LINCOLN NATIONAL CORP
Form 10-Q
August 09, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-Q

(Mark One)
x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2006.

¨ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from ______ to ______.

Commission File Number 1-6028

LINCOLN NATIONAL CORPORATION
(Exact name of registrant as specified in its charter)

Indiana	**35-1140070**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
1500 Market Street, Suite 3900, Philadelphia, Pennsylvania	**19102-2112**
(Address of principal executive offices)	**(Zip Code)**

(215) 448-1400
Registrant's telephone number, including area code

Not Applicable
Former name, former address and former fiscal year, if changed since last report

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

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

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

As of July 31, 2006, 280,786,053 shares of common stock of the registrant were outstanding.

***Item 1*. Financial Statements**

LINCOLN NATIONAL CORPORATION
CONSOLIDATED BALANCE SHEETS

	June 30, 2006 (Unaudited)	December 31, 2005
	(in millions)	
ASSETS		
Investments:		
Securities available-for-sale, at fair value:		
Fixed maturity (cost: 2006- $54,451; 2005-$32,384)	$ 54,024	$ 33,443
Equity (cost: 2006- $569; 2005-$137)	579	145
Trading securities	3,109	3,246
Mortgage loans on real estate	7,741	3,663
Real estate	429	183
Policy loans	2,716	1,862
Derivative investments	280	175
Other investments	836	452
Total Investments	69,714	43,169
Cash and invested cash	1,500	2,312
Deferred acquisition costs and value of businesses acquired	8,328	5,163
Premiums and fees receivable	344	343
Accrued investment income	879	526
Amounts recoverable from reinsurers	7,967	6,926
Goodwill	4,503	1,194
Other assets	3,050	1,480
Assets held in separate accounts	71,095	63,747
Total Assets	$ 167,380	$ 124,860
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Insurance and Investment Contract Liabilities:		
Insurance policy and claim reserves	$ 14,724	$ 11,703
Investment contract and policyholder funds	58,629	35,592
Total Insurance and Investment Contract Liabilities	73,353	47,295
Short-term debt	560	120
Long-term debt		
Senior notes	2,330	999
Junior subordinated debentures issued to affiliated trusts	330	334
Capital securities	1,072	-
Reinsurance related derivative liability	127	292
Funds withheld reinsurance liabilities	2,071	2,012
Deferred gain on indemnity reinsurance	798	836
Other liabilities	4,240	2,841
Liabilities related to separate accounts	71,095	63,747
Total Liabilities	155,976	118,476
Shareholders' Equity:		
Series A preferred stock-10,000,000 shares authorized (2006 liquidation value-$1)	1	1

Common stock-800,000,000 shares authorized	7,426	1,775
Retained earnings	4,013	4,081
Accumulated Other Comprehensive Income (Loss):		
Net unrealized gain (loss) on securities available-for-sale	(151)	497
Net unrealized gain on derivative instruments	51	7
Foreign currency translation adjustment	128	83
Minimum pension liability adjustment	(64)	(60)
Total Accumulated Other Comprehensive Income (Loss)	(36)	527
Total Shareholders' Equity	11,404	6,384
Total Liabilities and Shareholders' Equity	$ 167,380	$ 124,860

See accompanying Notes to the Consolidated Financial Statements.

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LINCOLN NATIONAL CORPORATION
CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
	(Unaudited) (in millions, except per share amounts)			
Revenue:				
Insurance premiums	$ 454	$ 73	$ 533	$ 143
Insurance fees	690	426	1,164	846
Investment advisory fees	81	62	159	117
Communications sales	58	-	58	-
Net investment income	1,068	704	1,747	1,364
Realized gain (loss)	(5)	(9)	(6)	3
Amortization of deferred gain on indemnity reinsurance	19	19	37	38
Other revenue and fees	131	100	225	183
Total Revenue	2,496	1,375	3,917	2,694
Benefits and Expenses:				
Benefits	1,179	590	1,760	1,161
Underwriting, acquisition, insurance and other expenses	717	525	1,220	1,013
Communications expenses	30	-	30	
Interest and debt expense	65	22	87	44
Total Benefits and Expenses	1,991	1,137	3,097	2,218
Income before Federal income taxes	505	238	820	476
Federal income taxes	156	40	250	99
Net Income	$ 349	$ 198	$ 570	$ 377
Net Income Per Common Share:				
Basic	$ 1.25	$ 1.15	$ 2.51	$ 2.18
Diluted	$ 1.23	$ 1.13	$ 2.47	$ 2.14

See accompanying Notes to the Consolidated Financial Statements.

LINCOLN NATIONAL CORPORATION
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

	Six Months Ended June 30,			
	Number of Shares		Amounts	
	2006	2005	2006	2005
	(Unaudited)		(Unaudited)	
	(in millions, except for share amounts)			
Series A Preferred Stock:				
Balance at beginning-of-year	15,515	16,912	$ 1	$ 1
Conversion into common stock	(987)	(656)	-	-
Balance at June 30	14,528	16,256	1	1
Common Stock:				
Balance at beginning-of-year	173,768,078	173,557,730	1,775	1,655
Issued for acquisition	112,301,906	-	5,632	-
Conversion of series A preferred stock	15,792	10,496	-	-
Stock compensation/issued for benefit plans	3,353,059	1,067,931	92	55
Deferred compensation payable in stock	158,342	51,079	9	2
Retirement of common stock	(8,060,131)	(2,331,000)	(82)	(22)
Balance at June 30	281,537,046	172,356,236	7,426	1,690
Retained Earnings:				
Balance at beginning-of-year			4,081	3,590
Comprehensive income			7	361
Less other comprehensive income (loss) (net of federal income tax):				
Net unrealized loss on securities available-for-sale, net of reclassification adjustment			(648)	28
Net unrealized gain (loss) on derivative instruments			44	(2)
Foreign currency translation adjustment			45	(45)
Minimum pension liability adjustment			(4)	3
Net Income			570	377
Retirement of common stock			(423)	(81)
Dividends declared:				
Series A preferred ($1.50 per share)			-	-
Common (2006-$0.76; 2005-$0.73)			(215)	(127)
Balance at June 30			4,013	3,759
Net Unrealized Gain on Securities Available-for-Sale:				

Balance at beginning-of-year		497		823
Change during the period		(648)		28
Balance at June 30		(151)		851
Net Unrealized Gain on Derivative Instruments:				
Balance at beginning-of-year		7		14
Change during the period		44		(2)
Balance at June 30		51		12
Foreign Currency Translation Adjustment:				
Accumulated adjustment at beginning-of-year		83		154
Change during the period		45		(45)
Balance at June 30		128		109
Minimum Pension Liability Adjustment:				
Balance at beginning-of-year		(60)		(61)
Change during the period		(4)		3
Balance at June 30		(64)		(58)
Total Shareholders' Equity at June 30	$	11,404	$	6,364
Common Stock at End of Quarter:				
Assuming conversion of preferred stock		281,769,494		172,616,332
Diluted basis		284,958,226		174,843,027

See accompanying Notes to the Consolidated Financial Statements.

LINCOLN NATIONAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30, 2006	2005
	(Unaudited) (in millions)	
Cash Flows from Operating Activities:		
Net income	$ 570	$ 377
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred acquisition costs	(249)	(139)
Premiums and fees receivable	61	10
Accrued investment income	2	(12)
Policy liabilities and accruals	(277)	(102)
Contractholder funds	533	725
Net trading securities purchases, sales and maturities	(20)	(74)
Gain on reinsurance embedded derivative/trading securities	(8)	1
Increase in funds withheld liability	59	70
Amounts recoverable from reinsurers	255	(174)
Federal income taxes	52	66
Stock-based compensation expense	30	27
Depreciation	30	46
Gain on sale of subsidiaries/business	-	(14)
Realized loss on investments and derivative instruments	14	11
Amortization of deferred gain	(38)	(38)
Other	(92)	(259)
Net Adjustments	352	144
Net Cash Provided by Operating Activities	922	521
Cash Flows from Investing Activities:		
Securities-available-for-sale:		
Purchases	(3,718)	(2,968)
Sales	2,565	1,596
Maturities	1,348	1,162
Purchase of other investments	(697)	(400)
Sale or maturity of other investments	449	464
Increase in cash collateral on loaned securities	133	98
Purchase of Jefferson Pilot Stock, net of cash acquired of $39	(1,847)	-
Proceeds from sale of subsidiaries/business	-	14
Other	(123)	186
Net Cash Provided by (Used in) Investing Activities	(1,890)	152
Cash Flows from Financing Activities:		
Issuance of long-term debt	2,045	-
Payment of long-term debt	-	(241)
Net increase (decrease) in short-term debt	(557)	201
Universal life and investment contract deposits	3,136	2,516
Universal life and investment contract withdrawals	(3,004)	(2,296)

Investment contract transfers	(817)	(658)
Common stock issued for benefit plans	71	34
Retirement of common stock	(503)	(104)
Dividends paid to shareholders	(215)	(128)
Net Cash (Used in) Provided by Financing Activities	156	(676)
Net (Decrease) Increase in Cash and Invested Cash	(812)	(3)
Cash and Invested Cash at Beginning-of-Year	2,312	1,662
Cash and Invested Cash at June 30	$ 1,500	$ 1,659

See accompanying Notes to the Consolidated Financial Statements.

LINCOLN NATIONAL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying Consolidated Financial Statements include Lincoln National Corporation and its majority-owned subsidiaries ("LNC" or the "Company" which also may be referred to as "we" or "us"). As discussed below in Note 2 we completed our merger with Jefferson-Pilot Corporation on April 3, 2006. Through subsidiary companies, we operate multiple insurance and investment management businesses divided into seven business segments (see Note 8). The collective group of companies uses "Lincoln Financial Group" as its marketing identity. We report less than majority-owned entities in which we have at least a 20% interest on the equity basis. These unaudited Consolidated Financial Statements have been prepared in conformity with accounting principles generally accepted in the United States ("GAAP"). In the opinion of management, these statements include all normal recurring adjustments necessary for a fair presentation of the results.

These financial statements should be read in conjunction with the audited Consolidated Financial Statements and the accompanying notes incorporated by reference into our latest annual report on Form 10-K for the year ended December 31, 2005 ("2005 Form 10-K"). On April 3, 2006, LNC filed a Current Report on Form 8-K dated April 3, 2006 that incorporated the audited financial statements and notes for Jefferson-Pilot as of December 31, 2005 and 2004, and for the years ended December 31, 2005, 2004 and 2003 from Jefferson-Pilot's Annual Report on Form 10-K for the year ended December 31, 2005. The accompanying consolidated financial statements should also be read in conjunction with those financial statements and notes.

Operating results for the three and six months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2006. All material intercompany accounts and transactions have been eliminated in consolidation.

Certain amounts reported in prior periods' unaudited Consolidated Financial Statements have been reclassified to conform to the 2006 presentation. These reclassifications have no effect on net income or shareholders' equity of the prior periods. Included in these reclassifications is the change in the definition of cash flows from funds withheld liabilities from financing to operating cash flows in the unaudited Consolidated Statements of Cash Flows. While this had no effect on total cash flow, for the six months ended June 30, 2005, net cash provided by operating activities and net cash used in financing activities were increased and decreased, respectively, by $70 million. A similar reclassification in our Consolidated Statements of Cash Flows for the years ended December 31, 2005, 2004 and 2003 would have increased net cash provided by operating activities (with corresponding decreases in net cash provided by (used) in financing activities) by $117 million, $77 million, and $56 million, resulting in net cash provided by operating activities of $1.1 billion, $1.1 billion and $1.0 billion, respectively.

2. Business Combination

On April 3, 2006, we completed our merger with Jefferson-Pilot Corporation ("Jefferson-Pilot") by acquiring 100% of the outstanding shares of Jefferson-Pilot in a transaction accounted for under the purchase method of accounting prescribed by SFAS No.141, "Business Combinations" ("SFAS 141"). Jefferson-Pilot's results of operations are included in our results of operations beginning April 3, 2006. As a result of the merger, our product portfolio was expanded, and we now offer fixed and variable universal life, fixed annuities, including indexed annuities, variable annuities, mutual funds and institutional accounts, 401(k) and 403(b) offerings, and group life, disability and dental insurance products. We also own and operate television and radio stations in selected markets in the Southeastern and Western United States and produce and distribute sports programming.

The aggregate consideration paid for the merger is as follows:

(in millions, except share data)	**Share Amounts**	
LNC common shares issued	112,301,906	
Purchase price per share of LNC common share (1)	$ 48.98	
Fair value of common shares issued		$ 5,501
Cash paid to Jefferson Pilot shareholders		1,800
Fair value of Jefferson-Pilot stock options (2)		131
Transaction costs		86
Total purchase price		$ 7,518

(1) The value of the shares of LNC common stock exchanged with Jefferson-Pilot shareholders was based upon the average of the closing prices of LNC common stock for the five day trading period ranging from two days before, to two days after, October 10, 2005, the date the merger was announced.
(2) Includes certain stock options that vested immediately upon the consummation of the merger. Any future income tax deduction related to these vested stock options will be recognized on the option exercise date as an adjustment to the purchase price and recorded to goodwill.

The fair value of Jefferson-Pilot's net assets assumed in the merger was $4.2 billion. Goodwill of $3.3 billion resulted from the excess of purchase price over the fair value of Jefferson-Pilot's net assets. We paid a premium over the fair value of Jefferson-Pilot's net assets for a number of potential strategic and financial benefits that are expected to be realized as a result of the merger including, but not limited to, the following:

· Greater size and scale with improved earnings diversification and strong financial flexibility;
· Broader, more balanced product portfolio;
· Larger distribution organization; and
· Value creation opportunities through expense savings and revenue enhancements across business units.

SFAS 141 requires that the total purchase price be allocated to the assets acquired and liabilities assumed based on their fair values at the merger date. We are in the process of finalizing our internal studies of the fair value of the net assets acquired including investments, value of business acquired ("VOBA"), intangible assets and certain liabilities. As such, the preliminary fair values in the table below are subject to adjustment as additional information is obtained, which may result in adjustments to goodwill, which we do not expect to be material. The following table summarizes the preliminary fair values of the net assets acquired as of the acquisition date:

(in millions)		**Preliminary Fair Value**
Investments	$	27,908
Due from reinsurers		1,296
Value of business acquired		2,474
Goodwill		3,307
Other assets		1,654
Assets held in separate accounts		2,574
Policy liabilities		(26,522)
Long-term debt		(905)
Income tax liabilities		(849)
Accounts payable, accruals and other liabilities		(845)
Liabilities related to separate accounts		(2,574)
Total purchase price	$	7,518

The goodwill resulting from the merger was allocated to the following segments:

(in millions)		
Individual Markets:		
Life Insurance	$	1,333
Annuities		987
Total Individual Markets		2,320
Employer Markets: Benefit Partners		279
Lincoln Financial Media		708
Total goodwill	$	3,307

The following table summarizes the fair value of identifiable intangible assets acquired in the merger and reported in other assets.

(in millions)			Weighted Average Amortization Period
Lincoln Financial Media:			
FCC licenses	$	638	N/A
Sports production rights		11	5 years
Network affiliation agreements		10	21 years
Other		11	16 years
Total Lincoln Financial Media		670	
Individual Markets - Life Insurance:			
Sales force		100	25 years
Total indentifiable intangibles	$	770	
Identifiable intangibles not subject to amortization	$	638	N/A
Identifiable intangibles subject to amortization		132	22 years
Total identifiable intangibles	$	770	

The following unaudited pro forma condensed consolidated results of operations assume that the merger with Jefferson-Pilot was completed as of January 1, 2006 and 2005:

(in millions, except per share amounts)		Three Months Ended June 30, 2005		Six Months Ended June 30, 2006		Six Months Ended June 30, 2005
Revenue	$	2,417	$	4,989	$	4,749
Net income		339		684		683
Net income per common share:						
Basic	$	1.06	$	3.01	$	2.12
Diluted	$	1.05	$	2.97	$	2.10

We initially financed the cash portion of the merger consideration by borrowing $1.8 billion under a credit agreement that we entered into with a group of banks in December 2005 (the "bridge facility"). During the second quarter of 2006, we issued the following debt securities:

Security		Net Proceeds (in millions)	Interest Due
$500M Floating Rate Senior Notes, due 4/6/2009 (1)	$	499	Quarterly in January, April, July and October
$500M 6.15% Senior Notes, due 4/7/2036 (2)		492	Semi-annually in April and October
Capital Securities		266	

$275M 6.75% Junior Subordinated Debentures, due 4/20/2066 (3)			Quarterly in January, April, July and October
$800M 7% Junior Subordinated Debentures, due 5/17/2066 (4)		788	Semi-annually in May and November
Total proceeds	$	2,045	

(1) Interest at a rate of three-month LIBOR plus 0.11%.
(2) Redeemable any time subject to a make-whole provision.
(3) Redeemable in whole or in part on or after April 20, 2011 (and prior to such date in whole or in part under certain circumstances).
(4) Redeemable in whole or in part on or after May 17, 2016 (and prior to such date in whole or in part under certain circumstances). Beginning May 17, 2016, interest is due quarterly in February, May, August and November.

We used the net proceeds from the offerings, and other cash, to repay the outstanding loan balance under the bridge facility.

At June 30, 2006, we maintain the following debt securities that were previously issued by Jefferson-Pilot and are included within our Consolidated Balance Sheet:

· Junior subordinated debentures issued by Jefferson-Pilot in 1997 consist of $211 million at an interest rate of 8.14% and $107 million at an interest rate of 8.285%. Interest is paid semi-annually. These debentures mature in 2046, but are redeemable prior to maturity at our option beginning January 15, 2007, with two-thirds subject to a call premium of 4.07% and the remainder subject to a call premium of 4.14%, each grading to zero as of January 15, 2017. Premiums arose from recording these securities at their respective fair values, which were based on discounted cash flows using our incremental borrowing rate at the date of the merger. The premiums are being amortized to the respective call dates using an approximate effective yield methodology. The unamortized premiums included in the amounts above totaled $9 million. As we expect to call these securities within the next twelve months, they have been reported in short-term debt on our consolidated balance sheet.

· Ten-year term notes of $284 million at 4.75% and $300 million of floating rate EXtendible Liquidity Securities® ("EXL"s) that currently have a maturity of August 2007, subject to periodic extension through 2011. Each quarter, the holders must make an election to extend the maturity of the EXLs for 13 months, otherwise they become due and payable on the next maturity date to which they had previously been extended. The EXLs bear interest at LIBOR plus a spread, which increases annually to a maximum of 10 basis points. The amount reported on our consolidated balance sheet is net of a $16 million discount that arose from recording the ten-year term notes at their respective fair values based on discounted cash flows using our incremental borrowing rate at the date of merger. The discount is being accreted over the remaining life using an approximate effective yield methodology.

See our current reports on Form 8-K filed with the SEC on April 3, 2006, April 7, 2006, April 20, 2006, May 9, 2006 and May 17, 2006 for additional information.

3. Changes in Accounting Principles and Changes in Estimates

SFAS No. 123(r) - Share-Based Payment. In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)"), which is a revision of SFAS 123, "Accounting for Stock-based Compensation" ("SFAS 123"). SFAS 123(R) requires us to recognize at fair value all costs resulting from share-based payments to employees, except for equity instruments held by employee share ownership plans. Similar to SFAS 123, under SFAS 123(R) the fair value of share-based payments are recognized as a reduction to earnings over the period an employee is required to provide service in exchange for the award. We had previously adopted the retroactive restatement method under SFAS No. 148, "Accounting for Stock-based Compensation - Transition and Disclosure," and restated all periods presented to reflect stock-based employee compensation cost under the fair value accounting method for all employee awards granted, modified or settled in fiscal years beginning after December 15, 1994.

Effective January 1, 2006, we adopted SFAS 123(R), using the modified prospective transition method. Under that transition method, compensation cost recognized in 2006 includes: (a) compensation cost for all share-based payments granted prior to but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Results from prior periods have not been restated. The effect of adopting SFAS 123(R) did not have a material effect on our income before Federal income taxes, net income and basic and diluted earnings per share.

SFAS 123(R) eliminates the alternative under SFAS 123 permitting the recognition of forfeitures as they occur. Expected forfeitures, resulting from the failure to satisfy service or performance conditions, must be estimated at the grant date, thereby recognizing compensation expense only for those awards expected to vest. In accordance with SFAS 123(R), we have included estimated forfeitures in the determination of compensation costs for all share-based payments. Estimates of expected forfeitures must be reevaluated at each balance sheet date, and any change in the estimate recognized retrospectively in net income in the period of the revised estimate.

Prior to the adoption of SFAS 123(R), we presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Statement of Cash Flows. SFAS 123(R) requires the cash flows from tax benefits resulting from tax deductions in excess of the compensation costs recognized to be classified as financing cash flows. Our excess tax benefits are classified as financing cash flows, prospectively, in our Statement of Cash Flows for the six months ended June 30, 2006.

We issue share-based compensation awards under an authorized plan, subject to specific vesting conditions. Generally, compensation expense is recognized ratably over a three-year vesting period, but recognition may be accelerated upon the occurrence of certain events. For awards that specify an employee will vest upon retirement and an employee is eligible to retire before the end of the normal vesting period, we would record compensation expense over the period from the grant date to the date of retirement eligibility. As a result of adopting SFAS 123(R), we have revised the prior method of recording unrecognized compensation expense upon retirement and use the non-substantive vesting period approach for all new share-based awards granted after January 1, 2006. Under the non-substantive vesting period approach, we recognize compensation cost immediately for awards granted to retirement-eligible employees, or ratably over a period from the grant date to the date retirement eligibility is achieved. If we would have applied the non-substantive vesting period approach to all share based compensation awards granted prior to January 1, 2006, it would not have a material effect on our results of operations or financial position.

See Note 11 for more information regarding our stock-based compensation plans.

FSP 115-1 - The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. In November 2005, the FASB issued FASB Staff Position ("FSP") FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" ("FSP 115-1"). The guidance in FSP 115-1 nullifies the accounting and measurement provisions of Emerging Issues Task Force No. 03-1 - "The Meaning of Other Than Temporary Impairments and Its Application to Certain Investments" references existing guidance, and supersedes EITF Topic No. D-44 "Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value." FSP 115-1 was effective for reporting periods beginning after December 15, 2005, on a prospective basis. Our existing policies for recognizing other-than-temporary impairments are consistent with the guidance in FSP 115-1. We adopted FSP 115-1 effective January 1, 2006. The adoption of FSP 115-1 did not have a material effect on our consolidated financial condition or results of operations.

Statement of Position 05-1. In September 2005, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants ("AICPA") issued Statement of Position ("SOP") 05-1, "Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts" ("SOP 05-1"). SOP 05-1 addresses the accounting for Deferred Acquisition Costs ("DAC") on internal replacements other than those described in SFAS No. 97, "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments." An internal replacement is defined by SOP 05-1 as a modification in product benefits, features, rights or coverages that occurs by (a) exchanging the contract for a new contract, (b) amending, endorsing or attaching a rider to the contract, or (c) electing a feature or coverage within a replaced contract. Contract modifications that result in a substantially unchanged contract will be accounted for as a continuation of the replaced contract. Contract modifications that result in a substantially changed contract should be accounted for as an extinguishment of the replaced contract, and any unamortized DAC, unearned revenue and deferred sales charges must be written-off. SOP 05-1 is to be applied prospectively and is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. We expect to adopt SOP 05-1 effective January 1, 2007. We are currently evaluating the potential effects of SOP 05-1 on our consolidated financial condition and results of operations.

SFAS No. 155 - Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140. In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140" ("SFAS 155"), which permits fair value remeasurement for a hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. Under SFAS 155, an entity may make an irrevocable election to measure a hybrid financial instrument at fair value, in its entirety, with changes in fair value recognized in earnings. SFAS 155 also: (a) clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"); (b) eliminates the interim guidance in SFAS 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," and establishes a requirement to evaluate beneficial interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation; (c) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and (d) eliminates restrictions on a qualifying special-purpose entity's ability to hold passive derivative financial instruments that pertain to beneficial interests that are or contain a derivative financial instrument. We expect to adopt SFAS 155 for all financial instruments acquired, issued, or subject to a remeasurement event occurring after January 1, 2007. Upon adoption of SFAS 155, the fair value election may also be applied to hybrid financial instruments that had previously been bifurcated pursuant to SFAS 133. Prior period restatement is not permitted. We are currently evaluating the potential effects of SFAS 155 on our consolidated financial condition and results of operations.

FASB Interpretation No. 48 - Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109. In July 2006, the FASB issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109” (“FIN 48”). SFAS No. 109, “Accounting for Income Taxes” does not contain specific guidance on how to address uncertainty in accounting for income tax assets and liabilities. With the issuance of FIN 48, the FASB provides criteria which an individual tax position must meet for any part of the benefit of the tax position to be recognized in the financial statements. The criterion includes determining whether it is more-likely-than-not that a tax position will be sustained upon examination by the appropriate taxing authority. If the tax position meets the more-likely-than-not threshold, the position is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. If a tax position does not meet the more-likely-than-not recognition threshold, the benefit is not recognized in the financial statements. Upon adoption of FIN 48, the guidance will be applied to all tax positions, and only those tax positions meeting the more-likely-than-not threshold will be recognized or continue to be recognized in the financial statements. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. In addition, FIN 48 expands disclosure requirements to include additional information related to unrecognized tax benefits. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the potential effects of FIN 48 on our consolidated financial condition and results of operations.

4. Federal Income Taxes

The effective tax rate on net income is lower than the prevailing corporate Federal income tax rate principally from tax-preferred investment income. LNC earns tax-preferred investment income that does not change proportionately with the overall change in earnings or losses before Federal income taxes.

We are required to establish a valuation allowance for any gross deferred tax assets that are unlikely to reduce taxes payable in future years' tax returns. At June 30, 2006, we believe that it is more likely than not that all gross deferred tax assets will reduce taxes payable in future years. Our Federal income tax liability at December 31, 2004 included a valuation allowance of $47 million attributable to the net operating losses of our foreign life reinsurance subsidiary domiciled in Barbados. This valuation allowance was reduced to zero as of December 31, 2005, including a reduction of $24 million and $29 million in the second quarter and first six months of 2005, respectively.

We are subject to annual tax examinations from the Internal Revenue Service ("IRS"). During the first quarter of 2006, the IRS completed its examination for the tax years 1999 through 2002 with assessments resulting in a payment that was not material to our consolidated results of operations. In addition to taxes assessed and interest, the payment included a deposit relating to a portion of the assessment, which we continue to challenge. We believe this portion of the assessment is inconsistent with existing law, and are protesting it through the established IRS appeals process. We do not anticipate that any adjustments that might result from such audits would be material to our consolidated results of operations or financial condition. The Jefferson-Pilot subsidiaries acquired in the April 2006 merger are subject to a separate IRS examination cycle. During the second quarter of 2006, the IRS completed its examinations for the tax years 2000-2003 of Jefferson-Pilot Corporation and its subsidiaries, resulting in a refund that was not material to our consolidated results of operations.

5. Supplemental Financial Data

A rollforward of DAC and value of business acquired on the Consolidated Balance Sheet is as follows:

	Six Months Ended June 30,	
(in millions)	**2006**	**2005**
Balance at beginning-of-year	$ 5,163	$ 4,590
Business acquired	2,474	-
Deferral	636	435
Amortization	(387)	(297)
Adjustment related to realized gains on securities available-for-sale	(30)	(26)
Adjustment related to unrealized losses on securities available-for-sale	416	11
Foreign currency translation adjustment	56	(56)
Balance at end-of-period	$ 8,328	$ 4,657

Realized gains and losses on investments and derivative instruments on the Consolidated Statements of Income for the six months ended June 30, 2006 and 2005 are net of amounts amortized against DAC of $30 million and $26 million, respectively. In addition, realized gains and losses for the six months ended June 30, 2006 and 2005 are net of adjustments made to policyholder reserves of $(3) million and $(2) million, respectively. We have either a contractual obligation or a consistent historical practice of making allocations of investment gains or losses to certain policyholders and to certain reinsurance arrangements.

A rollforward of deferred sales inducements, included in other assets on the Consolidated Balance Sheet, is as follows:

	Six Months Ended June 30,	
(in millions)	**2006**	**2005**
Balance at beginning-of-year	$ 129	$ 86
Capitalized	36	29
Amortization	(10)	(8)
Balance at end-of-period	$ 155	$ 107

Details underlying underwriting, acquisition, insurance and other expenses on the Consolidated Statements of Income are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in millions)	**2006**	**2005**	**2006**	**2005**
Commissions	$ 396	$ 200	$ 612	$ 379
General and administrative expenses	421	357	752	686
Deferred acquisition costs net of amortization	(170)	(81)	(249)	(138)
Other intangibles amortization	6	2	8	4
Taxes, licenses and fees	47	24	80	57
Restructuring charges - includes merger-integration expenses	10	23	10	25
Other merger-integration expenses	7	-	7	-
Total	$ 717	$ 525	$ 1,220	$ 1,013

As discussed in Note 2, the excess of the purchase price for the Jefferson-Pilot merger over the fair value of net assets acquired totaled $3.3 billion

The carrying amount of goodwill by reportable segment as of June 30, 2006 is as follows:

(in millions)	**Balance at December 31, 2005**	**Jefferson-Pilot Merger (Note 2)**	**Balance at June 30, 2006**
Individual Markets:			
Annuities	$ 44	$ 987	$ 1,031
Life Insurance	855	1,333	2,188
Employer Markets:			
Retirement Products & Other	20	-	20
Benefit Partners	-	279	279
Investment Management	261	-	261
Lincoln Financial Media	-	708	708
Lincoln UK*	14	-	16
Total	$ 1,194	$ 3,307	$ 4,503

*Changes in the carrying amount goodwill for the Lincoln UK segment from December 31, 2005 to June 30, 2006, are due to the translation of the balances from British pounds to U.S. dollars based on the prevailing exchange rate as of the respective balance sheet dates.

Details of investment contract and policyholder funds on the Consolidated Balance Sheet are as follows:

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(in millions)	June 30, 2006	December 31, 2005
Premium deposit funds	$ 21,199	$ 21,713
Other policyholder funds	36,518	12,972
Deferred front end loads	833	796
Undistributed earnings on participating business	79	111
Total	$ 58,629	$ 35,592

6. Insurance Benefit Reserves

We issue variable contracts through our separate accounts for which investment income and investment gains and losses accrue directly to, and investment risk is borne by, the contractholder (traditional variable annuities). We also issue variable annuity and life contracts through separate accounts that include various types of guaranteed minimum death benefit (“GMDB”) features, a guaranteed minimum withdrawal benefit (“GMWB”) and guaranteed income benefits (“GIB”). The GMDB features generally include those where we contractually guarantee that the contractholder receives (*a*) a return of no less than total deposits made to the contract less any partial withdrawals, (*b*) total deposits made to the contract less any partial withdrawals plus a minimum return, or (*c*) the highest contract value on any contract anniversary date through age 80 minus any payments or withdrawals following such contract anniversary.

The following table provides information on the GMDB features outstanding at June 30, 2006 and December 31, 2005. (Note that our variable contracts with guarantees may offer more than one type of guarantee in each contract; therefore, the amounts listed are not mutually exclusive.) The net amount at risk (“NAR”) is defined as the current guaranteed minimum death benefit in excess of the current account balance at the balance sheet date.

	In Event of Death	
(dollars in billions)	June 30, 2006	December 31, 2005
Return of net deposit		
Account value	$ 33.9	$ 31.9
NAR	0.1	0.1
Average attained age of contractholders	53	53
Return of net deposits plus a minimum return		
Account value	$ 0.4	$ 0.3
NAR	-	-
Average attained age of contractholders	66	66
Guaranteed minimum return	5%	5%
Highest specified anniversary account value minus withdrawals post anniversary		
Account value	$ 20.2	$ 18.8
NAR	0.4	0.4
Average attained age of contractholders	63	63

The following summarizes the liabilities for GMDB:

(in millions)	June 30, 2006	June 30, 2005
Balance at beginning of year	$ 15	$ 18
Changes in reserves	11	12
Benefits paid	(3)	(6)
Balance at end-of-period	$ 23	$ 24

The changes to the benefit reserves amounts above are reflected in benefits in the Consolidated Statements of Income. Also included in benefits are the results of the hedging program, which included gains (losses) of $0 and $(2) million for GMDB for the three and six months ended June 30, 2006, respectively, and $(2) million and $2 million for the three and six months ended June 30, 2005, respectively.

Approximately $10.6 billion and $8.2 billion of separate account values at June 30, 2006 and December 31, 2005 were attributable to variable annuities with a GMWB feature. This GMWB feature offers the contractholder a guarantee equal to the initial deposit adjusted for any subsequent purchase payments or withdrawals. There are one-year and five-year step-up options, which allow the contractholder to step up the guarantee. GMWB features are considered to be derivatives under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" resulting in the guarantees being recognized at fair value, with changes in fair value being reported in net income.

Approximately $1.6 billion and $1.2 billion of separate account values at June 30, 2006 and December 31, 2005, respectively, were attributable to variable annuities with a GIB feature. Similar to GMWB features, the GIB feature is considered a derivative with the resulting guarantees being recognized at fair value and changes in fair value being reported in net income.

Separate account balances attributable to variable annuity contracts with guarantees are as follows:

(in billions)	June 30, 2006	December 31, 2005
Asset Type		
Domestic equity	$ 34.7	$ 32.2
International equity	4.8	4.2
Bonds	5.5	5.1
Total	45.0	41.5
Money market	4.6	4.0
Total	$ 49.6	$ 45.5
Percent of total variable annuity separate account values	72%	84%

7. Restrictions and Contingencies

Statutory Restrictions

Our insurance subsidiaries are subject to certain insurance department regulatory restrictions as to the transfer of funds and payment of dividends to the holding company. Generally, these restrictions pose no short-term liquidity concerns for the holding company. For example, under Indiana laws and regulations, our Indiana insurance subsidiaries, including one of our major insurance subsidiaries, The Lincoln National Life Insurance Company ("LNL"), may pay dividends to LNC only from unassigned surplus, without prior approval of the Indiana Insurance Commissioner (the "Commissioner"), or must receive prior approval of the Commissioner to pay a dividend if such dividend, along with all other dividends paid within the preceding twelve consecutive months, would exceed the statutory limitation. The current statutory limitation is the greater of (i) 10% of the insurer's policyholders' surplus, as shown on its last annual statement on file with the Commissioner or (ii) the insurer's statutory net gain from operations for the previous twelve months, but in no event to exceed statutory unassigned surplus. Indiana law gives the Commissioner broad discretion to disapprove requests for dividends in excess of these limits. Our other major insurance subsidiaries, Jefferson-Pilot Life Insurance Company, Jefferson-Pilot Financial Insurance Company, and Jefferson-Pilot LifeAmerica Insurance Company are domiciled in North Carolina, Nebraska and New Jersey, respectively, and are subject to similar, but not identical, restrictions.

LNL is recognized as an accredited reinsurer in the state of New York, which effectively enables it to conduct reinsurance business with unrelated insurance companies that are domiciled within the state of New York. As a result, in addition to regulatory restrictions imposed by the state of Indiana, LNL is also subject to the regulatory requirements that the State of New York imposes upon authorized insurers. These include reserve requirements, which differ from Indiana's requirements.

The New York regulations require LNL to report more reserves to the state of New York. As a result, the level of statutory surplus that LNL reports to New York is less than the statutory surplus reported to Indiana and the National Association of Insurance Commissioners. If New York requires us to maintain a higher level of capital to remain an accredited reinsurer in New York, LNL's ability to pay dividends to us could be constrained. However, we do not expect that LNL's ability to pay dividends during 2006 will be constrained as a result of our status in New York.

Lincoln UK's operations consist primarily of unit-linked life and pension products, which are similar to U.S. produced variable life and annuity products. Lincoln UK's insurance subsidiaries are regulated by the U.K. Financial Services Authority ("FSA") and are subject to capital requirements as defined by the U.K. Capital Resources Requirement (formerly the Required Minimum Solvency Margin). All insurance companies operating in the U.K. also have to complete a risk-based capital ("RBC") assessment to demonstrate to the FSA that they hold sufficient capital to cover their risks. RBC requirements in the U.K. are different than the NAIC requirements. In addition, the FSA has imposed certain minimum

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capital requirements for the combined U.K. subsidiaries. Lincoln UK maintains approximately 1.5 to 2 times the required capital as prescribed by the regulatory margin. As is the case with regulated insurance companies in the U.S., changes to regulatory capital requirements can impact the dividend capacity of the UK insurance subsidiaries and cash flow to us.

Reinsurance

Our amounts recoverable from reinsurers represent receivables from and reserves ceded to reinsurers. We obtain reinsurance from a diverse group of reinsurers and we monitor concentration, as well as financial strength ratings of our principal reinsurers. Swiss Re Life & Health America, Inc. ("Swiss Re") represents our largest reinsurance exposure. In 2001, we sold our reinsurance business to Swiss Re primarily through indemnity reinsurance arrangements. Because we are not relieved of our liability to the ceding companies for this business, the liabilities and obligations associated with the reinsured contracts remain on our Consolidated Balance Sheets with a corresponding reinsurance receivable from the business sold to Swiss Re, which totaled $4.1 billion at June 30, 2006 and December 31, 2005. Swiss Re has funded a trust with a balance of $1.7 billion at June 30, 2006 to support this business. In addition to various remedies that we would have in the event of a default by Swiss Re, we continue to hold assets in support of certain of the transferred reserves. These assets consist of those reported as trading securities and certain mortgage loans. Our liabilities for funds withheld and embedded derivatives included $2.1 billion and $0.1 billion, respectively, at June 30, 2006 related to the business sold to Swiss Re.

We recorded the gain related to the indemnity reinsurance transactions on the business sold to Swiss Re as deferred gain in the liability section of our Consolidated Balance Sheet in accordance with the requirements of SFAS No. 113, “Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts” (“FAS 113”). We amortize the deferred gain into income at the rate that earnings on the reinsured business are expected to emerge, over a period of 15 years.

Because the reserves related to the personal accident business are based upon various estimates that are subject to considerable uncertainty, the reserves carried on the Consolidated Balance Sheet at June 30, 2006 may ultimately prove to be either excessive or deficient. For instance, in the event that future developments indicate that these reserves should be increased, under FAS 113 we would record a current period non-cash charge to record the increase in reserves. Because Swiss Re is responsible for paying the underlying claims to the ceding companies, we would record a corresponding increase in reinsurance recoverable from Swiss Re. However, FAS 113 does not permit us to take the full benefit in earnings for the recording of the increase in the reinsurance recoverable in the period of the change. Rather, we would increase the deferred gain recognized upon the closing of the indemnity reinsurance transaction with Swiss Re and would report a cumulative amortization “catch-up” adjustment to the deferred gain balance as increased earnings recognized in the period of change. Any amount of additional increase to the deferred gain above the cumulative amortization “catch-up” adjustment must continue to be deferred and will be amortized into income in future periods over the remaining period of expected run-off of the underlying business. No cash would be transferred between Swiss Re and us as a result of these developments.

United Kingdom Selling Practices

Various selling practices of the Lincoln UK operations have come under scrutiny by the U.K. regulators. These include the sale and administration of individual pension products and mortgage endowments. Regarding the sale and administration of pension products to individuals, regulatory agencies have raised questions as to what constitutes appropriate advice to individuals who bought pension products as an alternative to participation in an employer-sponsored plan. In cases of alleged inappropriate advice, an extensive investigation has been or is being carried out and the individual put in a position similar to what would have been attained if the individual had remained in an employer-sponsored plan.

At June 30, 2006 and December 31, 2005, the aggregate liability associated with Lincoln UK selling practices was $10 million and $13 million, respectively. On an ongoing basis, Lincoln UK evaluates various assumptions underlying these estimated liabilities, including the expected levels of future complaints and the potential implications with respect to the adequacy of the aggregate liability associated with UK selling practice matters. Any changes in the regulatory position on time limits for making a complaint regarding the sale of mortgage endowment contracts or higher than expected levels of complaints may result in Lincoln UK revising its estimate of the required level of these liabilities. The reserves for these issues are based on various estimates that are subject to considerable uncertainty. Future changes in complaint levels could affect Lincoln UK's ultimate exposure to mis-selling issues, although we believe that any future change would not materially affect our consolidated financial position.

In July 2006 we negotiated a memorandum of understanding with certain of our liability carriers, who have agreed to reimburse us $26 million for certain costs incurred in connection with certain United Kingdom selling practices. The reimbursement will be recorded in net income upon final settlement and receipt of cash, which is expected in the third quarter. We continue to pursue claims with other liability carriers.

Marketing and Compliance Issues

There continues to be a significant amount of federal and state regulatory activity in the industry relating to numerous issues including, but not limited to, market timing and late trading of mutual fund and variable insurance products and broker-dealer access arrangements. Like others in the industry, we have received inquiries including requests for information and/or subpoenas from various authorities including the SEC, National Association of Securities Dealers ("NASD"), and the New York Attorney General, as well as notices of potential proceedings from the SEC and NASD. We are in the process of responding to, and in some cases have settled or are in the process of settling, certain of these inquiries and potential proceedings. We continue to cooperate fully with such authorities.

Regulators also continue to focus on replacement and exchange issues. Under certain circumstances companies have been held responsible for replacing existing policies with policies that were less advantageous to the policyholder. Our management continues to monitor compliance procedures to minimize any potential liability. Due to the uncertainty surrounding all of these matters, it is not possible to provide a meaningful estimate of the range of potential outcomes; however it is management's opinion that future developments will not materially affect our consolidated financial position.

Media Commitments

Lincoln Financial Media has commitments to purchase future sports programming rights, and for employment contracts, leases and syndicated television programming of approximately $279 million through 2011. We have offset the purchase of these programming rights by receiving commitments from other entities to purchase a portion of our sports programming rights of approximately $199 million through 2011, as well as by entering into advertising contracts with customers for the airing of commercials. These commitments are not reflected as an asset or liability in our Consolidated Balance Sheet because the programs are not currently available for use.

Other Contingency Matters

We and our subsidiaries are involved in various pending or threatened legal proceedings, including purported class actions, arising from the conduct of business. In some instances, these proceedings include claims for unspecified or substantial punitive damages and similar types of relief in addition to amounts for alleged contractual liability or requests for equitable relief. After consultation with legal counsel and a review of available facts, it is management's opinion that these proceedings ultimately will be resolved without materially affecting our consolidated financial position.

State guaranty funds assess insurance companies to cover losses to policyholders of insolvent or rehabilitated companies. Mandatory assessments may be partially recovered through a reduction in future premium taxes in some states. We have accrued for expected assessments net of estimated future premium tax deductions.

Guarantees

We have guarantees with off-balance-sheet risks having contractual values of $3 million and $4 million at June 30, 2006 and December 31, 2005, respectively.

Certain of our subsidiaries have sold commercial mortgage loans through grantor trusts, which issued pass-through certificates. These subsidiaries have agreed to repurchase any mortgage loans which remain delinquent for 90 days at a repurchase price substantially equal to the outstanding principal balance plus accrued interest thereon to the date of repurchase. In case of default by the borrowers, we have recourse to the underlying real estate. It is management's opinion that the value of the properties underlying these commitments is sufficient that in the event of default, the impact would not be material to us. These guarantees expire in 2009.

We guarantee the repayment of operating leases on facilities that we have subleased to third parties, which obligate us to pay in the event the third parties fail to perform their payment obligations under the subleasing agreements. We have recourse to the third parties enabling us to recover any amounts paid under our guarantees. The annual rental payments subject to these guarantees are $15 million and expire in 2009.

Derivative Instruments

We maintain an overall risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate risk, foreign currency risk, equity risk, and credit risk. We assess these risks by continually identifying and monitoring changes in interest rate exposure, foreign currency exposure, equity market exposure, and credit exposure that may adversely impact expected future cash flows and by evaluating hedging opportunities. Derivative instruments that are currently used as part of our interest rate risk management strategy include interest rate swaps, interest rate futures and interest rate caps. Derivative instruments that are used as part of our foreign currency risk management strategy include foreign currency swaps and foreign exchange forwards. Call options on our stock, total return swaps, put options and equity futures are used as part of our equity market risk management strategy. We also use credit default swaps as part of our credit risk management strategy.

As a result of our acquisition of Jefferson-Pilot, we now distribute indexed annuity contracts. These contracts permit the holder to elect an interest rate return or an equity market component, where interest credited to the contracts is linked to the performance of the S&P 500® index. Policyholders may elect to rebalance index options at renewal dates, either annually or biannually. At each renewal date, we have the opportunity to re-price the indexed component by establishing participation rates, subject to minimum guarantees. We purchase S&P 500® index call options that are highly correlated to the portfolio allocation decisions of our policyholders, such that we are economically hedged with respect to equity returns for the current reset period. The mark-to-market of the options held impacts net investment income and generally offsets the change in value of the embedded derivative within the indexed annuity which is recorded as a component of interest credited to policyholders' within insurance benefits. SFAS 133 requires that we calculate fair values of index options we may purchase in the future to hedge policyholder index allocations in future reset periods. These fair values represent an estimate of the cost of the options we will purchase in the future, discounted back to the date of the balance sheet, using current market indicators of volatility and interest rates. Changes in the fair values of these liabilities are included in interest credited. The notional amounts of policyholder fund balances allocated to the equity-index options were $2.1 billion at June 30, 2006.

By using derivative instruments, we are exposed to credit risk (our counterparty fails to make payment) and market risk (the value of the instrument falls and we are required to make a payment). When the fair value of a derivative contract is positive, this generally indicates that the counterparty owes us and, therefore, creates a credit risk for us equal to the extent of the fair value gain in the derivative. When the fair value of a derivative contract is negative, we owe the counterparty and therefore we have no credit risk, but have been affected by market risk. We minimize the credit risk in derivative instruments by entering into transactions with high quality counterparties with minimum credit ratings that are reviewed regularly by us, by limiting the amount of credit exposure to any one counterparty, and by requiring certain counterparties to post collateral if our credit risk exceeds certain limits. We also maintain a policy of requiring that all derivative contracts be governed by an International Swaps and Derivatives Association ("ISDA") Master Agreement. We do not believe that the credit or market risks associated with derivative instruments are material to any insurance subsidiary or the Company.

We and our insurance subsidiaries are required to maintain minimum ratings as a matter of routine practice in negotiating ISDA agreements. Under some ISDA agreements our insurance subsidiaries have agreed to maintain certain financial strength or claims-paying ratings. A downgrade below these levels could result in termination of the derivatives contract at which time any amounts payable by us would be dependent on the market value of the underlying derivative contract. In certain transactions, we and the counterparty have entered into a collateral support agreement requiring us to post collateral upon significant downgrade. We do not believe the inclusion of termination or collateralization events pose any material threat to the liquidity position of any insurance subsidiary or the Company.

Market risk is the adverse effect that a change in interest rates, currency rates, implied volatility rates, or a change in certain equity indexes or instruments has on the value of a financial instrument. We manage the market risk by establishing and monitoring limits as to the types and degree of risk that may be undertaken.

Our derivative instruments are monitored by our risk management committee as part of that committee's oversight of our derivative activities. Our derivative instruments committee is responsible for implementing various hedging strategies that are developed through our analysis of financial simulation models and other internal and industry sources. The resulting hedging strategies are then incorporated into our overall risk management strategies.

8. Segment Information

In the quarter ended June 30, 2006, we completed our merger with Jefferson-Pilot and changed our management organization. We also realigned our reporting segments to reflect the current manner by which our chief operating decision makers view and manage the business. All segment data for reporting periods have been adjusted to reflect the current segment reporting. As a result of these changes, we provide products and services in five operating businesses: (1) Individual Markets, (2) Employer Markets, (3) Investment Management, (4) Lincoln UK and (5) Lincoln Financial Media, and report results through seven business segments. The following is a brief description of these segments.

Individual Markets. The Individual Markets business provides its products through two segments, Individual Annuities and Individual Life Insurance. Through its Individual Annuities segment, Individual Markets provides tax-deferred investment growth and lifetime income opportunities for its clients by offering individual fixed annuities, including indexed annuities, and variable annuities. The Individual Life Insurance segment offers wealth protection and transfer opportunities through both single and survivorship versions of universal life, variable universal life, interest-sensitive whole life, term insurance, as well as a linked-benefit product, which is a universal life insurance policy linked with riders that provide for long-term care costs.

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Employer Markets. The Employer Markets business provides its products through two segments, Retirement Products & Other and Benefit Partners. Through its Retirement Products & Other segment, Employer Markets provides employer-sponsored variable and fixed annuities, mutual-fund based programs in the 401(k), 403(b), and 457 marketplaces and corporate/bank owned life insurance. The Benefit Partners segment offers group non-medical insurance products, principally term life, disability and dental, to the employer marketplace through various forms of contributory and noncontributory plans. Most of our group contracts are sold to employers with fewer than 500 employees.

Investment Management. The Investment Management segment, through Delaware Investments, provides a broad range of managed accounts and portfolios, mutual funds, subadvised funds, and other investment products to individual investors and to institutional investors such as private and public pension funds, foundations, and endowment funds. Delaware Investments is the marketing name for Delaware Management Holdings, Inc. and its subsidiaries.

Lincoln UK. Lincoln UK is headquartered in Barnwood, Gloucester, England, and is licensed to do business throughout the United Kingdom. Lincoln UK primarily focuses on protecting and enhancing the value of its existing customer base. The segment accepts new deposits from existing relationships and markets a limited range of new products. Lincoln UK’s product portfolio principally consists of unit-linked life and pension products, which are similar to U.S. produced variable life and annuity products, where the risk associated with the underlying investments is borne by the policyholders.

Lincoln Financial Media. The Lincoln Financial Media segment operates domestic radio and television broadcasting stations and produces syndicated collegiate sports programming. Federal Communications Commission (“FCC”) licenses, which are required for operations, are subject to periodic renewal. All of our licenses are current.

We also have “Other Operations,” which includes the financial data for operations that are not directly related to the business segments, unallocated items (such as corporate investment income on assets not allocated to our business units, interest expense on short-term and long-term borrowings, and certain expenses, including restructuring and merger-related expenses) and the historical results of the former reinsurance segment, which was sold to Swiss Re Life & Health America Inc. (“Swiss Re”) in the fourth quarter of 2001, along with the ongoing amortization of deferred gain on the indemnity reinsurance portion of the transaction with Swiss Re.

Segment operating revenue and income (loss) from operations are internal measures used by our management and Board of Directors to evaluate and assess the results of our segments. Operating revenue is GAAP revenue excluding realized gains and losses on investments and derivative instruments, gains and losses on reinsurance embedded derivative/trading securities, gains and losses on sale of subsidiaries/businesses and the amortization of deferred gain arising from reserve development on business sold through reinsurance. Income (loss) from operations is GAAP net income excluding net realized investment gains and losses, losses on early retirement of debt, reserve development net of related amortization on business sold through reinsurance and cumulative effect of accounting changes. Our management and Board of Directors believe that operating revenue and income (loss) from operations explain the results of our ongoing businesses in a manner that allows for a better understanding of the underlying trends in our current businesses because net realized investment gains and losses, reserve development net of related amortization on business sold through reinsurance and cumulative effect of accounting changes are unpredictable and not necessarily indicative of current operating fundamentals or future performance of the business segments, and in many instances, decisions regarding these items do not necessarily relate to the operations of the individual segments. Operating revenue and income (loss) from operations do not replace revenues and net income as the GAAP measures of our consolidated results of operations.

The following tables show financial data by segment:

(in millions)	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Revenue:				
Segment Operating Revenue:				
Individual Markets:				
Individual Annuities	$ 552	$ 348	$ 927	$ 688
Life Insurance	901	475	1,402	951
Individual Markets Total	1,453	823	2,329	1,639
Employer Markets:				
Retirement Products & Other	350	287	656	574
Benefit Partners	355	-	355	-
Employer Markets Total	705	287	1,011	574
Investment Management (1)	135	114	274	224
Lincoln UK	81	79	151	153
Lincoln Financial Media(2)	58	-	58	-
Other Operations	98	102	157	160
Consolidating adjustments	(29)	(21)	(57)	(59)
Net realized investment results (3)	(5)	(9)	(6)	3
Total	$ 2,496	$ 1,375	$ 3,917	$ 2,694
Net Income:				
Segment Operating Income:				
Individual Markets:				
Individual Annuities	$ 89	$ 52	$ 155	$ 102
Life Insurance	147	63	216	121
Individual Markets Total	236	115	371	223
Employer Markets:				
Retirement Products & Other	70	50	131	96
Benefit Partners	37	-	37	-
Employer Markets Total	107	50	168	96
Investment Management (1)	12	(1)	27	3
Lincoln UK	10	10	21	20
Lincoln Financial Media	12	-	12	-
Other Operations	(26)	30	(26)	33
Net realized investment results (4)	(2)	(6)	(3)	2
Net Income	$ 349	$ 198	$ 570	$ 377

(1) Revenues for the Investment Management segment include inter-segment revenues for asset management services provided to our other segments. These inter-segment revenues totaled $24 million for the three months ended June 30, 2006 and 2005, and $48 million and $49 million for the six months ended June 30, 2006 and 2005, respectively.

(2) Lincoln Financial Media revenues are net of $9 million of commissions paid to agencies.

(3) Includes realized losses on investments and derivative instruments of $7 million and $4 million for the three months ended June 30, 2006 and 2005, respectively; gain (loss) on reinsurance embedded derivative/trading securities of $2 million and $(5) million for the three months ended June 30, 2006 and 2005, respectively. Includes realized losses on investments and derivative instruments of $14 million and $11 million for the six months ended June 30, 2006 and 2005, gain on reinsurance embedded derivative/trading securities of $8 million for the six months ended June 30, 2006; and gain on sale of subsidiaries/businesses of $14 million for the six months ended

June 30, 2005.

(4) Includes realized losses on investments and derivative instruments of $3 million for the three months ended June 30, 2006 and 2005; gain (loss) on reinsurance embedded derivative/trading securities of $1 million and $(3) million for the three months ended June 30, 2006 and 2005, respectively. Includes realized losses on investments and derivative instruments of $8 million and $7 million for the six months ended June 30, 2006 and 2005, respectively; gain on reinsurance embedded derivative/trading securities of $5 million for the six months ended June 30, 2006; and gain on sale of subsidiaries/businesses of $9 million for the six months ended June 30, 2005.

(in millions)		**As of June 30, 2006**
Assets:		
Individual Markets		
Individual Life Insurance	$	41,163
Individual Annuities		65,281
Employer Markets		
Retirement Products & Other		35,136
Benefit Partners		2,262
Investment Management		534
Lincoln UK		10,108
Lincoln Financial Media		1,486
Other Operations		24,728
Consolidating adjustments		(13,318)
Total	$	167,380

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9. Earnings Per Share

The income used in the calculation of our diluted earnings per share is net income reduced by minority interest adjustments related to outstanding stock options under the Delaware Investments U.S., Inc. ("DIUS") stock option incentive plan of less than $1 million for all periods presented.

A reconciliation of the denominator in the calculations of basic and diluted net income and income before cumulative effect of accounting change per share is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Denominator: [number of shares]				
Weighted-average shares as used in basic calculation	279,117,917	172,758,060	227,136,449	173,224,239
Conversion of preferred stock	235,656	260,096	239,492	264,471
Non-vested stock	1,112,575	837,829	1,336,800	841,289
Average stock options outstanding during the period	16,716,416	4,798,166	12,783,702	5,836,051
Assumed acquisition of shares with assumed proceeds and benefits from exercising stock options	(14,253,642)	(4,180,042)	(11,047,731)	(5,104,262)
Shares repurchaseable from measured but unrecognized stock option expense	(1,552,553)	(383,813)	(1,188,658)	(498,273)
Average deferred compensation shares	1,243,972	1,262,731	1,272,201	1,247,731
Weighted-average shares, as used in diluted calculation	282,620,341	175,353,027	230,532,255	175,811,246