gibraltar Life businesses, respectively.

Certain contracts issued by American Skandia include a market value adjustment ( MVA ) feature that requires the Company to pay to the contractholder upon surrender the accreted value of the fund as well as a market value adjustment based on the crediting rates on the contract surrendered compared to crediting rates on newly issued contracts or an indexed rate at time of surrender, as applicable. As of December 31, 2003, this liability was reflected at market value, which considers the effects of unrealized gains and losses in contract value resulting from changes in crediting rates. Upon the adoption of SOP 03-1 on January 1, 2004, the Company changed its accounting for American Skandia s contracts containing MVA features as described previously under New Accounting Pronouncements. The Company s net VOBA balance decreased \$130 million upon the

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****6. VALUATION OF BUSINESS ACQUIRED AND GOODWILL AND OTHER INTANGIBLES (continued)**

adoption of SOP 03-1, primarily due to the change in the liability for the MVA feature associated with the American Skandia business, since the expected cash flows on this business in force at the time of acquisition that corresponded to obligations covered by SOP 03-1 were considered in establishing the initial VOBA.

The following table provides estimated future amortization, net of interest, for the periods indicated.

	<b>VOBA Amortization</b>
2005	\$ 107
2006	83
2007	71
2008	60
2009	51
2010 and thereafter	639
<b>Total</b>	<b>\$ 1,011</b>

**Goodwill and Other Intangibles**

The changes in the book value of goodwill by segment are as follows:

	<b>Year Ended December 31, 2004</b>					
	<b>Balance at January 1</b>	<b>Acquisitions</b>	<b>Impairment Charge</b>	<b>Disposal of Reporting Unit</b>	<b>Other(a)</b>	<b>Balance at December 31</b>
	(in millions)					
Asset Management	\$ 142	\$ 119	\$	\$	\$ 18	\$ 279
Retirement		445				445
International Insurance	14				1	15
International Investments	113				7	120

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Corporate and Other	166		(53)	(6)	10	117
<b>Total</b>	<b>\$ 435</b>	<b>\$ 564</b>	<b>\$ (53)</b>	<b>\$ (6)</b>	<b>\$ 36</b>	<b>\$ 976</b>

Year Ended December 31, 2003

	Balance at January 1	Acquisitions	Impairment Charge	Disposal of Reporting Unit	Other(a)	Balance at December 31
(in millions)						
Asset Management	\$ 135	\$	\$	\$	\$ 7	\$ 142
International Insurance		14				14
International Investments	120				(7)	113
Corporate and Other	162	4				166
<b>Total</b>	<b>\$ 417</b>	<b>\$ 18</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$ 435</b>

Year Ended December 31, 2002

	Balance at January 1	Acquisitions	Impairment Charge	Disposal of Reporting Unit	Other	Balance at December 31
(in millions)						
Asset Management	\$ 54	\$ 85	\$	\$ (4)	\$	\$ 135
International Investments	87	33				120
Corporate and Other	184	14	(36)			162
<b>Total</b>	<b>\$ 325</b>	<b>\$ 132</b>	<b>\$ (36)</b>	<b>\$ (4)</b>	<b>\$</b>	<b>\$ 417</b>

(a) Other represents foreign currency translation and purchase price adjustments.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****6. VALUATION OF BUSINESS ACQUIRED AND GOODWILL AND OTHER INTANGIBLES (continued)**

The Company tests goodwill for impairment annually as of December 31 and more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. As a result of the December 31, 2004 annual impairment test, the Company determined that the goodwill related to its Dryden Wealth Management business, a business the Company has decided to exit or sell, which is included in Corporate and Other above, was impaired. Accordingly, the Company recorded an impairment charge of \$53 million representing the entire carrying amount of the business's goodwill. The December 31, 2003 annual impairment test resulted in no impairments. As a result of the December 31, 2002 annual impairment test, the Company determined that the goodwill related to its Property and Casualty Insurance business, included in Corporate and Other above, was impaired. Accordingly, the Company recorded an impairment charge of \$33 million representing the entire carrying amount of the business's goodwill.

At December 31, 2004, the gross carrying amount and accumulated amortization for the Company's other intangibles subject to amortization amounted to \$384 million and \$168 million, respectively, and at December 31, 2003, \$336 million and \$133 million, respectively. Other intangibles not subject to amortization amounted to \$18 million and \$11 million at December 31, 2004 and 2003, respectively. Other intangibles consist primarily of mortgage servicing rights and customer relationships related to the Asset Management segment. At December 31, 2004 and 2003, mortgage servicing rights, including both purchased and originated servicing rights, were \$135 million (fair value of \$149 million) and \$122 million (fair value of \$129 million), respectively, and customer relationships were \$64 million and \$77 million, respectively. Amortization expense for other intangibles was \$34 million, \$35 million and \$27 million for the years ended December 31, 2004, 2003 and 2002, respectively. Amortization expense for other intangibles currently owned by the Company is expected to be approximately \$33 million for each of the next four years and \$23 million in the fifth year.

**7. POLICYHOLDERS' LIABILITIES***Future Policy Benefits*

Future policy benefits at December 31, are as follows:

	<u>2004</u>	<u>2003</u>
	(in millions)	
Life insurance	\$ 84,744	\$ 78,927
Individual and group annuities	17,066	15,504
Other contract liabilities	495	414
	<u>          </u>	<u>          </u>
Total future policy benefits	\$ 102,305	\$ 94,845

Life insurance liabilities include reserves for death and endowment policy benefits, terminal dividends and certain health benefits. Individual and group annuities liabilities include reserves for life contingent immediate annuities and life contingent group annuities. Other contract liabilities primarily consist of unearned premium and benefit reserves for group and individual health products.

Future policy benefits for individual participating traditional life insurance are based on the net level premium method, calculated using the guaranteed mortality and nonforfeiture interest rates which range from 2.5% to 8.5%; less than 1% of the reserves are based on an interest rate in excess of 8%. Participating insurance represented 26% and 30% of domestic individual life insurance in force at December 31, 2004 and 2003, respectively, and 91%, 92% and 91% of domestic individual life insurance premiums for 2004, 2003 and 2002, respectively.

Future policy benefits for individual non-participating traditional life insurance policies, group and individual long-term care policies and individual health insurance policies are equal to the aggregate of (1) the

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**7. POLICYHOLDERS LIABILITIES (continued)**

present value of future benefit payments and related expenses, less the present value of future net premiums, and (2) premium deficiency reserves. Assumptions as to mortality, morbidity and persistency are based on the Company's experience when the basis of the reserve is established. Interest rates used for the aggregate reserves range from 0% to 11.3%; less than 2% of the reserves are based on an interest rate in excess of 8%.

Future policy benefits for individual and group annuities are equal to the aggregate of (1) the present value of expected future payments on the basis of actuarial assumptions established at issue, and (2) premium deficiency reserves. Assumptions as to mortality are based on the Company's experience when the basis of the reserve is established. The interest rates used in the determination of the aggregate reserves range from 1.4% to 14.8%; less than 2% of the reserves are based on an interest rate in excess of 8%.

Future policy benefits for other contract liabilities are generally equal to the present value of expected future payments based on the Company's experience (except for certain group insurance coverages for which future policy benefits are equal to gross unearned premium reserves). The interest rates used in the determination of the aggregate reserves range from 0% to 8.8%; less than 1% of the reserves are based on an interest rate in excess of 8%.

Premium deficiency reserves are established, if necessary, when the liability for future policy benefits plus the present value of expected future gross premiums are determined to be insufficient to provide for expected future policy benefits and expenses and to recover any unamortized policy acquisition costs. Premium deficiency reserves have been recorded for the group single premium annuity business, which consists of limited-payment, long-duration traditional and non-participating annuities; structured settlements and single premium immediate annuities with life contingencies; and for certain individual health policies. Liabilities of \$3,300 million and \$2,830 million are included in Future policy benefits with respect to these deficiencies at December 31, 2004 and 2003, respectively.

The Company's liability for future policy benefits is also inclusive of liabilities for guarantee benefits related to certain nontraditional long-duration life and annuity contracts, which are discussed more fully in Note 8.

***Policyholders Account Balances***

Policyholders' account balances at December 31, are as follows:

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	<u>2004</u>	<u>2003</u>
	(in millions)	
Individual annuities	\$ 14,297	\$ 9,565
Group annuities(1)	20,694	4,046
Guaranteed investment contracts and guaranteed interest accounts(1)	14,223	13,951
Funding agreements	3,147	1,451
Interest-sensitive life contracts	9,282	8,400
Dividend accumulations and other	13,582	12,278
	<u>          </u>	<u>          </u>
Policyholders' account balances	\$ 75,225	\$ 49,691
	<u>          </u>	<u>          </u>

(1) Includes as of December 31, 2004, \$16,356 million of group annuities and \$825 million of guaranteed investment contracts associated with the retirement business acquired from CIGNA. The interest crediting rates for these contracts range from 3% to 7.4% for group annuities and 5.4% to 9.1% for guaranteed investment contracts.

Policyholders' account balances represent an accumulation of account deposits plus credited interest less withdrawals, expenses and mortality charges, if applicable. These policyholders' account balances also include provisions for benefits under non-life contingent payout annuities. Included in Funding agreements at



**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****7. POLICYHOLDERS LIABILITIES (continued)**

December 31, 2004 and 2003, are \$2,756 and \$1,052 million, respectively, of medium-term notes of consolidated variable interest entities secured by funding agreements purchased from the Company with the proceeds of such notes. The interest rates associated with such notes range from 1.3% to 4.4%. Interest crediting rates range from 0.5% to 8% for interest-sensitive life contracts and from 0% to 14% for contracts other than interest-sensitive life. Less than 2% of policyholders' account balances have interest crediting rates in excess of 8%.

**Unpaid Claims and Claim Adjustment Expenses**

The following table provides a reconciliation of the activity in the liability for unpaid claims and claim adjustment expenses for accident and health insurance and property and casualty insurance at December 31:

	2004		2003		2002	
	Accident and Health	Property and Casualty	Accident and Health	Property and Casualty	Accident and Health	Property and Casualty
	(in millions)					
Balance at January 1	\$ 1,629	\$ 58	\$ 1,567	\$ 1,861	\$ 1,655	\$ 1,753
Less reinsurance recoverables, net	17		24	598	129	671
Net balance at January 1	1,612	58	1,543	1,263	1,526	1,082
Incurred related to:						
Current year	675	7	634	1,184	627	1,615
Prior years	48	3	33	(22)	(32)	(15)
Total incurred	723	10	667	1,162	595	1,600
Paid related to:						
Current year	248	7	237	706	237	967
Prior years	364		361	297	341	452
Total paid	612	7	598	1,003	578	1,419
Acquisitions (dispositions) and other	8	(3)		(1,364)		
Net balance at December 31	1,731	58	1,612	58	1,543	1,263

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Plus reinsurance recoverables, net	18	_____	17	_____	24	_____	598	_____
<b>Balance at December 31</b>	<b>\$ 1,749</b>	<b>\$ 58</b>	<b>\$ 1,629</b>	<b>\$ 58</b>	<b>\$ 1,567</b>	<b>\$ 1,861</b>	<b>\$ 1,861</b>	<b>\$ 1,861</b>

The unpaid claims and claim adjustment expenses presented above include estimates for liabilities associated with reported claims and for incurred but not reported claims based, in part, on the Company's experience. Changes in the estimated cost to settle unpaid claims are charged or credited to the Consolidated Statements of Operations periodically as the estimates are revised. Accident and health unpaid claims liabilities are discounted using interest rates ranging from 0.0% to 6.4%.

The property and casualty reinsurance recoverable balance related to unpaid claims at December 31, 2004, 2003 and 2002 includes \$0 million, \$0 million and \$151 million, respectively, attributable to the Company's discontinued property and casualty businesses. The accident and health reinsurance recoverable balance related to unpaid claims at December 31, 2004, 2003 and 2002 includes \$0 million, \$1 million and \$9 million, respectively, attributable to the Company's discontinued healthcare business.

The amounts incurred for claims and claim adjustment expenses for accident and health in 2004 and 2003 that related to prior years were primarily due to required interest somewhat offset by long-term disability claim termination experience. The amounts incurred for claims and claim adjustment expenses for accident and health in 2002 that related to prior years was due to long-term disability claim termination experience. The amounts incurred for claims and claim adjustment expenses for property and casualty in 2003 and 2002 that related to prior years were primarily driven by lower than anticipated losses for the auto line of business and prior period reserve releases.

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**8. CERTAIN NONTRADITIONAL LONG-DURATION CONTRACTS**

The Company issues traditional variable annuity contracts through its separate accounts for which investment income and investment gains and losses accrue directly to, and investment risk is borne by, the contractholder. The Company also issues variable annuity contracts with general and separate account options where the Company contractually guarantees to the contractholder a return of no less than (a) total deposits made to the contract less any partial withdrawals ( return of net deposits ), (b) total deposits made to the contract less any partial withdrawals plus a minimum return ( minimum return ), or (c) the highest contract value on a specified anniversary date minus any withdrawals following the contract anniversary ( anniversary contract value ). These guarantees include benefits that are payable in the event of death, annuitization or at specified dates during the accumulation period.

The Company also issues annuity contracts with market value adjusted investment options ( MVAs ), which provide for a return of principal plus a fixed rate of return if held to maturity, or, alternatively, a market adjusted value if surrendered prior to maturity. The market value adjustment may result in a gain or loss to the Company, depending on crediting rates or an indexed rate at surrender, as applicable.

In addition, the Company issues variable life, variable universal life and universal life contracts where the Company contractually guarantees to the contractholder a death benefit even when there is insufficient value to cover monthly mortality and expense charges, whereas otherwise the contract would typically lapse ( no lapse guarantee ). Variable life and variable universal life contracts are offered with general and separate account options.

The assets supporting the variable portion of both traditional variable annuities and certain variable contracts with guarantees are carried at fair value and reported as Separate account assets with an equivalent amount reported as Separate account liabilities. Amounts assessed against the contractholders for mortality, administration, and other services are included within revenue in Policy charges and fee income and changes in liabilities for minimum guarantees are generally included in Policyholders benefits. In 2004 there were no gains or losses on transfers of assets from the general account to a separate account.

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For those guarantees of benefits that are payable in the event of death, the net amount at risk is generally defined as the current guaranteed minimum death benefit in excess of the current account balance at the balance sheet date. For guarantees of benefits that are payable at annuitization, the net amount at risk is generally defined as the present value of the minimum guaranteed annuity payments available to the contractholder determined in accordance with the terms of the contract in excess of the current account balance. For guarantees of accumulation balances, the net amount at risk is generally defined as the guaranteed minimum accumulation balance minus the current account balance. The Company's contracts with guarantees may offer more than one type of guarantee in each contract; therefore, the amounts listed may not be mutually exclusive. As of December 31, 2004, the Company had the following guarantees associated with these contracts, by product and guarantee type:

	<u>December 31, 2004</u>	
	<u>In the Event of Death</u>	<u>At Annuitization / Accumulation</u>
	(dollars in millions)	
<b>Variable Annuity Contracts</b>		
<i>Return of net deposits</i>		
Account value	\$ 30,097	N/A
Net amount at risk	\$ 2,789	N/A
Average attained age of contractholders	62 years	N/A
<i>Minimum return or anniversary contract value</i>		
Account value	\$ 15,816	\$ 8,672
Net amount at risk	\$ 1,649	\$ 3
Average attained age of contractholders	65 years	59 years
Average period remaining until earliest expected annuitization	N/A	6 years
	<u>Unadjusted Value</u>	<u>Adjusted Value</u>
<b>Market value adjusted annuities</b>		
Account value	\$ 1,680	\$ 1,753
	<u>December 31, 2004</u>	
	<u>In the Event of Death</u>	
	(dollars in millions)	
<b>Variable Life, Variable Universal Life and Universal Life Contracts</b>		
<i>No lapse guarantees</i>		
Separate account value	\$ 1,651	

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General account value	\$ 2,292
Net amount at risk	\$ 59,923
Average attained age of contractholders	39 years

Account balances of variable annuity contracts with guarantees were invested in separate account investment options as follows:

	<b>December 31, 2004</b>
	<b>(in millions)</b>
Equity funds	\$ 27,714
Bond funds	6,173
Balanced funds	2,737
Money market funds	1,777
Other	2,266
	\$ 40,667
<b>Total</b>	<b>\$ 40,667</b>

In addition to the amounts invested in separate account investment options above, \$5,246 million of account balances of variable annuity contracts with guarantees, inclusive of contracts with MVA features, were invested in general account investment options.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****8. CERTAIN NONTRADITIONAL LONG-DURATION CONTRACTS (continued)***Liabilities For Guarantee Benefits*

The table below summarizes the changes in general account liabilities for guarantees on variable contracts. The liabilities for guaranteed minimum death benefits ( GMDB ) and guaranteed minimum income benefits ( GMIB ) are included in Future policy benefits and the related changes in the liabilities are included in Policyholders' benefits. Guaranteed minimum withdrawal benefits ( GMWB ) and guaranteed return option ( GRO ) features are considered to be derivatives under SFAS No. 133, and changes in the fair value of the derivative are recognized through Realized investment gains (losses), net. At December 31, 2004, there were no liabilities recorded related to these derivatives.

	Guaranteed Minimum Death Benefit (GMDB)	Guaranteed Minimum Income Benefit (GMIB)	Guaranteed Return Option/Minimum Withdrawal Benefit (GRO / GMWB)	Total
			(in millions)	
Balance at January 1, 2004	\$ 70	\$ 2	\$	\$ 72
Incurred guarantee benefits	86	6		92
Paid guarantee benefits	(68)			(68)
Balance at December 31, 2004	\$ 88	\$ 8	\$	\$ 96

The GMDB liability is determined each period end by estimating the accumulated value of a percentage of the total assessments to date less the accumulated value of the death benefits in excess of the account balance. The percentage of assessments used is chosen such that, at issue (or, in the case of American Skandia contracts, at the acquisition date), the present value of expected death benefits in excess of the projected account balance and the percentage of the present value of total expected assessments over the lifetime of the contracts are equal. The Company regularly evaluates the estimates used and adjusts the GMDB liability balance, with a related charge or credit to earnings, if actual experience or other evidence suggests that earlier assumptions should be revised. The GMIB liability was determined at December 31, 2004 by estimating the accumulated value of a percentage of the total assessments to date less the accumulated value of the projected income benefits in excess of the account balance.

The present value of death benefits in excess of the projected account balance and the present value of total expected assessments for GMDB s were determined over a reasonable range of stochastically generated scenarios. For variable annuities and variable universal life, 5,000 scenarios were stochastically generated and, from these, 200 scenarios were selected using a sampling technique. For variable life, various scenarios covering a reasonable range were weighted based on a statistical lognormal model. For universal life, 10,000 scenarios were stochastically generated and, from these, 100 were selected.

The GRO features predominantly provide for a guaranteed return of initial account value over a contractually defined period equal to seven years. One other variation of the GRO feature has an additional optional benefit that will provide for a base guarantee of account value seven years after the benefit is effective and every anniversary date thereafter and, if elected, an enhanced guarantee equal to the account value seven years after the effective date of any step-up and every anniversary date thereafter. All guaranteed amounts include any additional purchase payments and credits less withdrawals. Significant or prolonged declines in the value of any variable investment options a customer may choose as part of their GRO benefit may result in all or a substantial portion of their account values being allocated to fixed investment allocations, in conjunction with the Company's automatic rebalancing program associated with this feature.

The GMWB features provide the contractholder with a guaranteed remaining balance if the account value is reduced to zero through a combination of market declines and withdrawals. The guaranteed remaining balance is generally equal to the protected value under the contract, which is initially established as the greater of the account value or cumulative premiums when withdrawals commence, less cumulative withdrawals. The

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****8. CERTAIN NONTRADITIONAL LONG-DURATION CONTRACTS (continued)**

contractholder also has the option, after a specified time period, to reset the guaranteed remaining balance to the then-current account value, if greater.

***Sales Inducements***

The Company defers sales inducements and amortizes them over the anticipated life of the policy using the same methodology and assumptions used to amortize deferred policy acquisition costs. These deferred sales inducements are included in Other assets. The Company offers various types of sales inducements. These inducements include: (i) a bonus whereby the policyholder's initial account balance is increased by an amount equal to a specified percentage of the customer's initial deposit and (ii) additional interest credits after a certain number of years a contract is held. Changes in deferred sales inducements are as follows:

	<b>Sales Inducements</b>
	<b>(in millions)</b>
Balance at January 1, 2004	\$ 156
Capitalization	132
Amortization	(24)
Balance at December 31, 2004	\$ 264

**9. 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. For a discussion of the Closed Block Business see Note 20. The Company established a separate closed block for participating individual life insurance policies issued by the Canadian branch of Prudential Insurance. Due to the substantially smaller number of outstanding Canadian policies, this separate closed block is insignificant in size and is not included in the information presented below.



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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

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****9. CLOSED BLOCK (continued)**

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. As of December 31, 2004, the Company has not recognized a policyholder dividend obligation for the excess of actual cumulative earnings over the expected cumulative earnings. However, net unrealized investment gains that have arisen subsequent to the establishment of the Closed Block have been reflected as policyholder dividend obligations of \$3,141 million and \$2,443 million at December 31, 2004 and 2003, respectively, to be paid to Closed Block policyholders unless otherwise offset by future experience, with an offsetting amount reported in Accumulated other comprehensive income (loss).

On December 14, 2004, Prudential Insurance's Board of Directors acted to reduce dividends, effective January 1, 2005 on Closed Block policies to reflect changes in the economic environment, primarily the persistent low levels of fixed income interest rates experienced in recent years, as well as poor equity returns. These actions resulted in a \$91 million reduction of the liability for policyholder dividends recognized in the year ended December 31, 2004.

Closed Block Liabilities and Assets designated to the Closed Block at December 31, as well as maximum future earnings to be recognized from Closed Block Liabilities and Closed Block Assets, are as follows:

	<u>2004</u>	<u>2003</u>
	(in millions)	
<b>Closed Block Liabilities</b>		
Future policy benefits	\$ 49,511	\$ 48,842
Policyholders' dividends payable	1,077	1,168
Policyholder dividend obligation	3,141	2,443
Policyholders' account balances	5,557	5,523
Other Closed Block liabilities	8,943	7,222
	<u>68,229</u>	<u>65,198</u>
<b>Closed Block Assets</b>		
Fixed maturities, available for sale, at fair value	44,870	40,517
Equity securities, available for sale, at fair value	2,620	2,282
Commercial loans	6,707	6,423

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Policy loans	5,454	5,543
Other long-term investments	996	983
Short-term investments	1,769	3,361
	<u>          </u>	<u>          </u>
Total investments	62,416	59,109
Cash and cash equivalents	1,800	2,075
Accrued investment income	668	693
Other Closed Block assets	343	323
	<u>          </u>	<u>          </u>
Total Closed Block Assets	65,227	62,200
	<u>          </u>	<u>          </u>
Excess of reported Closed Block Liabilities over Closed Block Assets	3,002	2,998
Portion of above representing accumulated other comprehensive income:		
Net unrealized investment gains	3,459	3,415
Allocated to policyholder dividend obligation	(3,141)	(2,443)
	<u>          </u>	<u>          </u>
Future earnings to be recognized from Closed Block Assets and Closed Block Liabilities	\$ 3,320	\$ 3,970
	<u>          </u>	<u>          </u>

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****9. CLOSED BLOCK (continued)**

Information regarding the policyholder dividend obligation is as follows:

	<u>2004</u>	<u>2003</u>
	(in millions)	
Balance, January 1	\$ 2,443	\$ 1,606
Impact on income before gains allocable to policyholder dividend obligation		
Net investment gains		
Unrealized investment gains	698	837
	<u>          </u>	<u>          </u>
Balance, December 31	<u>\$ 3,141</u>	<u>\$ 2,443</u>

Closed Block revenues and benefits and expenses for the years ended December 31, 2004, 2003 and 2002 were as follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(in millions)		
<b>Revenues</b>			
Premiums	\$ 3,776	\$ 3,860	\$ 4,022
Net investment income	3,392	3,326	3,333
Realized investment gains (losses), net	709	430	(521)
Other income	59	64	68
	<u>          </u>	<u>          </u>	<u>          </u>
Total Closed Block revenues	<u>7,936</u>	<u>7,680</u>	<u>6,902</u>
<b>Benefits and Expenses</b>			
Policyholders' benefits	4,056	4,174	4,310
Interest credited to policyholders' account balances	137	139	139
Dividends to policyholders	2,364	2,452	2,506
General and administrative expenses	710	759	801
	<u>          </u>	<u>          </u>	<u>          </u>
Total Closed Block benefits and expenses	<u>7,267</u>	<u>7,524</u>	<u>7,756</u>
	<u>          </u>	<u>          </u>	<u>          </u>
Closed Block revenues, net of Closed Block benefits and expenses, before income taxes	<u>669</u>	<u>156</u>	<u>(854)</u>
	<u>          </u>	<u>          </u>	<u>          </u>
Income tax expense (benefit)	<u>19</u>	<u>(21)</u>	<u>(147)</u>

Closed Block revenues, net of Closed Block benefits and expenses and income taxes	\$ 650	\$ 177	\$ (707)
	<u>          </u>	<u>          </u>	<u>          </u>

**10. REINSURANCE**

The Company participates in reinsurance in order to provide additional capacity for future growth and limit the maximum net loss potential arising from large risks. In addition, the acquisition of the retirement business of CIGNA on April 1, 2004, required the Company through its wholly owned subsidiary, PRIAC, to enter into certain reinsurance arrangements with CIGNA to effect the transfer of the retirement business included in the transaction. These reinsurance arrangements include coinsurance-with-assumption, modified-coinsurance-with-assumption, and modified-coinsurance-without-assumption and are more fully described in Note 3.

Life reinsurance is accomplished through various plans of reinsurance, primarily yearly renewable term and coinsurance. Prior to the sale of the Company's property and casualty insurance businesses, property and casualty reinsurance was placed on a pro-rata basis and excess of loss, including stop-loss, basis. Reinsurance ceded arrangements do not discharge the Company as the primary insurer. Ceded balances would represent a liability of the Company in the event the reinsurers were unable to meet their obligations to the Company under the terms of the reinsurance agreements. Reinsurance premiums, commissions, expense reimbursements, benefits and reserves related to reinsured long-duration contracts are accounted for over the life of the underlying reinsured contracts using assumptions consistent with those used to account for the underlying contracts. The cost of reinsurance related to short-duration contracts is accounted for over the reinsurance contract period. Amounts recoverable from reinsurers, for both short-and long-duration reinsurance arrangements, are estimated in a manner consistent with the claim liabilities and policy benefits associated with the reinsured policies.

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The tables presented below exclude amounts pertaining to the Company's discontinued operations.

Reinsurance amounts included in the Consolidated Statements of Operations for the years ended December 31, were as follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(in millions)		
Direct premiums	\$ 13,366	\$ 13,968	\$ 13,731
Reinsurance assumed(1)	103	133	103
Reinsurance ceded	(889)	(868)	(781)
	<u>          </u>	<u>          </u>	<u>          </u>
Premiums	\$ 12,580	\$ 13,233	\$ 13,053
	<u>          </u>	<u>          </u>	<u>          </u>
Policyholders' benefits ceded	\$ 908	\$ 840	\$ 798
	<u>          </u>	<u>          </u>	<u>          </u>

(1) Includes \$2 million of premiums assumed for the period April 1, 2004 through December 31, 2004 under the reinsurance arrangements associated with acquisition of the retirement business of CIGNA.

Reinsurance recoverables at December 31, are as follows:

	<u>2004</u>	<u>2003</u>
	(in millions)	
Individual and group annuities(1)	\$ 32,215	\$
Life insurance	507	521
Other reinsurance	61	66
	<u>          </u>	<u>          </u>
Total reinsurance recoverable	\$ 32,783	\$ 587
	<u>          </u>	<u>          </u>

(1) Represents reinsurance recoverables as of December 31, 2004, under the modified coinsurance arrangement associated with the acquisition of the retirement business of CIGNA. At December 31, 2004, the Company has recorded a related reinsurance payable of \$32,198 million.

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Excluding the reinsurance recoverable associated with the acquisition of the retirement business of CIGNA, three major reinsurance companies account for approximately 67% of the reinsurance recoverable at December 31, 2004. The Company periodically reviews the financial condition of its reinsurers and amounts recoverable therefrom in order to minimize its exposure to loss from reinsurer insolvencies, recording an allowance when necessary for uncollectible reinsurance.

### 11. SHORT-TERM AND LONG-TERM DEBT

#### *Short-term Debt*

Short-term debt at December 31, is as follows:

	<u>2004</u>	<u>2003</u>
	(in millions)	
Commercial paper	\$ 2,447	\$ 3,258
Notes payable	1,539	1,027
Current portion of long-term debt	58	454
	<u>          </u>	<u>          </u>
Total short-term debt	<u>\$ 4,044</u>	<u>\$ 4,739</u>

The weighted average interest rate on outstanding short-term debt, excluding the current portion of long-term debt, was approximately 2.2% and 1.1% at December 31, 2004 and 2003, respectively.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****11. SHORT-TERM AND LONG-TERM DEBT (continued)**

At December 31, 2004, the Company had \$3,338 million in committed lines of credit from numerous financial institutions, of which \$3,326 million were unused. These lines of credit generally have terms ranging from one to five years.

The Company issues commercial paper primarily to manage operating cash flows and existing commitments, to meet working capital needs and to take advantage of current investment opportunities. At December 31, 2004 and 2003, a portion of commercial paper borrowings were supported by \$2,500 million of the Company's existing lines of credit. At December 31, 2004 and 2003, the weighted average maturity of commercial paper outstanding was 23 and 18 days, respectively.

**Long-term Debt**

Long-term debt at December 31, is as follows:

<u>Description</u>	<u>Maturity Dates</u>	<u>Rate</u>	<u>2004</u>	<u>2003</u>
<b>(in millions)</b>				
Prudential Holdings, LLC notes (the IHC debt )				
Series A	2017(a)	(c)	\$ 333	\$ 333
Series B	2023(a)	7.245%	777	777
Series C	2023(a)	8.695%	640	640
Fixed rate notes				
Fixed rate note subject to set-off arrangements	2009	4.45%	952	
Other fixed rate notes	2006-2033(b)	3.00%-7.30%	4,977	3,169
Floating rate notes ( FRNs )	2011-2014	(d)	40	
Surplus notes	2007-2025	(e)	692	691
<b>Sub-total</b>			<b>8,411</b>	<b>5,610</b>
<b>Less assets under set-off arrangements(f)</b>			<b>784</b>	
<b>Total long-term debt</b>			<b>\$ 7,627</b>	<b>\$ 5,610</b>

(a) Annual scheduled repayments of principal for the Series A and Series C notes begin in 2013. Annual scheduled repayments of principal for the Series B notes begin in 2018.

(b)



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U.S. dollar fixed rate notes at December 31, 2003 include \$711 million related to the issuance of equity security units. See Note 12 for more details regarding equity security units.

- (c) The interest rate on the Series A notes is a floating rate equal to LIBOR plus 0.875% per year. The interest rate ranged from 2.0% to 3.4% in 2004 and 1.94% to 2.29% in 2003.
- (d) The interest rates on the U.S. dollar denominated FRNs are based on the U.S. Consumer Price Index. Interest rates ranged from 4.04% to 5.09% in 2004.
- (e) The interest rate on the Surplus notes ranged from 7.65% to 8.30% in 2004 and 2003.
- (f) Assets under set-off arrangements represent a reduction in the amount of fixed rate notes included in long-term debt, relating to an arrangement where valid rights of set-off exist and it is the intent of both parties to settle on a net basis under legally enforceable arrangements.

Several long-term debt agreements have restrictive covenants related to the total amount of debt, net tangible assets and other matters. At December 31, 2004 and 2003, the Company was in compliance with all debt covenants.

Payment of interest and principal on the surplus notes issued after 1993, of which \$692 million and \$691 million was outstanding at December 31, 2004 and 2003, respectively, may be made only with the prior approval of the Commissioner of Banking and Insurance of the State of New Jersey (the Commissioner). The Commissioner could prohibit the payment of the interest and principal on the surplus notes if certain statutory capital requirements are not met. At December 31, 2004, the Company has met these statutory capital requirements.

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**11. SHORT-TERM AND LONG-TERM DEBT (continued)**

In order to modify exposure to interest rate and currency exchange rate movements, the Company utilizes derivative instruments, primarily interest rate swaps, in conjunction with some of its debt issues. These instruments qualify for hedge accounting treatment. The impact of these instruments, which is not reflected in the rates presented in the table above, were decreases in interest expense of \$40 million and \$18 million for the years ended December 31, 2004 and 2003, respectively. Floating rates are determined by contractual formulas and may be subject to certain minimum or maximum rates. See Note 19 for additional information on the Company's use of derivative instruments.

Interest expense for short-term and long-term debt was \$492 million, \$403 million and \$427 million, for the years ended December 31, 2004, 2003 and 2002, respectively. Securities business related interest expense of \$72 million, \$82 million and \$144 million for the years ended December 31, 2004, 2003 and 2002, respectively, is included in Net investment income.

Included in Policyholders' account balances are additional debt obligations of the Company. See Note 7 for further discussion.

***Prudential Holdings, LLC Notes***

On the date of demutualization, Prudential Holdings, LLC (PHLLC), a wholly owned subsidiary of Prudential Financial, issued \$1.75 billion in senior secured notes (the IHC debt). PHLLC owns the capital stock of Prudential Insurance and does not have any operating businesses of its own. The IHC debt represents senior secured obligations of PHLLC with limited recourse; neither Prudential Financial, Prudential Insurance nor any other affiliate of PHLLC is an obligor or guarantor on the IHC debt. The IHC debt is collateralized by 13.8% of the outstanding common stock of Prudential Insurance and other items specified in the indenture, primarily the Debt Service Coverage Account (the DSCA) discussed below.

PHLLC's ability to meet its obligations under the IHC debt is dependent principally upon sufficient available funds being generated by the Closed Block Business and the ability of Prudential Insurance, the sole direct subsidiary of PHLLC, to dividend such funds to PHLLC. The payment of scheduled principal and interest on the Series A notes and the Series B notes is insured by a financial guarantee insurance policy. The payment of principal and interest on the Series C notes is not insured. The IHC debt is redeemable prior to its stated maturity at the option of PHLLC and, in the event of certain circumstances, the IHC debt bond insurer can require PHLLC to redeem the IHC debt.

Net proceeds from the IHC debt amounted to \$1,727 million. The majority of the net proceeds, or \$1,218 million, was distributed to Prudential Financial through a dividend on the date of demutualization for use in the Financial Services Businesses. Net proceeds of \$437 million were deposited to a restricted account within PHLLC. This restricted account, referred to as the DSCA, constitutes additional collateral for the IHC debt. The remainder of the net proceeds, or \$72 million, was used to purchase a guaranteed investment contract to fund a portion of the financial

guarantee insurance premium related to the IHC debt.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****11. SHORT-TERM AND LONG-TERM DEBT (continued)**

Summarized consolidated financial data for Prudential Holdings, LLC is presented below.

	<u>2004</u>	<u>2003</u>		
	(in millions)			
<b>Consolidated Statements of Financial Position data at December 31:</b>				
Total assets	\$ 305,471	\$ 237,242		
Total liabilities	288,188	220,710		
Total equity	17,283	16,532		
Total liabilities and equity	305,471	237,242		
	<u>2004</u>	<u>2003</u>	<u>2002</u>	
	(in millions)			
<b>Consolidated Statements of Operations data for the years ended December 31:</b>				
Total revenues	\$ 18,982	\$ 17,344	\$ 15,906	
Total benefits and expenses	16,390	15,891	16,050	
Income (loss) from continuing operations before income taxes and cumulative effect of accounting change	2,592	1,453	(144)	
Net income (loss)	1,800	1,085	(93)	
<b>Consolidated Statements of Cash Flows data for the years ended December 31:</b>				
Cash flows from operating activities	\$ 3,885	\$ 1,122	\$ 4,206	
Cash flows used in investing activities	(6,341)	(2,097)	(7,503)	
Cash flows from financing activities	2,134	483	2,654	
Effect of foreign exchange rate changes on cash balances	(32)	8	4	
Net decrease in cash and cash equivalents	(354)	(484)	(639)	

Prudential Financial is a holding company and is a legal entity separate and distinct from its subsidiaries. The rights of Prudential Financial to participate in any distribution of assets of any subsidiary, including upon its liquidation or reorganization, are subject to the prior claims of creditors of that subsidiary, except to the extent that Prudential Financial may itself be a creditor of that subsidiary and its claims are recognized. PHLLC and its subsidiaries have entered into covenants and arrangements with third parties in connection with the issuance of the IHC debt which are intended to confirm their separate, bankruptcy-remote status, by assuring that the assets of PHLLC and its subsidiaries are not available to creditors of Prudential Financial or its other subsidiaries, except and to the extent that Prudential Financial and its other subsidiaries are, as shareholders or creditors of PHLLC and its subsidiaries, or would be, entitled to those assets.

At December 31, 2004, the Company was in compliance with all IHC debt covenants.

## 12. EQUITY SECURITY UNITS

In December 2001, in connection with the demutualization, Prudential Financial and Prudential Financial Capital Trust I (the Trust ) co-issued 13,800,000 6.75% equity security units (the Units ) to the public at an offering price of \$50 per Unit for gross proceeds of \$690 million. Each Unit had a stated amount of \$50 and initially consisted of (1) a contract requiring the holder to purchase, for \$50, shares of Common Stock of Prudential Financial by November 15, 2004 (the purchase contract ), at a price determined by a formula described in the purchase contract and (2) a redeemable capital security of the Trust, with a stated liquidation amount of \$50.

In accordance with the terms of the Units, the Trust was dissolved on July 29, 2004, and \$690 million aggregate principal amount of 5.34% debentures of Prudential Financial maturing on November 15, 2006 (the Debentures ), the sole assets of the Trust, were distributed to the owners of the Trust s capital securities in exchange for their capital securities. The Debentures were remarketed on behalf of the debenture owners on August 6, 2004 and the interest rate on the Debentures was reset as of August 11, 2004 to 4.104% per annum.

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**Notes to Consolidated Financial Statements**

**12. EQUITY SECURITY UNITS *(continued)***

In November 2004, the Company settled the purchase contracts associated with the Units by issuing 20.3 million new shares of Common Stock (based on 1.47 shares of Common Stock per purchase contract) for proceeds of \$690 million.

At the time of issuance of the Units, the Trust also issued 426,805 shares of common securities to Prudential Financial at a price of \$50 per common security for gross proceeds of \$21 million. The combined proceeds to the Trust from the issuances of the redeemable capital securities and the common securities were invested by the Trust in \$711 million of the 5.34% Debentures. As of December 31, 2003, the \$711 million of 5.34% Debentures are reported as Long-term debt, and the investment in common securities of \$21 million is reported in Other long-term investments. As of December 31, 2004 the \$690 million of 4.104% Debentures are reported as Long-term debt.

**13. STOCKHOLDERS EQUITY**

***Preferred Stock***

Prudential Financial adopted a shareholder rights plan (the rights plan) under which each outstanding share of Common Stock is coupled with a shareholder right. The rights plan is not applicable to any Class B Stock. Each right initially entitles the holder to purchase one one-thousandth of a share of a series of Prudential Financial preferred stock upon payment of the exercise price. At the time of the demutualization, the Board of Directors of Prudential Financial determined that the initial exercise price per right is \$110, subject to adjustment from time to time as provided in the rights plan. There was no preferred stock outstanding at December 31, 2004 and 2003.

***Common Stock and Class B Stock***

On the date of demutualization, Prudential Financial completed an initial public offering of 110.0 million shares of its Common Stock at an initial public offering price of \$27.50 per share. The shares of Common Stock issued in the offerings were in addition to shares of Common Stock the Company distributed to policyholders as part of the demutualization. On December 21, 2001, Prudential Financial issued an additional 16.5 million shares of Common Stock at an offering price of \$27.50 per share as a result of the exercise of the over-allotment option granted to underwriters in the initial public offering. The Common Stock is traded on the New York Stock Exchange under the symbol PRU. Also on the date of demutualization, Prudential Financial completed the sale, through a private placement, of 2.0 million shares of Class B Stock at a price of \$87.50 per share. The Class B Stock is a separate class of common stock which is not publicly traded. The Common Stock reflects the performance of the Financial Services Businesses and the Class B Stock reflects the performance of the Closed Block Business.

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Holders of Common Stock have no interest in a separate legal entity representing the Financial Services Businesses and holders of the Class B Stock have no interest in a separate legal entity representing the Closed Block Business and holders of each class of common stock are subject to all of the risks associated with an investment in the Company.

In the event of a liquidation, dissolution or winding-up of the Company, holders of Common Stock and holders of Class B Stock would be entitled to receive a proportionate share of the net assets of the Company that remain after paying all liabilities and the liquidation preferences of any preferred stock.

### *Dividends*

The principal sources of funds available to Prudential Financial, the parent holding company, to meet its obligations, including the payment of shareholder dividends, debt service, capital contributions and obligations to subsidiaries, and operating expenses, are cash and short-term investments, dividends, returns of capital, and

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**13. STOCKHOLDERS EQUITY (continued)**

interest income from its subsidiaries. The regulated insurance and various other subsidiaries are subject to regulatory limitations on their payment of dividends and other transfers of funds to Prudential Financial. Pursuant to Gibraltar Life's reorganization, in addition to regulatory restrictions, there are certain restrictions that preclude Gibraltar Life from paying dividends to Prudential Financial in the near term.

New Jersey insurance law provides that dividends or distributions may be declared or paid by Prudential Insurance without prior regulatory approval only from unassigned surplus, as determined pursuant to statutory accounting principles, less unrealized capital gains and certain other adjustments. Unassigned surplus of Prudential Insurance was \$3,327 million at December 31, 2004. There were applicable adjustments for unrealized gains of \$824 million at December 31, 2004. In addition, Prudential Insurance must obtain non-disapproval from the New Jersey insurance regulator before paying a dividend if the dividend, together with other dividends or distributions made within the preceding twelve months, would exceed the greater of 10% of Prudential Insurance's surplus as of the preceding December 31 (\$8.4 billion as of December 31, 2004) or its net gain from operations for the twelve month period ending on the preceding December 31, excluding realized capital gains and losses (\$1.5 billion for the year ended December 31, 2004).

The laws regulating dividends of Prudential Financial's other insurance subsidiaries domiciled in other states are similar, but not identical, to New Jersey's. The laws of foreign countries may also limit the ability of the Company's insurance and other subsidiaries organized in those countries to pay dividends to Prudential Financial.

The declaration and payment of dividends on the Common Stock depends primarily upon the financial condition, results of operations, cash requirements, future prospects and other factors relating to the Financial Services Businesses. Furthermore, dividends on the Common Stock are limited to both the amount that is legally available for payment under New Jersey corporate law if the Financial Services Businesses were treated as a separate corporation thereunder and the amount that is legally available for payment under New Jersey corporate law on a consolidated basis after taking into account dividends on the Class B Stock.

The declaration and payment of dividends on the Class B Stock depends upon the financial performance of the Closed Block Business and, as the Closed Block matures, the holders of the Class B Stock will receive the surplus of the Closed Block Business no longer required to support the Closed Block for regulatory purposes. Dividends on the Class B Stock are payable in an aggregate amount per year at least equal to the lesser of (1) a Target Dividend Amount of \$19.25 million or (2) the CB Distributable Cash Flow for such year, which is a measure of the net cash flows of the Closed Block Business. Notwithstanding this formula, as with any common stock, Prudential Financial will retain the flexibility to suspend dividends on the Class B Stock; however, if CB Distributable Cash Flow exists and Prudential Financial chooses not to pay dividends on the Class B Stock in an aggregate amount at least equal to the lesser of the CB Distributable Cash Flow or the Target Dividend Amount for any period, then cash dividends cannot be paid on the Common Stock with respect to such period.

***Stock Conversion Rights of the Class B Stock***



Prudential Financial may, at its option, at any time, exchange all outstanding shares of Class B Stock into such number of shares of Common Stock as have an aggregate average market value equal to 120% of the appraised fair market value of the outstanding shares of Class B Stock.

Holders of Class B Stock will be permitted to convert their shares of Class B Stock into such number of shares of Common Stock as have an aggregate average market value equal to 100% of the appraised fair market value of the outstanding shares of Class B Stock (1) in the holder's sole discretion, in the year 2016 or at any time thereafter, and (2) at any time in the event that (a) the Class B Stock will no longer be treated as equity of Prudential Financial for federal income tax purposes or (b) the New Jersey Department of Banking and Insurance amends, alters, changes or modifies the regulation of the Closed Block, the Closed Block Business, the Class B Stock or the IHC debt in a manner that materially adversely affects the CB Distributable Cash Flow; provided,

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**13. STOCKHOLDERS EQUITY (continued)**

however, that in no event may a holder of Class B Stock convert shares of Class B Stock to the extent such holder immediately upon such conversion, together with its affiliates, would be the beneficial owner (as defined under the Securities Exchange Act of 1934) of in excess of 9.9% of the total outstanding voting power of Prudential Financial's voting securities. In the event a holder of shares of Class B Stock requests to convert shares pursuant to clause (2)(a) in the preceding sentence, Prudential Financial may elect, instead of effecting such conversion, to increase the Target Dividend Amount to \$12.6875 per share per annum retroactively from the time of issuance of the Class B Stock.

***Common Stock Held in Treasury***

In January 2002, Prudential Financial's Board of Directors authorized a program to repurchase up to \$1 billion of Prudential Financial's outstanding Common Stock. During 2002, the Company acquired 26,027,069 shares of Common Stock at a total cost of \$800 million, including 1,696,929 shares at a cost of \$56 million that were immediately reissued to the Prudential Securities Incorporated ( Prudential Securities ) deferred compensation program referred to in Note 15.

In March 2003, Prudential Financial's Board of Directors authorized the Company to purchase up to an additional \$1 billion of its outstanding Common Stock. During 2003, the Company acquired 29,076,809 shares of its outstanding Common Stock at a total cost of \$1.0 billion.

In March 2004, Prudential Financial's Board of Directors authorized the Company to purchase up to \$1.5 billion of its outstanding Common Stock in 2004. This stock repurchase program superseded all previous repurchase programs. During 2004, the Company acquired 32,455,600 shares of its outstanding Common Stock at a total cost of \$1.5 billion.

In November 2004, Prudential Financial's Board of Directors authorized a new stock repurchase program under which the Company is authorized to purchase up to \$1.5 billion of its outstanding Common Stock in 2005. The timing and amount of repurchases under this authorization will be determined by management based upon market conditions and other considerations, and such repurchases may be effected in the open market or through negotiated transactions. The stock repurchase program supersedes the previous repurchase program.

Common Stock held in treasury is accounted for at cost. When these shares are reissued, the balance is reduced by the average cost per share.

***Comprehensive Income***

The components of comprehensive income for the years ended December 31, are as follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(in millions)		
Net income	\$ 2,256	\$ 1,264	\$ 194
Other comprehensive income, net of tax:			
Change in foreign currency translation adjustments	327	153	83
Change in net unrealized investments gains (losses)	(627)	(259)	1,606
Additional pension liability adjustment	(28)	(33)	(48)
Cumulative effect of accounting change	73		
	<u>          </u>	<u>          </u>	<u>          </u>
Other comprehensive income (loss), net of tax of \$(461), \$(159), \$818	(255)	(139)	1,641
	<u>          </u>	<u>          </u>	<u>          </u>
Comprehensive income	<u>\$ 2,001</u>	<u>\$ 1,125</u>	<u>\$ 1,835</u>

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## PRUDENTIAL FINANCIAL, INC.

## Notes to Consolidated Financial Statements

## 13. STOCKHOLDERS EQUITY (continued)

The balance of and changes in each component of Accumulated other comprehensive income (loss) for the years ended December 31, are as follows (net of taxes):

	Accumulated Other Comprehensive Income (Loss)			
	Foreign Currency Translation Adjustments	Net Unrealized Investment Gains (Losses)	Pension Liability Adjustment	Total Accumulated Other Comprehensive Income (Loss)
	(in millions)			
Balance, December 31, 2001	\$ (237)	\$ 1,228	\$ (47)	\$ 944
Change in component during year	83	1,606	(48)	1,641
Balance, December 31, 2002	(154)	2,834	(95)	2,585
Change in component during year	153	(259)	(33)	(139)
Balance, December 31, 2003	(1)	2,575	(128)	2,446
Change in component during year(a)	327	(554)	(28)	(255)
Balance, December 31, 2004	\$ 326	\$ 2,021	\$ (156)	\$ 2,191

(a) Net unrealized investment gains (losses) for 2004 includes the impact of cumulative effect of accounting change of \$73 million.

*Statutory Net Income and Surplus*

Prudential Financial's U.S. insurance subsidiaries are required to prepare statutory financial statements in accordance with statutory accounting practices prescribed or permitted by the insurance department of the state of domicile. Statutory accounting practices primarily differ from GAAP by charging policy acquisition costs to expense as incurred, establishing future policy benefit liabilities using different actuarial assumptions as well as valuing investments and certain assets and accounting for deferred taxes on a different basis. Statutory net income (loss) of Prudential Insurance amounted to \$1,878 million, \$1,231 million and \$(490) million for the years ended December 31, 2004, 2003 and 2002, respectively. Statutory capital and surplus of Prudential Insurance amounted to \$8,420 million and \$7,472 million at December 31, 2004 and 2003, respectively.

**14. 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 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 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.

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## PRUDENTIAL FINANCIAL, INC.

## Notes to Consolidated Financial Statements

## 14. EARNINGS PER SHARE (continued)

## Common Stock

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

	2004		2003			2002			
	(amounts in millions except per share amounts)								
							Per		
	Income	Weighted Average Shares	Per Share Amount	Income	Weighted Average Shares	Per Share Amount	Income	Weighted Average Shares	Share Amount
<b>Basic earnings per share</b>									
Income from continuing operations before extraordinary gain on acquisition and cumulative effect of accounting change attributable to the Financial Services Businesses	\$ 1,750			\$ 1,083			\$ 755		
Direct equity adjustment	84			60			43		
	<u>1,834</u>	<u>520.6</u>	<u>\$ 3.52</u>	<u>1,143</u>	<u>544.4</u>	<u>\$ 2.10</u>	<u>798</u>	<u>576.6</u>	<u>\$ 1.38</u>
<b>Effect of dilutive securities and compensation programs</b>									
Stock options		4.1			1.5			0.8	
Deferred and long-term compensation programs		2.1			1.5			0.6	
Equity security units		4.4			1.0				
		<u>10.6</u>			<u>4.0</u>				
<b>Diluted earnings per share</b>									
Income from continuing operations before extraordinary gain on acquisition and cumulative effect of accounting change attributable to the Financial Services Businesses available to holders of Common Stock after direct equity adjustment	\$ 1,834	531.2	\$ 3.45	\$ 1,143	548.4	\$ 2.08	\$ 798	578.0	\$ 1.38

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For the years ended December 31, 2004, 2003 and 2002, 4.5 million, 9.3 million and 5.3 million options, respectively, weighted for the portion of the period they were outstanding, with a weighted average exercise price of \$44.94, \$31.66 and \$32.97 per share, respectively, were excluded from the computation of diluted earnings per share because the options, based on application of the treasury stock method, were antidilutive.

### *Class B Stock*

The net income (loss) attributable to the Closed Block Business available to holders of Class B Stock after direct equity adjustment for the years ended December 31, 2004, 2003 and 2002, respectively, amounted to \$498 million, \$179 million, and \$(528) million, respectively. For the years ended December 31, 2004 and 2003 the direct equity adjustment resulted in decreases of \$84 million and \$60 million in the net income attributable to the Closed Block Business applicable to holders of Class B Stock for earnings per share purposes. For the year ended December 31, 2002, the direct equity adjustment resulted in an increase in loss of \$43 million applicable to holders of the Class B Stock for earnings per share purposes. For the years ended December 31, 2004, 2003 and 2002, the weighted average number of shares of Class B Stock used in the calculation of basic earnings per share amounted to 2 million shares. There are no potentially dilutive shares associated with the Class B Stock.

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**15. STOCK-BASED COMPENSATION**

In March 2003, the Company's Board of Directors adopted the Prudential Financial Inc. Omnibus Incentive Plan (the Omnibus Plan). Upon adoption of the Omnibus Plan, the Prudential Financial Inc. Stock Option Plan previously adopted by the Company on January 9, 2001 (the Option Plan) was merged into the Omnibus Plan. The Omnibus Plan provides for equity-based compensation incentives through the grant of stock options, stock appreciation rights (SARs), restricted stock shares, restricted stock units, and dividend equivalents, as well as cash and equity-based performance awards (performance shares). Any authorized shares of Common Stock not used under the Option Plan are available for the grant of awards under the Omnibus Plan. All outstanding award grants under the Option Plan continue in full force and effect, subject to the original terms under the Option Plan.

At adoption of the Omnibus Plan there were 69,543,352 authorized shares available for grant, including previously authorized but unissued shares under the Option Plan.

As of December 31, 2004, 57,856,334 authorized shares remained available for grant under the Omnibus Plan including previously authorized but unissued shares under the Option Plan.

Under the Omnibus Plan, the Company made grants of stock options, restricted stock shares, restricted stock units and performance share awards to executives. Restricted stock awards, restricted stock units, stock options and performance shares are granted to executives on a recurring basis primarily as replacements for a portion of long-term cash compensation.

Through December 31, 2004, there have been no grants of SARs.

***Options***

Under the Option Plan, the Company had made two types of grants, an Associates Grant and general grants (the Executive Grants). The Associates Grant, which occurred in December 2001, was a one-time broad based award that granted 240 stock options per full-time participant and 120 options per part-time participant. The Executive Grants, which began in 2002, are awarded to certain officers on a recurring basis primarily as replacement for a portion of long-term cash compensation. Each stock option granted under either type of grant has or will have an exercise price no less than the fair market value of the Company's Common Stock on the date of grant and has a maximum term of 10 years. Generally, one third of the option grant vests in each of the next three years. Participants are employees and non-employees (i.e., statutory agents who perform services for the Company and participating subsidiaries).



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Under the Option Plan, and subsequently the Omnibus Plan, a total of 12,322,009 shares were initially authorized for the Associates Grant and a total of 30,805,024 shares were initially authorized for the Executive Grants.

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A summary of the status of the Company's employee stock option grants is as follows:

	Shares	Weighted Average Exercise Price
Outstanding at December 31, 2001	11,205,960	\$ 27.53
Granted	10,367,694	33.53
Exercised	(45,109)	27.50
Forfeited	(2,338,522)	28.29
Expired		
Transfer to non-employee status	(68,662)	27.70
Outstanding at December 31, 2002	19,121,361	30.69
Granted	8,575,698	29.66
Exercised	(1,818,239)	28.60
Forfeited	(5,009,860)	29.40
Expired		
Transfer to non-employee status	(77,586)	27.55
Outstanding at December 31, 2003	20,791,374	30.77
Granted	5,258,900	44.98
Exercised	(3,144,888)	30.29
Forfeited	(1,352,841)	33.51
Expired		
Transfer to non-employee status	(105,450)	27.79
Outstanding at December 31, 2004	21,447,095	\$ 34.17

Options exercisable were 10,277,942 shares with a weighted average exercise price of \$30.69 at December 31, 2004, 7,424,250 shares with a weighted average exercise price of \$30.21 at December 31, 2003 and 3,291,965 shares with a weighted average exercise price of \$27.72 at December 31, 2002.

Employee options granted and their related grant date weighted average fair value are as follows:

	2004			2003			2002		
	Shares	Weighted Average Grant Date Fair Value	Weighted Average Exercise Price	Shares	Weighted Average Grant Date Fair Value	Weighted Average Exercise Price	Shares	Weighted Average Grant Date Fair Value	Weighted Average Exercise Price
		Value	Price		Value	Price		Value	Price
Exercise equals market	5,258,900	\$ 11.47	\$ 44.98	8,575,698	\$ 7.39	\$ 29.66	10,367,694	\$ 11.87	\$ 33.53
Exercise exceeds market									
Exercise less than market									
<b>Total granted during the year</b>	<b>5,258,900</b>	<b>\$ 11.47</b>	<b>\$ 44.98</b>	<b>8,575,698</b>	<b>\$ 7.39</b>	<b>\$ 29.66</b>	<b>10,367,694</b>	<b>\$ 11.87</b>	<b>\$ 33.53</b>

For options issued to employees 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 fair value of each option issued to employees prior to January 1, 2003 was estimated on the date of grant using a Black-Scholes option-pricing model. The weighted average assumptions used in the determination of the fair value of each option are as follows:

	2004	2003	2002
Dividend yield	1.20%	1.20%	1.05%
Expected volatility	25.84%	26.27%	33.33%
Risk-free interest rate	3.42%	3.01%	3.98%
Expected life of stock option	5.5 years	5.5 years	6 years

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****15. STOCK-BASED COMPENSATION (continued)**

The dividend yield reflects the assumption that the current dividend payout will continue with no anticipated increases.

The following table summarizes information about the employee stock options outstanding and employee stock options exercisable at December 31, 2004:

	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
Range of exercise prices:					
\$27.50 \$29.81	4,237,218	7.15	\$ 27.62	3,862,453	\$ 27.58
\$29.90 \$33.95	12,075,415	7.81	31.98	6,330,691	32.50
\$34.10 \$45.00	4,958,559	9.10	44.66	84,199	37.40
\$45.18 \$53.82	175,903	9.39	46.14	599	46.42
<b>Total</b>	<b>21,447,095</b>	<b>7.99</b>	<b>\$ 34.17</b>	<b>10,277,942</b>	<b>\$ 30.69</b>

**Non-employee Stock Option Grants**

A summary of the status of the Company's non-employee stock option grants is as follows:

	Shares	Weighted Average Exercise Price
Outstanding at December 31, 2001	813,600	\$ 27.50
Granted	83,980	33.96
Exercised	(2,480)	27.50
Forfeited	(99,935)	27.54

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Expired		
Transfer from employee status	68,662	27.70
	<u>          </u>	<u>          </u>
Outstanding at December 31, 2002	863,827	28.14
Granted	163,159	28.61
Exercised	(68,100)	27.65
Forfeited	(71,116)	27.59
Expired		
Transfer from employee status	77,586	27.55
	<u>          </u>	<u>          </u>
Outstanding at December 31, 2003	965,356	28.25
Granted	112,707	45.92
Exercised	(354,717)	28.26
Forfeited	(69,596)	29.48
Expired		
Transfer from employee status	105,450	27.79
	<u>          </u>	<u>          </u>
Outstanding at December 31, 2004	759,200	\$ 30.68
	<u>          </u>	<u>          </u>

Options exercisable were 517,978 shares with a weighted average exercise price of \$27.80 at December 31, 2004, 495,397 shares with a weighted average exercise price of \$27.85 at December 31, 2003 and 268,080 shares with a weighted average exercise price of \$27.50 at December 31, 2002. The weighted average fair value for nonvested options and options vesting during the year was \$22.19, \$14.80, and \$9.26 for the years ended December 31, 2004, 2003 and 2002, respectively.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****15. STOCK-BASED COMPENSATION (continued)**

In 2003, the Company implemented a binomial option-pricing model. The fair value of each option under the binomial model was estimated on the balance sheet date for nonvested options and on the vesting date for any option vesting during 2003 and 2004. Prior to January 1, 2003, the fair value of each option was estimated on the balance sheet date for nonvested options and on the vesting date for vested options using a Black-Scholes option-pricing model. The weighted average assumptions used in the determination of the fair value of each option are as follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Dividend yield	1.20%	1.20%	1.30%
Expected volatility	25.84%	26.27%	35.60%
Risk-free interest rate	3.10%	2.47%	2.15%
Expected life of stock option	3.33 years	3.20 years	3.21 years

The dividend yield reflects the assumption that the current dividend payout will continue with no anticipated increases.

The compensation expense recognized for stock-based non-employee compensation awards was \$6 million, \$5 million, and \$4 million for the years ended December 31, 2004, 2003 and 2002, respectively.

The following table summarizes information about the non-employee stock options outstanding and exercisable at December 31, 2004:

	<u>Options Outstanding</u>			<u>Options Exercisable</u>	
	<u>Number Outstanding</u>	<u>Weighted Average Remaining Contractual Life</u>	<u>Weighted Average Exercise Price</u>	<u>Number Exercisable</u>	<u>Weighted Average Exercise Price</u>
Range of exercise prices:					
\$27.50 \$29.90	604,302	7.23	\$ 27.71	499,305	\$ 27.55
\$30.96 \$33.95	44,665	7.54	33.72	16,552	33.77
\$34.24 \$46.42	110,233	9.13	45.75	2,121	40.15
<b>Total</b>	<b>759,200</b>	<b>7.53</b>	<b>\$ 30.68</b>	<b>517,978</b>	<b>\$ 27.80</b>

*Restricted Stock Shares, Restricted Stock Units and Performance Share Awards*

A restricted stock share represents a grant of Common Stock to employee and non-employee participants that is subject to certain transfer restrictions and forfeiture provisions for a specified period of time. A restricted stock unit is an unfunded, unsecured right to receive a share of Common Stock at the end of a specified period of time, which is also subject to forfeiture and transfer restrictions. Generally, the restrictions on restricted stock shares and restricted stock units will lapse on the third anniversary of the date of grant. Restricted stock shares subject to the transfer restrictions and forfeiture provisions are considered nonvested shares. Nonvested shares forfeited by participants revert to the Company and are reflected as Common Stock held in treasury as of the date of forfeiture.

Performance share awards are awards of units denominated in Common Stock. The number of units is determined over the performance period, and may be adjusted based on the satisfaction of certain performance goals. Performance share awards are payable in Common Stock.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****15. STOCK-BASED COMPENSATION (continued)**

Restricted stock shares, restricted stock units and performance shares are primarily awarded as a portion of long-term compensation. The following tables summarize awards granted, weighted average price and nonvested awards for restricted stock shares, restricted stock units and performance shares for the periods indicated:

	2004				
	Awards Granted			Weighted Average Grant Date Price	Weighted Average Balance Sheet Date Price
	Employee	Non-Employee	Total	Employee	Non-Employee
Restricted stock shares	1,376,892	10,629	1,387,521	\$ 44.96	\$ 54.96
Restricted stock units	94,084	844	94,928	45.00	54.96
Performance shares(a)	502,545		502,545	44.93	
<b>Total</b>	<b>1,973,521</b>	<b>11,473</b>	<b>1,984,994</b>	<b>\$ 44.95</b>	<b>\$ 54.96</b>

  

	2003				
	Awards Granted			Weighted Average Grant Date Price	Weighted Average Balance Sheet Date Price
	Employee	Non-Employee	Total	Employee	Non-Employee
Restricted stock shares	1,917,152	13,946	1,931,098	\$ 33.66	\$ 41.77
Restricted stock units	139,452		139,452	33.61	
Performance shares(a)	236,933		236,933	33.61	
<b>Total</b>	<b>2,293,537</b>	<b>13,946</b>	<b>2,307,483</b>	<b>\$ 33.65</b>	<b>\$ 41.77</b>

(a) Performance shares reflect the target awarded, reduced for cancellations and releases to date. The actual number of shares to be awarded at the end of each performance period will range between 50% and 150% of this target based upon a measure of the reported performance for the Company's Financial Services



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Businesses relative to stated goals.

The weighted average price of employee restricted stock shares, restricted stock units, and performance shares is based on the quoted fair value of the Company's Common Stock on the date of grant. The weighted average price of non-employee restricted stock shares is based on the Company's Common Stock price at the balance sheet date.

Compensation cost of awards is based on the weighted average price for each award and is recorded as expense over the vesting period which is typically three years. The compensation expense recognized for employee and non-employee restricted stock shares was \$34 million and \$19 million for the years ended December 31, 2004 and 2003, respectively. The compensation expense recognized for employee restricted stock units and performance shares combined was \$18 million and \$4 million for the years ended December 31, 2004 and 2003, respectively.

	<b>Nonvested Shares at December 31, 2004</b>		
	<b>Employee</b>	<b>Non-Employee</b>	<b>Total</b>
Restricted stock shares	2,689,264	22,867	2,712,131
Restricted stock units	221,951	844	222,795
Performance shares(a)	726,377		726,377
<b>Total</b>	<b>3,637,592</b>	<b>23,711</b>	<b>3,661,303</b>

- (a) Performance shares reflect the target awarded, reduced for cancellations and releases to date. The actual number of shares to be awarded at the end of each performance period will range between 50% and 150% of this target based upon a measure of the reported performance for the Company's Financial Services Businesses relative to stated goals.

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**15. STOCK-BASED COMPENSATION (continued)**

***Deferred Compensation Program***

Prior to the contribution of the Company's retail securities brokerage and clearing operations into the joint venture with Wachovia on July 1, 2003, the Company maintained a deferred compensation program for Financial Advisors and certain other employees (the participants) of the contributed operations, under which participants elected to defer a portion of their compensation. Amounts deposited to participant accounts, including matching contributions as well as other amounts based on the attainment of specific performance goals, vest in 3 to 8 years. Nonvested balances are forfeited if the participant is terminated for cause or voluntarily terminates prior to the vesting date. In 2002, participants were permitted to elect to redeem all or a portion of their existing nonvested account balances and invest the proceeds in Prudential Financial Common Stock. Accordingly, the Company acquired, on behalf of the participants electing to participate, 1,696,929 shares of Common Stock at a total cost of \$56 million. On the date the account balances were converted to Common Stock, related remaining deferred compensation expense of \$29 million, which is being amortized over the vesting period, was recorded as a reduction in stockholders' equity. The deferred compensation expense of \$14 million, as of July 1, 2003, was included in the net assets of the Company's retail securities brokerage and clearing operations contributed to the joint venture with that of Wachovia. The results of operations of the joint venture, of which the Company owns a 38% interest, will include the amortization of the deferred compensation expense. As of December 31, 2004, there were 356,291 nonvested shares in participants accounts. The Company continues to repurchase forfeited shares from the joint venture, which are reflected as Common Stock held in treasury as of the date of forfeiture.

**16. EMPLOYEE BENEFIT PLANS**

***Pension and Other Postretirement Plans***

The Company has funded and non-funded contributory and non-contributory defined benefit pension plans, which cover substantially all of its employees. For some employees, benefits are based on final average earnings and length of service, while benefits for other employees are based on a notional account balance that increases based on age, service and salary during their career.

The Company provides certain life insurance and health care benefits for its retired employees, their beneficiaries and covered dependents (other postretirement benefits). The health care plan is contributory; the life insurance plan is non-contributory. Substantially all of the Company's U.S. employees may become eligible to receive other postretirement benefits if they retire after age 55 with at least 10 years of service or under certain circumstances after age 50 with at least 20 years of continuous service. The Company has elected to amortize its transition obligation for other postretirement benefits over 20 years.

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On December 8, 2003, President Bush signed the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 ( the Act ) into law. The Act introduces a prescription drug benefit under Medicare (Medicare Part D) beginning in 2006. Under the Act, employers who sponsor postretirement plans that provide prescription drug benefits that are actuarially equivalent to Medicare qualify to receive subsidy payments.

On January 12, 2004, the FASB issued FSP 106-1, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003. As permitted by FSP 106-1, the Company elected to defer the accounting for the effects of the Act in 2003.

On May 19, 2004, the FASB issued FSP 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003. In accordance with FSP 106-2, the Company remeasured its plan assets and Accumulated Postretirement Benefit Obligation ( APBO ) as of January 1, 2004 to account for the subsidy and other effects of the Act. This remeasurement resulted in a \$39 million reduction in postretirement benefit costs in 2004. The \$39 million reduction in postretirement benefit costs reflects \$33 million as a result of the subsidy and is comprised of a \$18 million reduction in the amortization of actuarial loss, a \$15 million reduction in interest costs, and a \$0 million reduction in service cost. The reduction in the APBO for the subsidy related to past service was \$337 million.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****16. EMPLOYEE BENEFIT PLANS (continued)**

Prepaid and accrued benefits costs are included in Other assets and Other liabilities, respectively, in the Company's Consolidated Statements of Financial Position. The status of these plans as of September 30, adjusted for fourth-quarter activity, is summarized below:

	Pension Benefits		Other Postretirement Benefits	
	2004	2003	2004	2003
(in millions)				
<b>Change in benefit obligation</b>				
Benefit obligation at the beginning of period	\$ (7,789)	\$ (7,570)	\$ (2,859)	\$ (2,434)
Service cost	(147)	(180)	(10)	(14)
Interest cost	(416)	(444)	(148)	(152)
Plan participants' contributions	(1)	(1)	(15)	(11)
Amendments		(17)	(13)	73
Annuity purchase	3	3		
Actuarial gains/(losses), net	27	(645)	146	(559)
Settlements	4	436		
Curtailments	1	130		1
Contractual termination benefits		(1)		
Special termination benefits		(61)		(1)
Benefits paid	773	642	211	171
Foreign currency changes	(42)	(81)	(2)	(4)
Divestiture				71
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Benefit obligation at end of period	\$ (7,587)	\$ (7,789)	\$ (2,690)	\$ (2,859)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Change in plan assets</b>				
Fair value of plan assets at beginning of period	\$ 8,731	\$ 7,914	\$ 1,131	\$ 1,156
Actual return on plan assets	1,195	1,391	112	128
Annuity purchase	(3)	(3)		
Employer contributions	89	74	9	8
Plan participants' contributions	1	1	15	10
Contributions for settlements	1	423		
Disbursement for settlements	(4)	(436)		
Benefits paid	(773)	(642)	(211)	(171)
Foreign currency changes	9	9		
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Fair value of plan assets at end of period	\$ 9,246	\$ 8,731	\$ 1,056	\$ 1,131
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Funded status</b>				
Funded status at end of period	\$ 1,659	\$ 942	\$ (1,634)	\$ (1,728)
Unrecognized transition (asset) liability		(23)	5	6
Unrecognized prior service costs	157	181	(54)	(74)

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Unrecognized actuarial losses, net	1,001	1,428	659	866
Effects of fourth quarter activity	12	9	3	1
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net amount recognized	\$ 2,829	\$ 2,537	\$ (1,021)	\$ (929)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Amounts recognized in the Statements of Financial Position</b>				
Prepaid benefit cost	\$ 3,689	\$ 3,328	\$	\$
Accrued benefit liability	(1,100)	(1,003)	(1,021)	(929)
Intangible asset	12	17		
Accumulated other comprehensive income	228	195		
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net amount recognized	\$ 2,829	\$ 2,537	\$ (1,021)	\$ (929)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Accumulated benefit obligation	\$ (7,299)	\$ (7,249)	\$ (2,690)	\$ (2,859)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

Pension benefits for foreign plans comprised 9% and 7% of the ending benefit obligation for 2004 and 2003, respectively. Foreign plans comprised 1% and 1% of the ending fair value of market assets for 2004 and 2003, respectively. There are no foreign postretirement plans.

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**16. EMPLOYEE BENEFIT PLANS (continued)**

The projected benefit obligations, accumulated benefit obligations and fair value of plan assets for the pension plans with accumulated benefit obligations in excess of plan assets were \$1,305 million, \$1,186 million and \$124 million, respectively, at September 30, 2004 and \$1,195 million, \$1,057 million and \$88 million, respectively, at September 30, 2003.

In 2004 and 2003, the pension plan purchased annuity contracts from Prudential Insurance for \$3 million and \$3 million, respectively. The approximate future annual benefit payment for all annuity contracts was \$23 million and \$22 million in 2004 and 2003, respectively.

There were no material pension amendments in 2004. The benefit obligation for pensions increased by \$17 million in 2003 for the inclusion of a new non-qualified pension plan for mid-career hires.

The benefit obligation for other postretirement benefits increased by \$13 million in 2004 for changes in the substantive plan made to medical, dental and life insurance benefits. There was an increase in cost of \$11 million related to cost sharing changes for certain retirees for medical benefits. There was also an increase in cost of \$2 million associated with providing Prudential Financial benefits to employees of Cigna Life that were brought into Prudential Financial postretirement plans reflected at the January 1, 2004 remeasurement with credit for prior service. The benefit obligation for other postretirement benefits decreased by \$73 million in 2003 for changes in the substantive plan made to medical, dental and life insurance benefits. There was a reduction in cost related to changes in the prescription drug program of \$39 million and a reduction of \$39 million for cost sharing shifts to certain retirees for medical and dental benefits. There was an increase in cost of \$5 million associated with providing Prudential Financial benefits to former Prudential Securities employees that transferred to Prudential Financial effective July 1, 2003.

The pension benefits were amended during the time period presented for 2002 to provide contractual termination benefits to certain plan participants whose employment had been terminated. Costs related to these amendments are reflected in contractual termination benefits in the table below.

Employees were provided special termination benefits in conjunction with their termination of employment related to the Prudential Securities and Prudential Property and Casualty transactions in 2003. These benefits include the cost of vesting plan participants, accruing benefits until year-end, crediting service for vesting purposes and certain early retirement subsidies. Costs related to these amendments are reflected in special termination benefits in the table below.

Net periodic (benefit) cost included in General and administrative expenses in the Company's Consolidated Statements of Operations for the years ended December 31, includes the following components:

	Pension Benefits			Other Postretirement Benefits		
	2004	2003	2002	2004	2003	2002
(in millions)						
<b>Components of net periodic (benefit) cost</b>						
Service cost	\$ 147	\$ 180	\$ 175	\$ 10	\$ 14	\$ 14
Interest cost	416	444	463	148	152	152
Expected return on plan assets	(831)	(839)	(913)	(81)	(83)	(114)
Amortization of transition amount	(23)	(106)	(106)	1	3	17
Amortization of prior service cost	25	29	30	(7)	(1)	
Amortization of actuarial (gain) loss, net	23	14	(45)	28	10	(10)
Settlements		16				
Curtailments		31				
Contractual termination benefits	(1)		1			
Special termination benefits		61			1	
<b>Net periodic (benefit) cost</b>	<b>\$ (244)</b>	<b>\$ (170)</b>	<b>\$ (395)</b>	<b>\$ 99</b>	<b>\$ 96</b>	<b>\$ 59</b>

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The increase in the minimum liability included in Accumulated other comprehensive income as of September 30, 2004 and September 30, 2003 is as follows:

	Pension Benefits		Other Postretirement Benefits	
	2004	2003	2004	2003
	(in millions)			
Increase in minimum liability included in other comprehensive income	\$ 33	\$ 59	\$	\$

The assumptions as of September 30, used by the Company to calculate the domestic benefit obligations as of that date and to determine the benefit cost in the year are as follows:

	Pension Benefits			Other Postretirement Benefits			
	2004	2003	2002	2004	2003	2002	
<b>Weighted-average assumptions</b>							
Discount rate (beginning of period)	5.75%	6.50%	7.25%	5.75%	6.50%	7.25%	
Discount rate (end of period)	5.75%	5.75%	6.50%	5.50%	5.75%	6.50%	
Rate of increase in compensation levels (beginning of period)	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	
Rate of increase in compensation levels (end of period)	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	
Expected return on plan assets (beginning of period)	8.75%	8.75%	9.50%	7.75%	7.75%	9.00%	
Health care cost trend rates (beginning of period)				6.05	10.00%	6.40	10.00%
Health care cost trend rates (end of period)				5.44	10.00%	6.05	10.00%
For 2004, 2003 and 2002, the ultimate health care cost trend rate after gradual decrease until: 2009, 2007, 2007 (beginning of period)				5.00%	5.00%	5.00%	
For 2004, 2003 and 2002, the ultimate health care cost trend rate after gradual decrease until: 2009, 2007, 2007 (end of period)				5.00%	5.00%	5.00%	

The assumptions for foreign pension plans are based on local markets. There are no foreign postretirement plans.



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The pension and postretirement expected long term rates of return for 2004 were determined based upon an approach that considered an expectation of the allocation of plan assets during the measurement period of 2004. Expected returns are estimated by asset class as noted in the discussion of investment policies and strategies below. The expected returns by an asset class contemplate the risk free interest rate environment as of the measurement date and then add a risk premium. The risk premium is a range of percentages and is based upon historical information and other factors such as expected reinvestment returns and asset manager performance.

The Company applied the same approach to the determination of the expected long term rate of return in 2005. The expected long term rate of return for 2005 is 8.50% and 8.25%, respectively, for the pension and postretirement plans.

The Company, with respect to pension benefits, uses market related value to determine the components of net periodic benefit cost. Market related value is a measure of asset value that reflects the difference between actual and expected return on assets over a five year period.

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Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plan. A one-percentage point increase and decrease in assumed health care cost trend rates would have the following effects:

	<b>Other Postretirement Benefits</b>
	<b>2004</b>
	<b>(in millions)</b>
<b>One percentage point increase</b>	
Increase in total service and interest costs	\$ 12
Increase in postretirement benefit obligation	209
<b>One percentage point decrease</b>	
Decrease in total service and interest costs	\$ 10
Decrease in postretirement benefit obligation	178

Pension and postretirement plan asset allocation as of September 30, 2004 and September 30, 2003, are as follows:

<b>Asset category</b>	<b>Pension Percentage of Plan Assets as of September 30</b>		<b>Postretirement Percentage of Plan Assets as of September 30</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
U.S. Stocks	41%	49%	58%	52%
International Stocks	12%	9%	6%	5%
Bonds	39%	34%	22%	20%
Short-term Investments	0%	2%	3%	3%
Real Estate	6%	6%	0%	0%
Municipal Bonds	0%	0%	11%	20%
Other	2%	0%	0%	0%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

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The Company, for its domestic pension and postretirement plans, has developed guidelines for asset allocations. As of the September 30, 2004 measurement date the range of target percentages are as follows:

<b>Asset category</b>	<b>Pension Investment Policy Guidelines as of September 30, 2004</b>		<b>Postretirement Investment Policy Guidelines as of September 30, 2004</b>	
	<b>Minimum</b>	<b>Maximum</b>	<b>Minimum</b>	<b>Maximum</b>
U.S. Stocks	30%	51%	28%	68%
International Stocks	5%	16%	1%	8%
Bonds	42%	68%	11%	50%
Short-term Investments	0%	21%	0%	29%
Real Estate	2%	7%	0%	3%
Municipal Bonds	0%	0%	12%	12%
Other	0%	10%	0%	0%

Management reviews its investment strategy on an annual basis.

The investment goal of the domestic pension plan assets is to generate an above benchmark return on a diversified portfolio of stocks, bonds and real estate, while meeting the cash requirements for a pension obligation that includes a traditional formula principally representing payments to annuitants and a cash balance

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formula that allows lump sum payments and annuity payments. The pension plan risk management practices include guidelines for asset concentration, credit rating and liquidity. The pension plan does not invest in leveraged derivatives. Derivatives such as futures contracts are used to reduce transaction costs and change asset concentration.

The investment goal of the domestic postretirement plan assets is to generate an above benchmark return on a diversified portfolio of stocks, real estate, bonds and municipal bonds, while meeting the cash requirements for the postretirement obligations that includes a medical benefit including prescription drugs, a dental benefit and a life benefit. The postretirement equity is used to provide expected growth in assets deposited into the plan assets. Bonds provide liquidity and income. Real estate provides for capital growth and income. Short-term investments provide liquidity and allow for defensive asset mixes. Municipal bonds provide liquidity and tax efficient income, where appropriate. The postretirement plans risk management practices include guidelines for asset concentration, credit rating, liquidity, and tax efficiency. The postretirement plan does not invest in leveraged derivatives. Derivatives such as futures contracts are used to reduce transaction costs and change asset concentration.

There were no investments in Prudential Financial Common Stock as of September 30, 2004 or 2003 for either the pension or postretirement plans. Pension plan assets of \$7,161 million and \$7,311 million are included in Separate Account assets and liabilities as of September 30, 2004 and 2003, respectively.

The expected benefit payments for the Company's domestic pension and postretirement plans for the years indicated are as follows:

	<b>Pension</b>	<b>Other Postretirement Benefits</b>	<b>Other Postretirement Benefits Subsidy Receipt</b>
	<u>          </u>	<u>          </u>	<u>          </u>
	(in millions)		
2005	\$ 458	\$ 238	\$
2006	455	247	18
2007	458	253	19
2008	461	255	20
2009	464	255	21
2010-2014	2,423	1,267	121
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Total</b>	<b>\$ 4,719</b>	<b>\$ 2,515</b>	<b>\$ 199</b>
	<u>          </u>	<u>          </u>	<u>          </u>

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The Company anticipates that it will make cash contributions in 2005 of \$73 million to the pension plans and \$10 million to the postretirement plans.

### *Postemployment Benefits*

The Company accrues postemployment benefits primarily for life and health benefits provided to former or inactive employees who are not retirees. The net accumulated liability for these benefits at December 31, 2004 and 2003 was \$62 million and \$52 million, respectively, and is included in Other liabilities.

### *Other Employee Benefits*

The Company sponsors voluntary savings plans for employees (401(k) plans). The plans provide for salary reduction contributions by employees and matching contributions by the Company of up to 4% of annual salary. The matching contributions by the Company included in General and administrative expenses were \$52 million, \$54 million and \$55 million for the years ended December 31, 2004, 2003 and 2002, respectively.

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The components of income tax expense (benefit) for the years ended December 31, were as follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(in millions)		
Current tax expense (benefit)			
U.S.	\$ 497	\$ 108	\$ (124)
State and local	23	23	2
Foreign	81	38	32
	<u>601</u>	<u>169</u>	<u>(90)</u>
Deferred tax expense (benefit)			
U.S.	54	143	(238)
State and local	(26)	43	(61)
Foreign	326	302	201
	<u>354</u>	<u>488</u>	<u>(98)</u>
Total income tax expense (benefit)	<u>\$ 955</u>	<u>\$ 657</u>	<u>\$ (188)</u>

The Company's actual income tax expense (benefit) for the years ended December 31, differs from the expected amount computed by applying the statutory federal income tax rate of 35% to income from continuing operations before income taxes, extraordinary gain on acquisition and cumulative effect of accounting change for the following reasons:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(in millions)		
Expected federal income tax expense	\$ 1,151	\$ 693	\$ 30
Assumed repatriation of foreign earnings		120	
Disposition of subsidiaries		(78)	(183)
Non-taxable investment income	(149)	(72)	(116)
State and local income taxes	(9)	43	(41)
Non-deductible expenses	6	(12)	40
Valuation allowance	(24)	(2)	37
Other	(20)	(35)	45
	<u>\$ 955</u>	<u>\$ 657</u>	<u>\$ (188)</u>

Deferred tax assets and liabilities at December 31, resulted from the items listed in the following table:

	<b>2004</b>	<b>2003</b>
	<b>(in millions)</b>	
<b>Deferred tax assets</b>		
Insurance reserves	\$ 1,314	\$ 1,282
Policyholder dividends	1,207	1,230
Net operating and capital loss carryforwards	1,118	263
Other	1,548	791
	<u>5,187</u>	<u>3,566</u>
Deferred tax assets before valuation allowance	5,187	3,566
Valuation allowance	(677)	(230)
	<u>4,510</u>	<u>3,336</u>
<b>Deferred tax liabilities</b>		
Net unrealized investment gains	2,951	3,166
Deferred policy acquisition costs	2,249	1,943
Employee benefits	365	253
Other	990	82
	<u>6,555</u>	<u>5,444</u>
Deferred tax liabilities	6,555	5,444
<b>Net deferred tax liability</b>	<b>\$ (2,045)</b>	<b>\$ (2,108)</b>

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**Notes to Consolidated Financial Statements**

**17. INCOME TAXES (continued)**

Management believes that based on its historical pattern of taxable income, the Company will produce sufficient income in the future to realize its deferred tax asset after valuation allowance. A valuation allowance has been recorded primarily related to tax benefits associated with foreign operations and state and local deferred tax assets. The valuation allowance as of December 31, 2004 includes \$443 million recorded in connection with the acquisition of Hyundai.

Adjustments to the valuation allowance will be made if there is a change in management's assessment of the amount of the deferred tax asset that is realizable. At December 31, 2004 and 2003, respectively, the Company had federal net operating and capital loss carryforwards of \$874 million and \$170 million, which expire between 2007 and 2024. At December 31, 2004 and 2003, respectively, the Company had state operating and capital loss carryforwards for tax purposes approximating \$2,655 million and \$5,160 million, which expire between 2007 and 2024. At December 31, 2004 and 2003, respectively, the Company had foreign operating loss carryforwards for tax purposes approximating \$2,090 million and \$35 million, \$2,066 million of which expires between 2005 and 2011 and \$24 million of which have an unlimited carryforward.

During the third quarter of 2004, the Company completed a review of its deferred tax accounts relating to Gibraltar Life that identified a miscalculation of deferred tax assets before valuation allowance. As a result, deferred tax assets before valuation allowance at April 1, 2001 (Gibraltar Life's acquisition date) have been increased by approximately \$130 million. Analysis of the recoverability of these tax benefits as of the same date caused the Company to record a valuation allowance in a substantially equivalent amount, resulting in no material change in net deferred tax assets as of that date.

The Company previously had not provided U.S. income taxes on unremitted foreign earnings of its non-U.S. operations because such earnings had been considered to be permanently reinvested in such operations. During 2003, the Company determined that earnings from companies in high tax jurisdictions will be repatriated to the U.S. Accordingly, earnings from its Japanese insurance operations and German investment management subsidiaries are no longer considered permanently reinvested. The U.S. income tax benefit of \$31 million associated with the assumed repatriation of 2004 earnings has been recognized. The Company has undistributed earnings of foreign subsidiaries, other than its Japanese insurance operations and German investment management subsidiaries, of \$862 million and \$674 million at December 31, 2004 and 2003, respectively, for which deferred taxes have not been provided. Such earnings are considered permanently invested in the foreign subsidiaries. Determining the tax liability that would arise if these earnings were remitted is not practicable.

On October 22, 2004, the American Jobs Creation Act (the AJCA) was signed into law. The AJCA includes a deduction of 85% of certain foreign earnings that are repatriated, as defined in the AJCA. The Company may elect to apply this provision to qualifying earning repatriations during 2005. The Company has started an evaluation of the effects of the repatriation provision; however, the Company does not expect to be able to substantially complete any aspect of this evaluation earlier than the second quarter of 2005 and the evaluation of the effects of the repatriation provision will likely be assessed throughout 2005. The maximum allowable amount to be considered for repatriation under the laws applicable to the Company is \$2.24 billion (which is the amount of unrepatriated earnings as disclosed in the Company's 2002 financial statements); however, the Company is unable to reasonably estimate what portion, if any, of this amount the Company may repatriate. Similarly, the Company is unable to reasonably estimate the related potential range of income tax benefit or expense.



The Internal Revenue Service (the Service ) has completed all examinations of the consolidated federal income tax returns through 1996. Tax years 1997 through 2001 are currently under examination by the Service. Management believes sufficient provisions have been made for potential adjustments.

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**Notes to Consolidated Financial Statements**

**18. FAIR VALUE OF FINANCIAL INSTRUMENTS**

The fair values presented below have been determined by using available market information and by applying valuation methodologies. Considerable judgment is applied in interpreting data to develop the estimates of fair value. These fair values may not be realized in a current market exchange. The use of different market assumptions and/or estimation methodologies could have a material effect on the fair values. The methods and assumptions discussed below were used in calculating the fair values of the instruments. See Note 19 for a discussion of derivative instruments.

*Fixed Maturities*

The fair values of public fixed maturity securities are based on quoted market prices or estimates from independent pricing services. However, for investments in private placement fixed maturity securities, this information is not available. For these private investments, the fair value is determined typically by using a discounted cash flow model, which considers current market credit spreads for publicly traded issues with similar terms by companies of comparable credit quality, and an additional spread component for the reduced liquidity associated with private placements. This additional spread component is determined based on surveys of various third party financial institutions. Historically, changes in estimated future cash flows or the assessment of an issuer's credit quality have been the more significant factors in determining fair values.

*Commercial Loans*

The fair value of commercial loans is primarily based upon the present value of the expected future cash flows discounted at the appropriate U.S. Treasury rate or Japanese Government Bond rate for yen based loans, adjusted for the current market spread for similar quality loans.

*Policy Loans*

The fair value of U.S. insurance policy loans is calculated using a discounted cash flow model based upon current U.S. Treasury rates and historical loan repayment patterns, while Japanese insurance policy loans use the risk-free proxy based on the Yen Libor.

*Mortgage Brokerage-Loan Inventory*

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The fair value of the mortgage brokerage-loan inventory is based upon various factors, including the terms of the loans, the intended exit strategy for the loans based upon either a securitization pricing model or commitments from investors, prevailing interest rates, and credit risk.

### *Investment Contracts*

For guaranteed investment contracts, income annuities and other similar contracts without life contingencies, fair values are derived using discounted projected cash flows based on interest rates being offered for similar contracts with maturities consistent with those of the contracts being valued. For individual deferred annuities and other deposit liabilities, carrying value approximates fair value.

### *Debt*

The fair value of short-term and long-term debt is derived by using discount rates based on the borrowing rates currently available to the Company for debt and financial instruments with similar terms and remaining maturities.

The carrying amount approximates or equals fair value for the following instruments: fixed maturities classified as available for sale, equity securities, short-term investments, cash and cash equivalents, restricted

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****18. FAIR VALUE OF FINANCIAL INSTRUMENTS (continued)**

cash and securities, separate account assets and liabilities, trading account assets supporting insurance liabilities, other trading account assets, broker-dealer related receivables/payables, securities purchased under agreements to resell, securities sold under agreements to repurchase, cash collateral for loaned securities, and securities sold but not yet purchased. The following table discloses the Company's financial instruments where the carrying amounts and fair values differ at December 31,

	2004		2003	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(in millions)			
Fixed maturities, held to maturity	\$ 2,747	\$ 2,765	\$ 3,068	\$ 3,084
Commercial loans	24,389	25,549	19,469	21,037
Policy loans	8,373	9,794	8,152	9,706
Mortgage brokerage-loan inventory	985	993	1,056	1,058
Investment contracts	63,569	64,064	40,681	41,450
Short-term and long-term debt	11,671	12,271	10,349	10,844

**19. DERIVATIVE INSTRUMENTS***Types of Derivative Instruments*

Interest rate swaps are used by the Company to manage interest rate exposures arising from mismatches between assets and liabilities (including duration mismatches) and to hedge against changes in the value of assets it anticipates acquiring and other anticipated transactions and commitments. Swaps may be specifically attributed to specific assets or liabilities or may be based on a portfolio basis. Under interest rate swaps, the Company agrees with other parties to exchange, at specified intervals, the difference between fixed rate and floating rate interest amounts calculated by reference to an agreed upon notional principal amount. Generally, no cash is exchanged at the outset of the contract and no principal payments are made by either party. Cash is paid or received based on the terms of the swap. These transactions are entered into pursuant to master agreements that provide for a single net payment to be made by one counterparty at each due date.

Exchange-traded futures and options are used by the Company to reduce market risks from changes in interest rates, to alter mismatches between the duration of assets in a portfolio and the duration of liabilities supported by those assets, and to hedge against changes in the value of securities it owns or anticipates acquiring or selling. In exchange-traded futures transactions, the Company agrees to purchase or sell a specified number of contracts, the values of which are determined by the values of designated classes of securities, and to post variation margin on a daily

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basis in an amount equal to the difference in the daily market values of those contracts. The Company enters into exchange-traded futures and options with regulated futures commissions merchants who are members of a trading exchange.

Futures typically are used to hedge duration mismatches between assets and liabilities. Futures move substantially in value as interest rates change and can be used to either modify or hedge existing interest rate risk. This strategy protects against the risk that cash flow requirements may necessitate liquidation of investments at unfavorable prices resulting from increases in interest rates. This strategy can be a more cost effective way of temporarily reducing the Company's exposure to a market decline than selling fixed income securities and purchasing a similar portfolio when such a decline is believed to be over.

Currency derivatives, including exchange-traded currency futures and options, currency forwards and currency swaps, are used by the Company to reduce market risks from changes in currency exchange rates with respect to investments denominated in foreign currencies that the Company either holds or intends to acquire or sell. The Company also uses currency forwards to hedge the currency risk associated with net investments in foreign operations and anticipated earnings of its foreign operations.

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**19. DERIVATIVE INSTRUMENTS (continued)**

Under currency forwards, the Company agrees with other parties to deliver a specified amount of an identified currency at a specified future date. Typically, the price is agreed upon at the time of the contract and payment for such a contract is made at the specified future date. As noted above, the Company uses currency forwards to mitigate the risk that unfavorable changes in currency exchange rates will reduce U.S. dollar equivalent earnings generated by certain of its non-U.S. businesses, primarily its international insurance and investment operations. The Company executes forward sales of the hedged currency in exchange for U.S. dollars at a specified exchange rate. The maturities of these forwards correspond with the future periods in which the non-U.S. earnings are expected to be generated. These contracts do not qualify for hedge accounting.

Under currency swaps, the Company agrees with other parties to exchange, at specified intervals, the difference between one currency and another at a forward exchange rate and calculated by reference to an agreed principal amount. Generally, the principal amount of each currency is exchanged at the beginning and termination of the currency swap by each party. These transactions are entered into pursuant to master agreements that provide for a single net payment to be made by one counterparty for payments made in the same currency at each due date.

Credit derivatives are used by the Company to enhance the return on the Company's investment portfolio by providing comparable exposure to fixed income securities that might not be available in the primary market. They are also used to hedge credit exposures in the Company's investment portfolio. With credit derivatives the Company can sell or buy credit protection on an identified name or names in return for receiving or paying a quarterly premium. This premium generally corresponds to a referenced name's credit spread at the time the agreement is executed. When selling protection, if there is an event of default by the referenced name, as defined by the agreement, then the Company is obligated to pay the counterparty the referenced amount of the contract and receive in return the referenced security. See Note 21 for a discussion of guarantees related to these credit derivatives.

Forward contracts are used by the Company to manage market risks relating to interest rates. The Company also uses to be announced ( TBA ) forward contracts to gain exposure to the investment risk and return of mortgage-backed securities. TBA transactions can help the Company to achieve better diversification and to enhance the return on its investment portfolio. TBAs provide a more liquid and cost effective method of achieving these goals than purchasing or selling individual mortgage-backed pools. Typically, the price is agreed upon at the time of the contract and payment for such a contract is made at a specified future date.

When the Company has cash flows that it has allocated for investment in equity securities or plans to sell investments in equity securities, it may enter into equity derivatives as a temporary hedge against an increase or decrease in the price of the securities it intends to purchase or sell. These hedges are intended to permit such investment transactions to be executed with less adverse market impacts. The Company also may use equity-based derivatives to hedge the equity risks embedded in some of its annuity products.

***Cash Flow, Fair Value and Net Investment Hedges***

The primary derivative instruments used by the Company in its fair value, cash flow, and net investment hedge accounting relationships are interest rate swaps, currency swaps and currency forwards. As noted above, these instruments are only designated for hedge accounting in instances where the appropriate criteria are met. The Company does not use futures, options, credit or equity derivatives in any of its fair value, cash flow or net investment hedge accounting relationships.

The ineffective portion of derivatives accounted for using hedge accounting in the years ended December 31, 2004, 2003 and 2002 was not material to the results of operations of the Company. In addition, there were no instances in which the Company discontinued cash flow hedge accounting because the forecasted transaction did not occur by the anticipated date or within the additional time period permitted by SFAS No. 133.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****19. DERIVATIVE INSTRUMENTS (continued)**

Presented below is a roll forward of current period cash flow hedges in Accumulated other comprehensive income (loss) before taxes:

	<b>(in millions)</b>
Balance, December 31, 2001	\$ (16)
Net deferred gains on cash flow hedges from January 1 to December 31, 2002	40
Amount reclassified into current period earnings	(27)
	<hr/>
Balance, December 31, 2002	(3)
Net deferred losses on cash flow hedges from January 1 to December 31, 2003	(90)
Amount reclassified into current period earnings	(18)
	<hr/>
Balance, December 31, 2003	(111)
Net deferred losses on cash flow hedges from January 1 to December 31, 2004	(146)
Amount reclassified into current period earnings	47
	<hr/>
Balance, December 31, 2004	\$ (210)
	<hr/>

It is anticipated that a pre-tax gain of approximately \$16 million will be reclassified from Accumulated other comprehensive income (loss) to earnings during the year ended December 31, 2005, offset by amounts pertaining to the hedged items. As of December 31, 2004, the Company does not have any cash flow hedges of forecasted transactions other than those related to the variability of the payment or receipt of interest or foreign currency amounts on existing financial instruments. The maximum length of time for which these variable cash flows are hedged is 19 years. Income amounts deferred in Accumulated other comprehensive income (loss) as a result of cash flow hedges are included in Net unrealized investment gains (losses) in the Consolidated Statements of Stockholders' Equity.

For effective net investment hedges, the amounts, before applicable taxes, recorded in the cumulative translation adjustment account within Accumulated other comprehensive income (loss) were losses of \$147 million, \$84 million and \$67 million in 2004, 2003 and 2002, respectively.

For the years ended December 31, 2004, 2003 and 2002, there were no derivative reclassifications to earnings due to hedged firm commitments no longer deemed probable or due to hedged forecasted transactions that had not occurred by the end of the originally specified time period.

**Credit Risk**



The Company is exposed to credit-related losses in the event of nonperformance by counterparties to derivative financial instruments. Generally, the current credit exposure of the Company's derivative contracts is limited to the fair value at the reporting date. The credit exposure of the Company's over-the-counter derivative transactions is represented by the fair value (market value) of contracts with a positive fair value (market value) at the reporting date. Because exchange-traded futures and options are effected through regulated exchanges, and positions are marked to market on a daily basis, the Company has little exposure to credit-related losses in the event of nonperformance by counterparties to such financial instruments.

The Company manages credit risk by entering into transactions with creditworthy counterparties and obtaining collateral where appropriate and customary. In addition, the Company enters into over-the-counter swaps pursuant to master agreements that provide for a single net payment to be made by one counterparty to another at each due date and upon termination. Likewise, the Company effects exchange-traded futures and options through regulated exchanges and these positions are marked to market on a daily basis.

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**20. SEGMENT INFORMATION**

*Segments*

The Company has organized its principal operations into the Financial Services Businesses and the Closed Block Business. Within the Financial Services Businesses, the Company operates through three divisions, which together encompass seven reportable segments. Businesses that are not sufficiently material to warrant separate disclosure and businesses to be divested are included in Corporate and Other operations. Collectively, the businesses that comprise the three operating divisions and Corporate and Other are referred to as the Financial Services Businesses.

*Insurance Division.* The Insurance division consists of the Individual Life and Annuities and Group Insurance segments. The Individual Life and Annuities segment manufactures and distributes individual variable life, term life, universal life, non-participating whole life insurance, and variable and fixed annuity products, primarily to the U.S. market. The Group Insurance segment manufactures and distributes a full range of group life, long-term and short-term group disability, long-term care and corporate-owned and trust-owned life insurance products in the U.S. to institutional clients primarily for use in connection with employee and membership benefit plans.

*Investment Division.* The Investment division consists of the Asset Management, Financial Advisory and Retirement segments. In 2004, the Company combined the former Other Asset Management segment and the former Investment Management segment to form the Asset Management segment. The Asset Management segment provides a broad array of investment management and advisory services, mutual funds and other structured products. These products and services are marketed and provided to the public and private marketplace in addition to other segments of the Company. The Financial Advisory segment includes, effective July 1, 2003, the equity method investment in Wachovia Securities. This segment also includes the equity sales, trading and research operations. The Retirement segment manufactures and distributes products and provides administrative services for qualified and non-qualified retirement plans and offers guaranteed investment contracts, funding agreements, retail notes, structured settlement annuities and group annuities.

*International Insurance and Investments Division.* The International Insurance and Investments division consists of the International Insurance and International Investments segments. The International Insurance segment manufactures and distributes individual life insurance products to the mass affluent and affluent markets in Japan, Korea and other foreign countries through Life Planners. In addition, similar products are offered to the broad middle income market across Japan through Life Advisors, the proprietary distribution channel of the Company's Gibraltar Life operations. The International Investments segment offers asset management, investment advice and product choice services to high net worth and mass affluent retail clients and to institutional clients in selected international markets.

*Corporate and Other.* Corporate and Other operations include corporate-level activities that are not allocated to business segments and the real estate and relocation services operations, as well as certain wind-down and divested businesses. Wind-down businesses include individual health insurance and Canadian life insurance. The divested businesses consist primarily of the Dryden Wealth Management business, property and casualty insurance business, Prudential Securities capital markets and Gibraltar Casualty Company. Corporate-level activities include

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corporate-level income and expenses not allocated to any business segments, including the cost of company-wide initiatives, income from the Company's qualified pension plan, investment returns on capital not deployed in any segments, returns from investments not allocated to any business segments, transactions with other segments and consolidating adjustments.

*Closed Block Business.* The Closed Block Business, which is managed separately from the Financial Services Businesses, was established on the date of demutualization. It includes the Closed Block (as discussed in Note 9); assets held outside the Closed Block necessary to meet insurance regulatory capital requirements related to products included within the Closed Block; deferred policy acquisition costs related to the Closed Block policies; the principal amount of the IHC debt (as discussed in Note 11) and certain related assets and liabilities.

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**20. SEGMENT INFORMATION (continued)**

*Segment Accounting Policies.* The accounting policies of the segments are the same as those described in Note 2. Results for each segment include earnings on attributed equity established at a level which management considers necessary to support each segment's risks. Operating expenses specifically identifiable to a particular segment are allocated to that segment as incurred. Operating expenses not identifiable to a specific segment that are incurred in connection with the generation of segment revenues are generally allocated based upon the segment's historical percentage of general and administrative expenses.

***Adjusted Operating Income***

In managing the Financial Services Businesses, the Company analyzes the operating performance of each segment using adjusted operating income. Adjusted operating income does not equate to income from continuing operations before income taxes, extraordinary gain on acquisition and cumulative effect of accounting change as determined in accordance with GAAP but is the measure of segment profit or loss used by the Company to evaluate segment performance and allocate resources, and, consistent with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, is the measure of segment performance presented below.

Adjusted operating income is calculated by adjusting each segment's income from continuing operations before income taxes, extraordinary gain on acquisition and cumulative effect of accounting change to exclude the following items, which are described in greater detail below:

realized investment gains, net of losses, except as indicated below, and related charges and adjustments;

net investment gains and losses on trading account assets supporting insurance liabilities and changes in experience-rated contractholder liabilities due to asset value changes;

life insurance sales practices remedies and costs; and

the contribution to income/loss of divested businesses that have been or will be sold or exited but that did not qualify for discontinued operations accounting treatment under GAAP.

The excluded items are important to an understanding of overall results of operations. Adjusted operating income is not a substitute for net income determined in accordance with GAAP, and the Company's definition of adjusted operating income may differ from that used by other companies. However, the Company believes that the presentation of adjusted operating income as measured for management purposes enhances the understanding of results of operations by highlighting the results from ongoing operations and the underlying profitability factors of the

Financial Services Businesses.

*Realized investment gains, net of losses, and related charges and adjustments.* Adjusted operating income excludes net realized investment gains and losses. A significant element of realized losses is impairments and losses from sales of credit-impaired securities, the timing of which depends largely on market credit cycles and can vary considerably across periods. The timing of other sales that would result in gains or losses is largely subject to the Company's discretion and influenced by market opportunities. Trends in the underlying profitability of the Company's businesses can be more clearly identified without the fluctuating effects of these transactions.

Charges that relate to realized investment gains, net of losses, are also excluded from adjusted operating income. The related charges, which are offset against net realized investment gains and losses in the schedules below, relate to policyholder dividends, amortization of deferred policy acquisition costs, reserves for future policy benefits, and payments associated with the market value adjustment features related to certain of the annuity products we sell. The related charges associated with policyholder dividends include a percentage of net realized investment gains on specified Gibraltar Life assets that is required to be paid as dividends to Gibraltar Life policyholders. Deferred policy acquisition costs for certain investment-type products are amortized based on

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**20. SEGMENT INFORMATION (continued)**

estimated gross profits, which include net realized investment gains and losses on the underlying invested assets. The related charge for deferred policy acquisition costs represents the portion of this amortization associated with net realized investment gains and losses. The reserves for certain policies are adjusted when cash flows related to these policies are affected by net realized investment gains and losses, and the related charge for reserves for future policy benefits represents that adjustment. Certain of our annuity products contain a market value adjustment feature that requires us to pay to the contractholder or entitles us to receive from the contractholder, upon surrender, a market value adjustment based on the crediting rates on the contract surrendered compared to crediting rates on newly issued contracts. These payments mitigate the realized investment gains or losses incurred upon the disposition of the underlying invested assets. The related charge represents the payments or receipts associated with these market value adjustments features.

Adjustments to realized investment gains, net of losses, for purposes of calculating adjusted operating income, include the following:

Gains and losses pertaining to derivative contracts that do not qualify for hedge accounting treatment, other than derivatives used for trading purposes, are included in Realized investment gains (losses), net. This includes mark-to-market adjustments of open contracts as well as periodic settlements. As discussed further below, adjusted operating income includes a portion of realized gains and losses pertaining to certain derivative contracts.

Adjusted operating income of the International Insurance segment reflects the impact of an intercompany arrangement with Corporate and Other operations pursuant to which the segment's results in certain countries for a particular year, including its interim reporting periods, are translated at fixed currency exchange rates. The fixed rates are determined in connection with a currency hedging program designed to mitigate the risk that unfavorable rate changes will reduce the segment's U.S. dollar equivalent earnings. Pursuant to this program, the Company executes forward sale contracts in the hedged currency in exchange for U.S. dollars at a specified exchange rate. The maturities of these contracts correspond with the future periods in which the non-U.S. earnings are expected to be generated. These contracts do not qualify for hedge accounting under GAAP and, as noted above, all resulting profits or losses from such contracts are included in Realized investment gains (losses), net. When the contracts are terminated in the same period that the expected earnings emerge, the resulting positive or negative cash flow effect is included in adjusted operating income (losses of \$84 million and \$51 million, and revenues of \$42 million for the years ended December 31, 2004, 2003 and 2002, respectively). As of December 31, 2004 and 2003, the fair value of open contracts used for this purpose was a net liability of \$230 million and \$152 million, respectively.

The Company utilizes interest and currency swaps to manage interest and currency exchange rate exposures arising from mismatches between assets and liabilities, including duration mismatches. For the derivative contracts that do not qualify for hedge accounting treatment, mark-to-market adjustments of open contracts as well as periodic settlements are included in Realized investment gains (losses), net. However, the periodic swap settlements, as well as other derivative related yield adjustments, are included in adjusted operating income to reflect the after-hedge yield of the underlying instruments. Adjusted operating income includes gains of \$14 million, \$51 million and \$52 million for the years ended December 31, 2004, 2003 and 2002, respectively, of periodic settlements and yield adjustments of such contracts.

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As part of the acquisition of CIGNA's retirement business, the Company entered into reinsurance agreements with CIGNA, including a modified-coinsurance-with-assumption arrangement that applies to the defined benefit guaranteed-cost contracts acquired. The net results of these contracts are recorded in Commissions and other income, as a result of the reinsurance arrangement, and such net results include realized investment gains and losses. These realized investment gains and losses are excluded from adjusted operating income as an adjustment to Realized investment gains (losses), net. For the year ended December 31, 2004, realized investment gains of \$1 million were excluded.

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**Notes to Consolidated Financial Statements**

**20. SEGMENT INFORMATION (continued)**

*Investment gains and losses on trading account assets supporting insurance liabilities and changes in experience-rated contractholder liabilities due to asset value changes.* Certain products included in the retirement business acquired from CIGNA are experience-rated in that investment results associated with these products will ultimately inure to contractholders. The investments supporting the experience-rated products acquired from CIGNA, as well as certain Prudential legacy experience-rated products included in the International Insurance segment, are classified as trading. These trading investments are reflected on the balance sheet as Trading account assets supporting insurance liabilities, at fair value and all investment results are reported in Commissions and other income. Mortgage loans that support these experience-rated products are carried at unpaid principal, net of unamortized discounts and an allowance for losses.

Adjusted operating income excludes net investment gains and losses on trading account assets supporting insurance liabilities. This is consistent with the exclusion of realized investment gains and losses with respect to other investments supporting insurance liabilities managed on a consistent basis, as discussed above. In addition, to be consistent with the historical treatment of charges related to realized gains and losses on available-for-sale securities, adjusted operating income also excludes the change in contractholder liabilities due to asset value changes in the pool of investments (including mortgage loans) supporting these experience-rated contracts, which are reflected in Interest credited to policyholders account balances. The result of this approach is that adjusted operating income for these products includes only net fee revenue and interest spread the Company earns on these experience-rated contracts, and excludes changes in fair value of the pool of investments, both realized and unrealized, that inure to the contractholders.

*Life insurance sales practices remedies and costs.* Adjusted operating income excludes life insurance sales practices remedies and costs relating to the settlement of individual life insurance sales practices issues for the period from 1982 through 1995 because they related to a substantial and identifiable non-recurring event.

*Divested businesses.* The contribution to income/loss of divested businesses that have been or will be sold or exited, but that did not qualify for discontinued operations accounting treatment under GAAP, are excluded from adjusted operating income as the results of divested businesses are not relevant to understanding the Company's ongoing operating results.



**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****20. SEGMENT INFORMATION (continued)**

The summary below reconciles adjusted operating income to income from continuing operations before income taxes, extraordinary gain on acquisition and cumulative effect of accounting change:

	Years Ended December 31,		
	2004	2003	2002
	(in millions)		
Adjusted Operating Income before income taxes for Financial Services Businesses by Segment:			
Individual Life and Annuities	\$ 817	\$ 619	\$ 390
Group Insurance	174	169	155
<b>Total Insurance Division</b>	<b>991</b>	<b>788</b>	<b>545</b>
Asset Management	266	208	184
Financial Advisory	(245)	(111)	(43)
Retirement	334	192	141
<b>Total Investment Division</b>	<b>355</b>	<b>289</b>	<b>282</b>
International Insurance	917	819	757
International Investments	86	(10)	
<b>Total International Insurance and Investments Division</b>	<b>1,003</b>	<b>809</b>	<b>757</b>
Corporate and Other	158	88	156
<b>Adjusted Operating Income before income taxes for Financial Services Businesses</b>	<b>2,507</b>	<b>1,974</b>	<b>1,740</b>
Items excluded from Adjusted Operating Income:			
Realized investment gains (losses), net, and related adjustments	82	(156)	(872)
Charges related to realized investment gains (losses), net	(58)	(43)	6
Investment gains (losses) on trading account assets supporting insurance liabilities, net	(43)		
Change in experience-rated contractholder liabilities due to asset value changes	(11)		
Sales practices remedies and costs			(20)
Divested businesses	(105)	(166)	(15)
<b>Income from continuing operations before income taxes, extraordinary gain on acquisition and cumulative effect of accounting change for Financial Services Businesses</b>	<b>2,372</b>	<b>1,609</b>	<b>839</b>
Income (loss) from continuing operations before income taxes for Closed Block Business	915	370	(757)

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Income from continuing operations before income taxes, extraordinary gain on acquisition and cumulative effect of accounting change	\$ 3,287	\$ 1,979	\$ 82
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The Individual Life and Annuities segment results reflect deferred policy acquisition costs as if the individual annuity business were a stand-alone operation. The elimination of intersegment costs capitalized in accordance with this policy is included in consolidating adjustments within Corporate and Other operations.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****20. SEGMENT INFORMATION (continued)**

The summary below presents certain financial information for the Company's reportable segments:

Year ended December 31, 2004

	Revenues	Net Investment Income	Policyholders Benefits	Interest Credited to Policyholders Account Balances	Dividends to Policyholders	Interest Expense	Amortization of Deferred Policy Acquisition Costs
	(in millions)						
<b>Financial Services Businesses:</b>							
Individual Life and Annuities	\$ 3,703	\$ 1,010	\$ 844	\$ 523	\$ 18	\$ 24	\$ 399
Group Insurance	3,867	561	2,930	185		8	4
<b>Total Insurance Division</b>	<b>7,570</b>	<b>1,571</b>	<b>3,774</b>	<b>708</b>	<b>18</b>	<b>32</b>	<b>403</b>
Asset Management	1,464	69				11	43
Financial Advisory	318	2					
Retirement	3,225	2,272	862	1,362		37	10
<b>Total Investment Division</b>	<b>5,007</b>	<b>2,343</b>	<b>862</b>	<b>1,362</b>		<b>48</b>	<b>53</b>
International Insurance	6,435	908	4,096	117	86	5	365
International Investments	447	30				2	
<b>Total International Insurance and Investments Division</b>	<b>6,882</b>	<b>938</b>	<b>4,096</b>	<b>117</b>	<b>86</b>	<b>7</b>	<b>365</b>
Corporate and Other	526	532	95	(4)	4	209	(55)
<b>Total</b>	<b>19,985</b>	<b>5,384</b>	<b>8,827</b>	<b>2,183</b>	<b>108</b>	<b>296</b>	<b>766</b>
<b>Items excluded from adjusted operating income:</b>							
Realized investment gains (losses), net, and related adjustments	82						
Related charges	(43)		3	3	13		2
<b>Total realized investment gains (losses), net, and related charges and adjustments</b>	<b>39</b>		<b>3</b>	<b>3</b>	<b>13</b>		<b>2</b>

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Investment gains (losses) on trading account assets supporting insurance liabilities, net	(43)						
Change in experience-rated contractholder liabilities due to asset value changes				11			
Divested businesses	136	14	10				
<b>Total Financial Services Businesses</b>	<b>20,117</b>	<b>5,398</b>	<b>8,840</b>	<b>2,197</b>	<b>121</b>	<b>296</b>	<b>768</b>
<b>Closed Block Business</b>	<b>8,231</b>	<b>3,681</b>	<b>4,056</b>	<b>137</b>	<b>2,364</b>	<b>169</b>	<b>105</b>
<b>Total per Consolidated Financial Statements</b>	<b>\$ 28,348</b>	<b>\$ 9,079</b>	<b>\$ 12,896</b>	<b>\$ 2,334</b>	<b>\$ 2,485</b>	<b>\$ 465</b>	<b>\$ 873</b>

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****20. SEGMENT INFORMATION (continued)**

Year ended December 31, 2003

	Revenues	Net Investment Income	Policyholders Benefits	Interest Credited to Policyholders Account Balances	Dividends to Policyholders	Interest Expense	Amortization of Deferred Policy Acquisition Costs
	(in millions)						
Financial Services Businesses:							
Individual Life and Annuities	\$ 3,082	\$ 861	\$ 984	\$ 420	\$ 17	\$ (2)	\$ 242
Group Insurance	3,690	585	2,797	216		2	3
<b>Total Insurance Division</b>	<b>6,772</b>	<b>1,446</b>	<b>3,781</b>	<b>636</b>	<b>17</b>		<b>245</b>
Asset Management	1,360	55				16	54
Financial Advisory	1,306	53					
Retirement	2,281	2,043	791	946		17	12
<b>Total Investment Division</b>	<b>4,947</b>	<b>2,151</b>	<b>791</b>	<b>946</b>		<b>33</b>	<b>66</b>
International Insurance	5,655	787	3,520	109	94	3	284
International Investments	240	4					
<b>Total International Insurance and Investments Division</b>	<b>5,895</b>	<b>791</b>	<b>3,520</b>	<b>109</b>	<b>94</b>	<b>3</b>	<b>284</b>
Corporate and Other	494	547	77		4	164	(62)
<b>Total</b>	<b>18,108</b>	<b>4,935</b>	<b>8,169</b>	<b>1,691</b>	<b>115</b>	<b>200</b>	<b>533</b>
Items excluded from adjusted operating income:							
Realized investment gains (losses), net, and related adjustments	(156)						
Related charges			(1)		35		9
<b>Total realized investment gains (losses), net, and related charges and adjustments</b>	<b>(156)</b>		<b>(1)</b>		<b>35</b>		<b>9</b>
Investment gains (losses) on trading account assets supporting insurance liabilities, net							
Change in experience-rated contractholder liabilities due to asset value changes							
Divested businesses	1,954	113	1,082				269

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Total Financial Services Businesses	19,906	5,048	9,250	1,691	150	200	811
Closed Block Business	7,982	3,632	4,174	139	2,452	165	121
Total per Consolidated Financial Statements	\$ 27,888	\$ 8,680	\$ 13,424	\$ 1,830	\$ 2,602	\$ 365	\$ 932

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****20. SEGMENT INFORMATION (continued)**

Year ended December 31, 2002

	Revenues	Net Investment Income	Policyholders Benefits	Interest Credited to Policyholders Account Balances	Dividends to Policyholders	Interest Expense	Amortization of Deferred Policy Acquisition Costs
	(in millions)						
<b>Financial Services Businesses:</b>							
Individual Life and Annuities	\$ 2,696	\$ 837	\$ 815	\$ 398	\$ 16	\$ 1	\$ 500
Group Insurance	3,586	582	2,703	235		2	(2)
<b>Total Insurance Division</b>	<b>6,282</b>	<b>1,419</b>	<b>3,518</b>	<b>633</b>	<b>16</b>	<b>3</b>	<b>498</b>
Asset Management	1,325	60				12	72
Financial Advisory	2,421	148					
Retirement	2,375	2,090	880	978		18	20
<b>Total Investment Division</b>	<b>6,121</b>	<b>2,298</b>	<b>880</b>	<b>978</b>		<b>30</b>	<b>92</b>
International Insurance	5,073	682	3,175	96	103	1	233
International Investments	245	31					1
<b>Total International Insurance and Investments Division</b>	<b>5,318</b>	<b>713</b>	<b>3,175</b>	<b>96</b>	<b>103</b>	<b>1</b>	<b>234</b>
Corporate and Other	420	622	98		3	161	(85)
<b>Total</b>	<b>18,141</b>	<b>5,052</b>	<b>7,671</b>	<b>1,707</b>	<b>122</b>	<b>195</b>	<b>739</b>
<b>Items excluded from adjusted operating income:</b>							
Realized investment gains (losses), net, and related adjustments	(872)						
Related charges			(1)		16		(21)
<b>Total realized investment gains (losses), net, and related charges and adjustments</b>	<b>(872)</b>		<b>(1)</b>		<b>16</b>		<b>(21)</b>
Investment gains (losses) on trading account assets supporting insurance liabilities, net Change in experience-rated contractholder liabilities due to asset value changes							
Divested businesses	1,888	148	1,403				335

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Total Financial Services Businesses	19,157	5,200	9,073	1,707	138	195	1,053
Closed Block Business	7,121	3,618	4,305	139	2,506	156	162
Total per Consolidated Financial Statements	\$ 26,278	\$ 8,818	\$ 13,378	\$ 1,846	\$ 2,644	\$ 351	\$ 1,215

Income from continuing operations before income taxes, extraordinary gain on acquisition and cumulative effect of accounting change includes income from foreign operations of \$913 million, \$659 million and \$332 million for the years ended December 31, 2004, 2003 and 2002, respectively. Revenues, calculated in accordance with GAAP, include revenues from foreign operations of \$7,051 million, \$6,007 million and \$5,112 million for the years ended December 31, 2004, 2003 and 2002, respectively. Included in the revenues from foreign operations are revenues from Japanese operations of \$5,439 million, \$4,703 million and \$4,126 million for the years ended December 31, 2004, 2003 and 2002, respectively.



**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****20. SEGMENT INFORMATION (continued)**

The Asset Management segment revenues include intersegment revenues of \$348 million, \$343 million and \$378 million for the years ended December 31, 2004, 2003 and 2002, respectively, primarily consisting of asset-based management and administration fees. In addition, the Financial Advisory segment revenues include intersegment revenues of \$0 million, \$85 million and \$194 million for the years ended December 31, 2004, 2003 and 2002, respectively, relating to the sale of proprietary investments products. Management has determined the intersegment revenues with reference to market rates. Intersegment revenues are eliminated in consolidation.

The summary below presents total assets for the Company's reportable segments at December 31,

	Assets		
	2004	2003	2002
	(in millions)		
Individual Life and Annuities	\$ 84,498	\$ 77,313	\$ 44,482
Group Insurance	24,250	20,898	18,419
<b>Total Insurance Division</b>	<b>108,748</b>	<b>98,211</b>	<b>62,901</b>
Asset Management	24,795	27,124	24,498
Financial Advisory	1,151	2,805	15,525
Retirement	116,596	59,268	56,018
<b>Total Investment Division</b>	<b>142,542</b>	<b>89,197</b>	<b>96,041</b>
International Insurance	57,761	45,989	40,741
International Investments	4,425	3,883	2,332
<b>Total International Insurance and Investments Division</b>	<b>62,186</b>	<b>49,872</b>	<b>43,073</b>
Corporate and Other	16,002	15,258	21,155
<b>Total Financial Services Businesses</b>	<b>329,478</b>	<b>252,538</b>	<b>223,170</b>
Closed Block Business	71,580	68,736	69,446
<b>Total</b>	<b>\$ 401,058</b>	<b>\$ 321,274</b>	<b>\$ 292,616</b>

**21. COMMITMENTS AND GUARANTEES, CONTINGENCIES AND LITIGATION AND REGULATORY MATTERS***Commitments and Guarantees*

The Company occupies leased office space in many locations under various long-term leases and has entered into numerous leases covering the long-term use of computers and other equipment. Rental expense, net of sub-lease income, incurred for the years ended December 31, 2004, 2003 and 2002 was \$199 million, \$308 million and \$449 million, respectively.

The following table presents, at December 31, 2004, the Company's future commitments on long-term debt, as more fully described in Note 11, and future minimum lease payments under non-cancelable operating leases along with associated sub-lease income:

	<b>Long-term Debt</b>	<b>Operating Leases</b>	<b>Sub-lease Income</b>
	<u>          </u>	<u>          </u>	<u>          </u>
	(in millions)		
2005	\$	\$ 214	\$ (46)
2006	753	190	(43)
2007	264	166	(41)
2008	1,123	118	(31)
2009	24	95	(27)
Beyond 2009	5,463	264	(37)
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Total</b>	<b>\$ 7,627</b>	<b>\$ 1,047</b>	<b>\$ (225)</b>
	<u>          </u>	<u>          </u>	<u>          </u>

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**21. COMMITMENTS AND GUARANTEES, CONTINGENCIES AND LITIGATION AND REGULATORY MATTERS *(continued)***

For business reasons, the Company exits certain non-cancelable leases prior to their expiration. In these instances, the Company's policy is to accrue the future rental expense and any sub-lease income immediately and release the reserve over the remaining commitment in the year that it is due. Of the \$1,047 million in total non-cancelable operating leases and \$225 million in total sub-lease income, \$237 million and \$178 million, respectively, has already been reserved toward future period rental expenses.

In connection with the Company's commercial mortgage banking business, it originates commercial mortgage loans. At December 31, 2004, the Company had outstanding commercial mortgage loan commitments with borrowers of \$1,350 million. In certain of these transactions, the Company prearranges that it will sell the loan to an investor after the Company funds the loan. As of December 31, 2004, \$494 million of the Company's commitments to originate commercial mortgage loans are subject to such arrangements.

The Company also has other commitments, some of which are contingent upon events or circumstances not under the Company's control, including those at the discretion of the Company's counterparty. These other commitments amounted to \$4,067 million at December 31, 2004. Reflected in these other commitments are \$3,971 million of commitments to purchase or fund investments, including \$2,932 million that the Company anticipates will be funded from the assets of its separate accounts.

In the course of the Company's business, it provides certain guarantees and indemnities to third parties pursuant to which it may be contingently required to make payments now or in the future.

A number of guarantees provided by the Company relate to real estate investments, in which the investor has borrowed funds, and the Company has guaranteed their obligation to their lender. In some cases, the investor is an affiliate, and in other cases the unaffiliated investor purchases the real estate investment from the Company. The Company provides these guarantees to assist them in obtaining financing for the transaction on more beneficial terms. The Company's maximum potential exposure under these guarantees was \$1,315 million at December 31, 2004. Any payments that may become required of the Company under these guarantees would either first be reduced by proceeds received by the creditor on a sale of the assets, or would provide the Company with rights to obtain the assets. These guarantees expire at various times over the next 10 years. At December 31, 2004, no amounts were accrued as a result of the Company's assessment that it is unlikely payments will be required.

Certain contracts underwritten by the Retirement segment's guaranteed products business include guarantees related to financial assets owned by the guaranteed party. These contracts are accounted for as derivatives, at fair value, in accordance with SFAS No. 133. At December 31, 2004, such contracts in force carried a total guaranteed value of \$2,002 million.

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The Company's commercial mortgage banking business provides guarantees related to debt instruments owned by the guaranteed party. At December 31, 2004, such arrangements carried a total guaranteed value of \$247 million, with remaining contractual maturities of up to 15 years. The Company anticipates the extinguishment of its obligation under these guarantees prior to maturity as the Company intends to aggregate and pool individual items for transfer to substitute guarantors. These guarantees are secured by rights to properties valued at \$323 million at December 31, 2004. At December 31, 2004, the Company has accrued liabilities of \$7 million representing unearned fees on these guarantees.

As discussed in Note 19, the Company writes credit default swaps requiring payment of principal due in exchange for the referenced credits, depending on the nature or occurrence of specified credit events for the referenced entities. In the event of a specified credit event, the Company's maximum amount at risk, assuming the value of the referenced credits become worthless, is \$628 million at December 31, 2004. The credit default swaps generally have maturities of five years or less.

In connection with certain acquisitions, the Company has agreed to pay additional consideration in future periods, based upon the attainment by the acquired entity of defined operating objectives. In accordance with

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**21. COMMITMENTS AND GUARANTEES, CONTINGENCIES AND LITIGATION AND REGULATORY MATTERS *(continued)***

GAAP, the Company does not accrue contingent consideration obligations prior to the attainment of the objectives. At December 31, 2004, maximum potential future consideration pursuant to such arrangements, to be resolved over the following five years, is \$344 million. Any such payments would result in increases in intangible assets, including goodwill.

The Company is also subject to other financial guarantees and indemnity arrangements. The Company has provided indemnities and guarantees related to acquisitions, dispositions, investments or other transactions that are triggered by, among other things, breaches of representations, warranties or covenants provided by the Company. These obligations are typically subject to various time limitations, defined by the contract or by operation of law, such as statutes of limitation. In some cases, the maximum potential obligation is subject to contractual limitations, while in other cases such limitations are not specified or applicable. Since certain of these obligations are not subject to limitations, it is not possible to determine the maximum potential amount due under these guarantees. At December 31, 2004, the Company has accrued liabilities of \$13 million associated with all other financial guarantees and indemnity arrangements, which does not include retained liabilities associated with sold businesses.

***Contingencies***

As discussed in Note 3, in the fourth quarter of 2003, the Company sold its property and casualty insurance companies that operated nationally in 48 states outside of New Jersey, and the District of Columbia, to Liberty Mutual. In connection with that sale, the Company reinsured Liberty Mutual for certain losses including: any adverse loss development on losses occurring prior to the sale that arise from insurance contracts generated through certain discontinued distribution channels or due to certain loss events including mold damage or the October 2003 California wild fires; stop-loss protection on losses occurring after the sale and arising from those same distribution channels of up to \$95 million, in excess of related premiums and other adjustments; and stop-loss protection on losses occurring prior to the sale and arising from most other business, up to 75% of the first \$30 million of adverse loss development recorded through October 31, 2005. The reinsurance covering the losses associated with the discontinued distribution channels will be settled based upon loss experience through December 31, 2008, with a provision that profits on the insurance business from these channels will be shared, with Liberty Mutual receiving up to \$20 million of the first \$50 million. In addition, the Company reinsured Liberty Mutual for the remaining \$54 million of potential adverse loss on the stop-loss reinsurance agreement that one of the subsidiaries sold to Liberty Mutual had entered into with the purchaser of the Company's commercial property and casualty insurer in 2000.

On an ongoing basis, the Company's internal supervisory and control functions review the quality of sales, marketing and other customer interface procedures and practices and may recommend modifications or enhancements. In certain cases, if appropriate, the Company may offer customers remediation and may incur charges, including the cost of such remediation, administrative costs and regulatory fines.

It is possible that the results of operations or the cash flow of the Company in a particular quarterly or annual period could be materially affected as a result of payments in connection with the matters discussed above or other matters depending, in part, upon the results of operations or cash

flow for such period. Management believes, however, that ultimate payments in connection with these matters, after consideration of applicable reserves, should not have a material adverse effect on the Company's financial position.

***Litigation and Regulatory Matters***

The Company is subject to legal and regulatory actions in the ordinary course of its businesses. Pending legal and regulatory actions include proceedings relating to aspects of our businesses and operations that are specific to the Company and proceedings that are typical of the businesses in which the Company operates, including in both cases businesses that have either been divested or placed in wind-down status. Some of these

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Consolidated Financial Statements**

**21. COMMITMENTS AND GUARANTEES, CONTINGENCIES AND LITIGATION AND REGULATORY MATTERS *(continued)***

proceedings have been brought on behalf of various alleged classes of complainants. In certain of these matters, the plaintiffs are seeking large and/or indeterminate amounts, including punitive or exemplary damages.

In 2004, the Company, along with a number of other insurance companies, received formal requests for information from the New York State Attorney General's Office, the Securities and Exchange Commission, the Connecticut Attorney General's Office, the Massachusetts Office of the Attorney General, the Department of Labor and various state insurance departments relating to payments to insurance intermediaries and certain other practices that may be viewed as anti-competitive. The Company may receive additional requests from these and other regulators and governmental authorities concerning these and related subjects. The Company is cooperating fully with these inquiries. These matters are the subject of litigation brought by private plaintiffs, including putative class actions and shareholder derivative actions, and the California Department of Insurance and may be the subject of additional regulatory and private actions.

Commencing in 2003, the Company received formal requests for information from regulators and law enforcement authorities relating to the purchase and sale of mutual fund shares and variable annuities. They include, among others, the Securities and Exchange Commission, the New York Stock Exchange, the National Association of Securities Dealers, the New Jersey Bureau of Securities, the State of New York Attorney General's Office, the Securities Division of Massachusetts and the United States Attorney, District of Massachusetts. The matters under investigation principally concern the retail brokerage operations of the former Prudential Securities and the business of certain American Skandia entities.

The Securities Division of Massachusetts filed an administrative complaint in 2003 against Prudential Securities alleging that it knew or should have known about alleged deceptive market timing and late trading in mutual funds in its Boston branch, failed reasonably to supervise the conduct of the brokers in that branch and failed to implement controls designed to prevent and detect violations of Massachusetts securities law. This action remains pending. The Company believes that other pending investigations will likely result in proceedings and/or settlements based on allegations related to market timing similar to those asserted by the Securities Division of Massachusetts. The Company is engaged in ongoing discussions with all relevant parties, including the Securities Division of Massachusetts, and is fully cooperating with them. The Company has established a reserve for anticipated settlement costs, but there are no assurances that this reserve will prove adequate.

In connection with American Skandia, the Company believes that certain of the investigations are likely to lead to proceedings and/or settlements based on allegations concerning market timing in American Skandia products. The Company is engaged in ongoing discussions with the relevant regulators and is fully cooperating with them. Prudential Financial purchased the American Skandia entities in May 2003. Any regulatory settlement involving an American Skandia entity would be subject to the indemnification provisions of the acquisition agreement between Prudential Financial and Skandia Insurance Company Ltd (publ).

In addition to these regulatory proceedings, in October 2004, the Company and Prudential Securities were named as defendants in several class actions brought on behalf of purchasers and holders of shares in a number of mutual fund complexes. The actions are consolidated as part of a

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multi-district proceeding, *In re: Mutual Fund Investment Litigation*, pending in the United States District Court for the District of Maryland. The complaints allege that the purchasers and holders were harmed by dilution of the funds' values and excessive fees, caused by market timing and late trading, and seek unspecified damages.

In August 2000, plaintiffs filed a purported national class action against Prudential Insurance in the District Court of Valencia County, New Mexico, *Azar, et al. v. Prudential Insurance*, based upon the alleged failure to disclose adequately the increased costs associated with payment of life insurance premiums on a modal basis, *i.e.*, more frequently than once a year. Similar actions have been filed in New Mexico against over a dozen other insurance companies. The complaint includes allegations that Prudential Insurance should have disclosed to each policyholder who paid for coverage on a modal basis the dollar cost difference between the modal premium and



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**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****21. COMMITMENTS AND GUARANTEES, CONTINGENCIES AND LITIGATION AND REGULATORY MATTERS (continued)**

the annual premium required for the policy, as well as the effective annual percentage rate of interest of such difference. Based on these allegations, plaintiffs assert statutory claims including violation of the New Mexico Unfair Practices Act, and common law claims for breach of the implied covenant of good faith and fair dealing, breach of fiduciary duty, unjust enrichment and fraudulent concealment. The complaint seeks injunctive relief, compensatory and punitive damages, both in unspecified amounts, restitution, treble damages, pre-judgment interest, costs and attorneys' fees. In March 2001, the court entered an order granting partial summary judgment to plaintiffs as to liability. In January 2003, the New Mexico Court of Appeals reversed the finding of summary judgment in favor of plaintiffs and dismissed the counts in the complaint for breach of the covenant of good faith and fair dealing and breach of fiduciary duty. The case was remanded to the trial court to determine if the alleged nondisclosures were material to plaintiffs. In November 2004, the trial court issued an order holding that, as to the named plaintiffs, the non-disclosure was material and reliance had been established. Plaintiffs' motion for class certification of a multi-state class is under consideration by the court.

In 2000, a nationwide class action, *Shane v. Humana, et al.*, was brought on behalf of provider physicians and physician groups in the United States District Court for the Southern District of Florida. The complaint alleges that Prudential Insurance and other health care companies engaged in an industry-wide conspiracy to defraud physicians by failing to pay under provider agreements and by unlawfully coercing providers to enter into agreements with unfair and unreasonable terms. An amended complaint, naming additional plaintiffs, including three state medical associations, and an additional defendant, was filed in March 2001, and alleges claims of breach of contract, *quantum meruit*, unjust enrichment, violations of the Racketeer Influenced and Corrupt Organizations Act, or RICO, conspiracy to violate RICO, aiding and abetting RICO violations, and violations of state prompt pay statutes and the California unfair business practices statute. The amended complaint seeks compensatory and punitive damages in unspecified amounts, treble damages pursuant to RICO, and attorneys' fees. In September 2002, the District Court granted plaintiffs' motion for class certification of a nationwide class of provider physicians. In September 2004, the United States Court of Appeals for the Eleventh Circuit affirmed with respect only to the federal RICO claims. The trial is scheduled for September 2005.

In 1999, a class action lawsuit, *Burns, et al. v. Prudential Securities Inc., et al.*, was filed in the Marion County, Ohio Court of Common Pleas against Jeffrey Pickett (a former Prudential Securities financial advisor) and Prudential Securities alleging that Pickett transferred, without authorization, his clients' equity mutual funds into fixed income mutual funds in October 1998. The claims were based on theories of conversion, breach of contract, breach of fiduciary duty and negligent supervision. In October 2002, the case was tried and the jury returned a verdict against Prudential Securities and Pickett for \$11.7 million in compensatory damages and against Prudential Securities for \$250 million in punitive damages. In July 2003, the court denied Prudential Securities' motion to set aside or reduce the jury verdict, and sustained the judgment in the amount of \$269 million including interest and attorneys fees. Prudential Securities' appeal is pending.

In November 2003, an action was commenced in the United States Bankruptcy Court for the Southern District of New York, *Enron Corp. v. J.P. Morgan Securities, Inc., et al.*, against approximately 100 defendants, including Prudential Insurance and other Prudential entities, who invested in Enron's commercial paper. The complaint alleges that Enron's October 2001 prepayment of its commercial paper is a voidable preference under the bankruptcy laws, constitutes a fraudulent conveyance and that the Company received prepayment of approximately \$100 million. All defendants have moved to dismiss the complaint.

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The Company's litigation is subject to many uncertainties, and given its complexity and scope, its outcome cannot be predicted. It is possible that the results of operations or the cash flow of the Company in a particular quarterly or annual period could be materially affected by an ultimate unfavorable resolution of pending litigation and regulatory matters depending, in part, upon the results of operations or cash flow for such period. Management believes, however, that the ultimate outcome of all pending litigation and regulatory matters, after consideration of applicable reserves, should not have a material adverse effect on the Company's financial position.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Notes to Consolidated Financial Statements****22. QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)**

The unaudited quarterly results of operations for the years ended December 31, 2004 and 2003 are summarized in the table below:

	Three months ended			
	March 31	June 30	September 30	December 31
	(in millions, except per share amounts)			
<b>2004</b>				
Total revenues	\$ 6,743	\$ 6,904	\$ 7,346	\$ 7,355
Total benefits and expenses	6,037	6,221	6,282	6,521
Income from continuing operations before income taxes, extraordinary gain on acquisition and cumulative effect of accounting change	706	683	1,064	834
Net income	401	549	728	578
Basic income from continuing operations before extraordinary gain on acquisition and cumulative effect of accounting change per share Common Stock(a)	0.74	1.01	1.12	0.65
Diluted income from continuing operations before extraordinary gain on acquisition and cumulative effect of accounting change per share Common Stock(a)	0.73	0.99	1.10	0.64
Basic net income per share Common Stock(a)	0.58	1.04	1.11	0.65
Diluted net income per share Common Stock(a)	0.57	1.02	1.08	0.64
Basic and diluted net income (loss) per share Class B Stock	46.00	3.50	79.00	120.50
<b>2003</b>				
Total revenues	\$ 6,781	\$ 7,298	\$ 6,688	\$ 7,121
Total benefits and expenses	6,468	7,077	6,112	6,252
Income from continuing operations before income taxes, extraordinary gain on acquisition and cumulative effect of accounting change	313	221	576	869
Net income	196	196	297	575
Basic income from continuing operations before extraordinary gain on acquisition and cumulative effect of accounting change per share Common Stock(a)	0.41	0.22	0.51	0.97
Diluted income from continuing operations before extraordinary gain on acquisition and cumulative effect of accounting change per share Common Stock(a)	0.41	0.22	0.50	0.96
Basic net income per share Common Stock(a)	0.39	0.25	0.44	0.93
Diluted net income per share Common Stock(a)	0.39	0.25	0.44	0.92
Basic and diluted net income (loss) per share Class B Stock	(9.50)	30.50	29.00	39.50

(a) Quarterly earnings per share amounts may not add to the full year amounts due to the averaging of shares.

As discussed in Note 2, the Company adopted SOP 03-1 effective January 1, 2004. Results for the first quarter of 2004 include a loss from the cumulative effect of accounting changes, net of taxes, of \$79 million related to the adoption of SOP 03-1. In the fourth quarter of 2004 the

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Company committed to the sale or exit of its Dryden Wealth Management Business and results for the fourth quarter include a charge of \$53 million for the impairment of goodwill associated with this business.

As discussed in Note 3, on July 1, 2003, the Company completed the combination of its retail securities brokerage and clearing operations, with that of Wachovia, forming a joint venture in which the Company has a 38% ownership interest. The Company accounts for its ownership interest under the equity method of accounting; periods prior to July 1, 2003, continue to reflect the results of the Company's previously wholly-owned securities brokerage operations on a fully consolidated basis. Results for the fourth quarter of 2003 include the gain from the receipt by the Company of a \$332 million settlement of an arbitration award. Results for the second quarter of 2003 include a \$455 million loss related to the disposition of the Company's property and casualty insurance operations discussed in Note 3.

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Supplemental Combining Statements of Financial Position****December 31, 2004 and 2003 (in millions)**

	2004			2003		
	Financial Services Businesses	Closed Block Business	Consolidated	Financial Services Businesses	Closed Block Business	Consolidated
<b>ASSETS</b>						
Fixed maturities:						
Available for sale, at fair value	\$ 102,155	\$ 48,813	\$ 150,968	\$ 84,353	\$ 44,590	\$ 128,943
Held to maturity, at amortized cost	2,747		2,747	3,068		3,068
Trading account assets supporting insurance liabilities, at fair value	12,964		12,964	88		88
Other trading account assets, at fair value	1,547		1,547	3,214		3,214
Equity securities, available for sale, at fair value	1,663	2,620	4,283	1,119	2,282	3,401
Commercial loans	17,092	7,297	24,389	12,463	7,006	19,469
Policy loans	2,919	5,454	8,373	2,609	5,543	8,152
Securities purchased under agreements to resell	127		127	1,464		1,464
Other long-term investments	4,934	1,047	5,981	4,568	1,041	5,609
Short-term investments	3,405	1,840	5,245	4,052	3,581	7,633
<b>Total investments</b>	<b>149,553</b>	<b>67,071</b>	<b>216,624</b>	<b>116,998</b>	<b>64,043</b>	<b>181,041</b>
Cash and cash equivalents	6,164	1,908	8,072	5,791	2,158	7,949
Accrued investment income	1,307	721	2,028	1,046	751	1,797
Reinsurance recoverables	32,790		32,790	633		633
Deferred policy acquisition costs	7,624	1,223	8,847	6,605	1,221	7,826
Other assets	16,472	657	17,129	14,785	563	15,348
Separate account assets	115,568		115,568	106,680		106,680
<b>TOTAL ASSETS</b>	<b>\$ 329,478</b>	<b>\$ 71,580</b>	<b>\$ 401,058</b>	<b>\$ 252,538</b>	<b>\$ 68,736</b>	<b>\$ 321,274</b>
<b>LIABILITIES AND ATTRIBUTED EQUITY</b>						
<b>LIABILITIES</b>						
Future policy benefits	\$ 52,794	\$ 49,511	\$ 102,305	\$ 46,003	\$ 48,842	\$ 94,845
Policyholders' account balances	69,668	5,557	75,225	44,168	5,523	49,691
Unpaid claims and claim adjustment expenses	1,807		1,807	1,687		1,687
Policyholders' dividends	1,132	4,218	5,350	1,077	3,611	4,688
Reinsurance payables	32,386		32,386	180		180
Securities sold under agreements to repurchase	4,657	4,301	8,958	5,196	4,458	9,654
Cash collateral for loaned securities	4,248	3,021	7,269	3,571	2,215	5,786
Income taxes payable	2,681		2,681	2,234	48	2,282
Securities sold but not yet purchased	427		427	1,598		1,598
Short-term debt	3,896	148	4,044	4,739		4,739
Long-term debt	5,877	1,750	7,627	3,860	1,750	5,610
Other liabilities	13,128	1,939	15,067	11,205	1,337	12,542
Separate account liabilities	115,568		115,568	106,680		106,680
<b>Total liabilities</b>	<b>308,269</b>	<b>70,445</b>	<b>378,714</b>	<b>232,198</b>	<b>67,784</b>	<b>299,982</b>
<b>COMMITMENTS AND CONTINGENCIES</b>						

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**ATTRIBUTED EQUITY**

Accumulated other comprehensive income	1,817	374	2,191	1,777	669	2,446
Other attributed equity	19,392	761	20,153	18,563	283	18,846
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total attributed equity	21,209	1,135	22,344	20,340	952	21,292
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>TOTAL LIABILITIES AND ATTRIBUTED EQUITY</b>	<b>\$ 329,478</b>	<b>\$ 71,580</b>	<b>\$ 401,058</b>	<b>\$ 252,538</b>	<b>\$ 68,736</b>	<b>\$ 321,274</b>
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

*See Notes to Supplemental Combining Financial Information*

**Table of Contents****PRUDENTIAL FINANCIAL, INC.****Supplemental Combining Statements of Operations****Years Ended December 31, 2004 and 2003 (in millions)**

	2004			2003		
	Financial Services Businesses	Closed Block Business	Consolidated	Financial Services Businesses	Closed Block Business	Consolidated
<b>REVENUES</b>						
Premiums	\$ 8,804	3,776	12,580	\$ 9,373	\$ 3,860	\$ 13,233
Policy charges and fee income	2,317		2,317	2,001		2,001
Net investment income	5,398	3,681	9,079	5,048	3,632	8,680
Realized investment gains (losses), net	11	715	726	(156)	426	270
Commissions and other income	3,587	59	3,646	3,640	64	3,704
<b>Total revenues</b>	<b>20,117</b>	<b>8,231</b>	<b>28,348</b>	<b>19,906</b>	<b>7,982</b>	<b>27,888</b>
<b>BENEFITS AND EXPENSES</b>						
Policyholders' benefits	8,840	4,056	12,896	9,250	4,174	13,424
Interest credited to policyholders' account balances	2,197	137	2,334	1,691	139	1,830
Dividends to policyholders	121	2,364	2,485	150	2,452	2,602
General and administrative expenses	6,587	759	7,346	6,715	847	7,562
Loss on disposition of property and casualty insurance operations				491		491
<b>Total benefits and expenses</b>	<b>17,745</b>	<b>7,316</b>	<b>25,061</b>	<b>18,297</b>	<b>7,612</b>	<b>25,909</b>
<b>INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES, EXTRAORDINARY GAIN ON ACQUISITION AND CUMULATIVE EFFECT OF ACCOUNTING CHANGE</b>						
	2,372	915	3,287	1,609	370	1,979
<b>Total income tax expense</b>	<b>622</b>	<b>333</b>	<b>955</b>	<b>526</b>	<b>131</b>	<b>657</b>
<b>INCOME FROM CONTINUING OPERATIONS BEFORE EXTRAORDINARY GAIN ON ACQUISITION AND CUMULATIVE EFFECT OF ACCOUNTING CHANGE</b>						
	1,750	582	2,332	1,083	239	1,322
Loss from discontinued operations, net of taxes	(18)		(18)	(58)		(58)
Extraordinary gain on acquisition, net of taxes	21		21			
Cumulative effect of accounting change, net of taxes	(79)		(79)			
<b>NET INCOME</b>	<b>\$ 1,674</b>	<b>\$ 582</b>	<b>\$ 2,256</b>	<b>\$ 1,025</b>	<b>\$ 239</b>	<b>\$ 1,264</b>

See Notes to Supplemental Combining Financial Information





**Table of Contents**

**PRUDENTIAL FINANCIAL, INC.**

**Notes to Supplemental Combining Financial Information**

**1. BASIS OF PRESENTATION**

The supplemental combining financial information presents the consolidated financial position and results of operations for Prudential Financial, Inc. and its subsidiaries (together, the Company), separately reporting the Financial Services Businesses and the Closed Block Business. The Financial Services Businesses and the Closed Block Business are both fully integrated operations of the Company and are not separate legal entities. The supplemental combining financial information presents the results of the Financial Services Businesses and the Closed Block Business as if they were separate reporting entities and should be read in conjunction with the Consolidated Financial Statements.

The Company has outstanding two 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 Block Business.

The Closed Block Business was established on the date of demutualization and includes the assets and liabilities of the Closed Block (see Note 9 to the Consolidated Financial Statements for a description of the Closed Block). It also includes assets held outside the Closed Block necessary to meet insurance regulatory capital requirements related to products included within the Closed Block; deferred policy acquisition costs related to the Closed Block policies; the principal amount of the IHC debt (as discussed below and in Note 11 to the Consolidated Financial Statements) and related unamortized debt issuance costs and an interest rate swap related to the IHC debt; and certain other related assets and liabilities. The Financial Services Businesses consist of the Insurance, Investment, and International Insurance and Investments divisions and Corporate and Other operations.

**2. ALLOCATION OF RESULTS**

This supplemental combining financial information reflects the assets, liabilities, revenues and expenses directly attributable to the Financial Services Businesses and the Closed Block Business, as well as allocations deemed reasonable by management in order to fairly present the financial position and results of operations of each business on a stand alone basis. While management considers the allocations utilized to be reasonable, management has the discretion to make operational and financial decisions that may affect the allocation methods and resulting assets, liabilities, revenues and expenses of each business. In addition, management has limited discretion over accounting policies and the appropriate allocation of earnings between the two businesses. The Company is subject to agreements which provide that, in most instances, the Company may not change the allocation methodology or accounting policies for the allocation of earnings between the Financial Services Businesses and Closed Block Business without the prior consent of the Class B Stock holders or IHC debt bond insurer.

General corporate overhead not directly attributable to a specific business that has been incurred in connection with the generation of the businesses' revenues is generally allocated based on the historical general and administrative expenses of each business as a percentage of the total for the Company.

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PHLLC has outstanding IHC debt, of which net proceeds of \$1.66 billion were allocated to the Financial Services Businesses concurrent with the demutualization on December 18, 2001. The IHC debt is serviced by the cash flows of the Closed Block Business, and the results of the Closed Block Business reflect interest expense associated with the IHC debt.

Income taxes are allocated between the Financial Services Businesses and the Closed Block Business as if they were separate companies based on the taxable income or losses and other tax characterizations of each business. If a business generates benefits, such as net operating losses, it is entitled to record such tax benefits to the extent they are expected to be utilized on a consolidated basis.

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**PRUDENTIAL FINANCIAL, INC.**

**Notes to Supplemental Combining Financial Information**

Holders of Common Stock have no interest in a separate legal entity representing the Financial Services Businesses; holders of the Class B Stock have no interest in a separate legal entity representing the Closed Block Business; and holders of each class of common stock are subject to all of the risks associated with an investment in the Company.

In the event of a liquidation, dissolution or winding-up of the Company, holders of Common Stock and holders of Class B Stock would be entitled to receive a proportionate share of the net assets of the Company that remain after paying all liabilities and the liquidation preferences of any preferred stock.

The results of the Financial Services Businesses are subject to certain risks pertaining to the Closed Block. These include any expenses and liabilities from litigation affecting the Closed Block policies as well as the consequences of certain potential adverse tax determinations. In connection with the sale of the Class B Stock and IHC debt, the cost of indemnifying the investors with respect to certain matters will be borne by the Financial Services Businesses.

**ITEM 9A. CONTROLS AND PROCEDURES**

Management's Annual Report on Internal Control Over Financial Reporting and the report of the Company's independent registered public accounting firm thereon are included in Part II, Item 8 of this Form 10-K/A.

In order to ensure that the information we must disclose in our filings with the Securities and Exchange Commission is recorded, processed, summarized, and reported on a timely basis, the Company's management, including our Chief Executive Officer and Chief Financial Officer, previously reviewed and evaluated the effectiveness of our disclosure controls and procedures, as defined in Exchange Act Rule 13a-15(e), as of December 31, 2004. Based on such evaluation, the Chief Executive Officer and Chief Financial Officer previously concluded that, as of December 31, 2004, our disclosure controls and procedures were effective in timely alerting them to material information relating to us (and our consolidated subsidiaries) required to be included in our periodic SEC filings. No change in our internal control over financial reporting, as defined in Exchange Act Rule 13a-15(f), occurred during the quarter ended December 31, 2004, that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. These conclusions are not affected by the misclassifications in the Company's Consolidated Statements of Cash Flows discussed in the following paragraph, which were identified subsequent to the filing of the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005.

As reported in a Current Report on Form 8-K filed by the Company on February 6, 2006, management of the Company concluded that certain amounts were incorrectly classified in the Company's audited Consolidated Statements of Cash Flows for the years ended December 31, 2004, 2003 and 2002 included in the Company's 2004 Annual Report on Form 10-K (the 2004 Form 10-K) and in the Company's unaudited Consolidated Statements of Cash Flows for the periods ended March 31 and June 30, 2005 and 2004 included in the Company's Quarterly Reports on Form 10-Q for the quarters ended March 31 and June 30, 2005 (the 2005 Forms 10-Q). In connection with the preparation of the Company's consolidated financial statements for the year ended December 31, 2005, management of the Company concluded on February 1, 2006 that the Company should file this Form 10-K/A and Forms 10-Q/A, restating the Consolidated Statements of Cash Flows included in the

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2004 Form 10-K and in the 2005 Forms 10-Q. The restatements are limited in scope, relating to the classification of data collected and not to the collection of data or to the numerical accuracy of data collected. The Company has implemented enhancements to its internal control over financial reporting, primarily with respect to the periodic analysis and review of statements of cash flows, designed to provide reasonable assurance that errors of this type in the Company's Consolidated Statements of Cash Flows will not recur.

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**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

3. Exhibits:

- 23.1 Consent of PricewaterhouseCoopers LLP.
- 24.1 Powers of Attorney.
- 31.1 Section 302 Certification of the Chief Executive Officer.
- 31.2 Section 302 Certification of the Chief Financial Officer.
- 32.1 Section 906 Certification of the Chief Executive Officer.
- 32.2 Section 906 Certification of the Chief Financial Officer.

Prudential Financial, Inc. will furnish upon request a copy of any exhibit listed above upon the payment of a reasonable fee covering the expense of furnishing the copy. Requests should be directed to:

Shareholder Services

Prudential Financial, Inc.

751 Broad Street, 22nd Floor

Newark, New Jersey 07102

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**Table of Contents****SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the city of Newark, and state of New Jersey, on the 15<sup>th</sup> day of February, 2006.

Prudential Financial, Inc.

By:                 /s/ RICHARD J. CARBONE                

Name: **Richard J. Carbone**  
Title: **Senior Vice President**

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on February 15, 2006:

<u>Name</u>	<u>Title</u>
<u>                /s/ ARTHUR F. RYAN                </u>	
<b>Arthur F. Ryan</b>	Chairman, Chief Executive Officer, President and Director
<u>                /s/ RICHARD J. CARBONE                </u>	
<b>Richard J. Carbone</b>	Chief Financial Officer (Principal Financial Officer)
<u>                /s/ DENNIS G. SULLIVAN                </u>	
<b>Dennis G. Sullivan</b>	Vice President (Principal Accounting Officer)
<u>                FREDERIC K. BECKER*                </u>	
<b>Frederic K. Becker</b>	Director
<u>                GORDON M. BETHUNE*                </u>	
<b>Gordon M. Bethune</b>	Director
<u>                GASTON CAPERTON*                </u>	
<b>Gaston Caperton</b>	Director
<u>                GILBERT F. CASELLAS*                </u>	
<b>Gilbert F. Casellas</b>	Director

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JAMES G. CULLEN\*

Director

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**James G. Cullen**

WILLIAM H. GRAY, III\*

Director

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**William H. Gray, III**

JON F. HANSON\*

Director

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**Jon F. Hanson**

CONSTANCE J. HORNER\*

Director

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**Constance J. Horner**

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	<u>Name</u>	<u>Title</u>
	KARL J. KRAPEK*	Director
	<hr/>	
	<b>Karl J. Krapek</b>	
	<hr/>	
By:*	/s/ RICHARD J. CARBONE	
	<hr/>	
	<b>Attorney-in-fact</b>	



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**Exhibit Index**

**Exhibit Number and Description**

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