PRUDENTIAL FINANCIAL INC
Form 10-Q
May 03, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2013

OR

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

For the Transition Period from to

Commission File Number 001-16707

Prudential Financial, Inc.

(Exact Name of Registrant as Specified in its Charter)

New Jersey	**22-3703799**
(State or Other Jurisdiction of 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)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of the Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨

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 April 30, 2013, 464 million shares of the registrant s Common Stock (par value $0.01) were outstanding. In addition, 2 million shares of the registrant s Class B Stock, for which there is no established public trading market, were outstanding.

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Forward-Looking Statements

Certain of the statements included in this Quarterly Report on Form 10-Q, including but not limited to those in Management s Discussion and Analysis of Financial Condition and Results of Operations, constitute forward-looking statements within the meaning of the U.S. Private Securities Litigation Reform Act of 1995. Words such as expects, believes, anticipates, includes, plans, assumes, estimates, projects, should, will, shall or variations of such words are generally part of forward-looking statements. Forward-looking statements are made based on management s current expectations and beliefs concerning future developments and their potential effects upon Prudential Financial, Inc. and its subsidiaries. There can be no assurance that future developments affecting Prudential Financial, Inc. and its subsidiaries will be those anticipated by management. These forward-looking statements are not a guarantee of future performance and involve risks and uncertainties, and there are certain important factors that could cause actual results to differ, possibly materially, from expectations or estimates reflected in such forward-looking statements, including, among others: (1) general economic, market and political conditions, including the performance and fluctuations of fixed income, equity, real estate and other financial markets; (2) the availability and cost of additional debt or equity capital or external financing for our operations; (3) interest rate fluctuations or prolonged periods of low interest rates; (4) the degree to which we choose not to hedge risks, or the potential ineffectiveness or insufficiency of hedging or risk management strategies we do implement, with regard to variable annuity or other product guarantees; (5) any inability to access our credit facilities; (6) reestimates of our reserves for future policy benefits and claims; (7) differences between actual experience regarding mortality, longevity, morbidity, persistency, surrender experience, interest rates or market returns and the assumptions we use in pricing our products, establishing liabilities and reserves or for other purposes; (8) changes in our assumptions related to deferred policy acquisition costs, value of business acquired or goodwill; (9) changes in assumptions for retirement expense; (10) changes in our financial strength or credit ratings; (11) statutory reserve requirements associated with term and universal life insurance policies under Regulation XXX and Guideline AXXX; (12) investment losses, defaults and counterparty non-performance; (13) competition in our product lines and for personnel; (14) difficulties in marketing and distributing products through current or future distribution channels; (15) changes in tax law; (16) economic, political, currency and other risks relating to our international operations; (17) fluctuations in foreign currency exchange rates and foreign securities markets; (18) regulatory or legislative changes, including the Dodd-Frank Wall Street Reform and Consumer Protection Act; (19) inability to protect our intellectual property rights or claims of infringement of the intellectual property rights of others; (20) adverse determinations in litigation or regulatory matters and our exposure to contingent liabilities, including in connection with our divestiture or winding down of businesses; (21) domestic or international military actions, natural or man-made disasters including terrorist activities or pandemic disease, or other events resulting in catastrophic loss of life; (22) ineffectiveness of risk management policies and procedures in identifying, monitoring and managing risks; (23) effects of acquisitions, divestitures and restructurings; (24) interruption in telecommunication, information technology or other operational systems or failure to maintain the security, confidentiality or privacy of sensitive data on such systems; (25) changes in statutory or U.S. GAAP accounting principles, practices or policies; (26) Prudential Financial, Inc. s primary reliance, as a holding company, on dividends or distributions from its subsidiaries to meet debt payment obligations and the ability of the subsidiaries to pay such dividends or distributions in light of our ratings objectives and/or applicable regulatory restrictions; and (27) risks due to the lack of legal separation between our Financial Services Businesses and our Closed Block Business. Prudential Financial, Inc. does not intend, and is under no obligation, to update any particular forward-looking statement included in this document. See Risk Factors included in the Annual Report on Form 10-K for the year ended December 31, 2012 for discussion of certain risks relating to our businesses and investment in our securities.

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

PART I - FINANCIAL INFORMATION

ITEM 1. ***Financial Statements***

PRUDENTIAL FINANCIAL, INC.

Unaudited Interim Consolidated Statements of Financial Position

March 31, 2013 and December 31, 2012 (in millions, except share amounts)

	March 31, 2013	December 31, 2012
ASSETS		
Fixed maturities, available-for-sale, at fair value (amortized cost: 2013-$273,678; 2012-$277,654)(1)	$ 300,382	$ 301,336
Fixed maturities, held-to-maturity, at amortized cost (fair value: 2013-$4,186; 2012-$4,511)(1)	3,878	4,268
Trading account assets supporting insurance liabilities, at fair value(1)	20,890	20,590
Other trading account assets, at fair value	6,862	6,328
Equity securities, available-for-sale, at fair value (cost: 2013-$6,613; 2012-$6,759)(1)	8,918	8,277
Commercial mortgage and other loans (includes $726 and $162 measured at fair value under the fair value option at March 31, 2013 and December 31, 2012, respectively)(1)	38,458	36,733
Policy loans	11,938	11,575
Other long-term investments (includes $487 and $465 measured at fair value under the fair value option at March 31, 2013 and December 31, 2012, respectively)(1)	9,863	10,028
Short-term investments(1)	6,288	6,447
Total investments	407,477	405,582
Cash and cash equivalents(1)	14,477	18,100
Accrued investment income(1)	3,143	3,127
Deferred policy acquisition costs	14,374	14,100
Value of business acquired	4,167	3,248
Other assets(1)	14,151	11,887
Separate account assets (1)	266,308	253,254
TOTAL ASSETS	$ 724,097	$ 709,298
LIABILITIES AND EQUITY		
LIABILITIES		
Future policy benefits	$ 210,918	$ 216,050
Policyholders account balances	138,316	134,413
Policyholders dividends	7,452	7,507
Securities sold under agreements to repurchase	6,702	5,818
Cash collateral for loaned securities	3,390	3,941
Income taxes	8,039	8,551
Short-term debt	2,228	2,484
Long-term debt	25,488	24,729

Other liabilities	12,694	11,683
Notes issued by consolidated variable interest entities (includes $1,768 and $1,406 measured at fair value under the fair value option at March 31, 2013 and December 31, 2012, respectively)(1)	1,896	1,577
Separate account liabilities(1)	266,308	253,254
Total liabilities	683,431	670,007
COMMITMENTS AND CONTINGENT LIABILITIES (See Note 15)		
EQUITY		
Preferred Stock ($.01 par value; 10,000,000 shares authorized; none issued)	0	0
Common Stock ($.01 par value; 1,500,000,000 shares authorized; 660,111,307 and 660,111,307 shares issued at March 31, 2013 and December 31, 2012, respectively)	6	6
Class B Stock ($.01 par value; 10,000,000 shares authorized; 2,000,000 shares issued and outstanding at March 31, 2013 and December 31, 2012, respectively)	0	0
Additional paid-in capital	24,354	24,380
Common Stock held in treasury, at cost (194,777,322 and 197,077,940 shares at March 31, 2013 and December 31, 2012, respectively)	(12,018)	(12,163)
Accumulated other comprehensive income (loss)	12,418	10,214
Retained earnings	15,203	16,138
Total Prudential Financial, Inc. equity	39,963	38,575
Noncontrolling interests	703	716
Total equity	40,666	39,291
TOTAL LIABILITIES AND EQUITY	$ 724,097	$ 709,298

(1) See Note 5 for details of balances associated with variable interest entities.

See Notes to Unaudited Interim Consolidated Financial Statements

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PRUDENTIAL FINANCIAL, INC.

Unaudited Interim Consolidated Statements of Operations

Three Months Ended March 31, 2013 and 2012 (in millions, except per share amounts)

	Three Months Ended March 31, 2013	Three Months Ended March 31, 2012
REVENUES		
Premiums	$ 7,084	$ 6,773
Policy charges and fee income	1,356	1,049
Net investment income	3,638	3,320
Asset management fees and other income	(1,170)	(135)
Realized investment gains (losses), net:		
Other-than-temporary impairments on fixed maturity securities	(308)	(573)
Other-than-temporary impairments on fixed maturity securities transferred to Other Comprehensive Income	238	461
Other realized investment gains (losses), net	(653)	(1,272)
Total realized investment gains (losses), net	(723)	(1,384)
Total revenues	10,185	9,623
BENEFITS AND EXPENSES		
Policyholders benefits	7,219	6,443
Interest credited to policyholders account balances	1,050	966
Dividends to policyholders	560	442
Amortization of deferred policy acquisition costs	218	(225)
General and administrative expenses	2,683	2,760
Total benefits and expenses	11,730	10,386
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES AND EQUITY IN EARNINGS OF OPERATING JOINT VENTURES	(1,545)	(763)
Income tax expense (benefit)	(831)	179
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE EQUITY IN EARNINGS OF OPERATING JOINT VENTURES	(714)	(942)
Equity in earnings of operating joint ventures, net of taxes	49	7
INCOME (LOSS) FROM CONTINUING OPERATIONS	(665)	(935)
Income from discontinued operations, net of taxes	1	7
NET INCOME (LOSS)	(664)	(928)
Less: Income attributable to noncontrolling interests	42	11
NET INCOME (LOSS) ATTRIBUTABLE TO PRUDENTIAL FINANCIAL, INC	$ (706)	$ (939)
EARNINGS PER SHARE (See Note 8)		
Financial Services Businesses		

Basic earnings per share-Common Stock:		
Income (loss) from continuing operations attributable to Prudential Financial, Inc.	$ (1.55)	$ (2.04)
Income from discontinued operations, net of taxes	0.00	0.01
Net income (loss) attributable to Prudential Financial, Inc.	$ (1.55)	$ (2.03)
Diluted earnings per share-Common Stock:		
Income (loss) from continuing operations attributable to Prudential Financial, Inc.	$ (1.55)	$ (2.04)
Income from discontinued operations, net of taxes	0.00	0.01
Net income (loss) attributable to Prudential Financial, Inc.	$ (1.55)	$ (2.03)
Dividends declared per share of Common Stock	$ 0.40	
Closed Block Business		
Basic and Diluted earnings per share-Class B Stock:		
Income (loss) from continuing operations attributable to Prudential Financial, Inc.	$ 5.50	$ 6.50
Income from discontinued operations, net of taxes	0.00	0.00
Net income (loss) attributable to Prudential Financial, Inc.	$ 5.50	$ 6.50
Dividends declared per share of Class B Stock	$ 2.41	

See Notes to Unaudited Interim Consolidated Financial Statements

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PRUDENTIAL FINANCIAL, INC.

Unaudited Interim Consolidated Statements of Comprehensive Income

Three Months Ended March 31, 2013 and 2012 (in millions)

	Three Months Ended March 31, 2013	Three Months Ended March 31, 2012
NET INCOME (LOSS)	$ (664)	$ (928)
Other comprehensive income (loss), before tax:		
Foreign currency translation adjustments:		
Foreign currency translation adjustments for the period	(902)	(179)
Reclassification adjustment for amounts included in net income	1	0
Total	(901)	(179)
Net unrealized investment gains:		
Unrealized investment gains for the period	4,452	2,891
Reclassification adjustment for (gains) losses included in net income	(174)	93
Total	4,278	2,984
Defined benefit pension and postretirement unrecognized net periodic benefit:		
Impact of foreign currency changes and other	19	15
Amortization included in net income	31	24
Total	50	39
Other comprehensive income, before tax	3,427	2,844
Less: Income tax expense (benefit) related to:		
Foreign currency translation adjustments	(269)	(34)
Net unrealized investment gains	1,474	1,083
Defined benefit pension and postretirement unrecognized net periodic benefit	18	1
Total	1,223	1,050
Other comprehensive income, net of taxes	2,204	1,794
Comprehensive income	1,540	866
Less: Comprehensive income attributable to noncontrolling interests	42	7
Comprehensive income attributable to Prudential Financial, Inc.	$ 1,498	$ 859

See Notes to Unaudited Interim Consolidated Financial Statements

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PRUDENTIAL FINANCIAL, INC.

Unaudited Interim Consolidated Statements of Equity(1)

Three Months Ended March 31, 2013 and 2012 (in millions)

	Prudential Financial, Inc. Equity							
	Common Stock	**Additional Paid-in Capital**	**Retained Earnings**	**Common Stock Held In Treasury**	**Accumulated Other Comprehensive Income (Loss)**	**Total Prudential Financial, Inc. Equity**	**Noncontrolling Interests**	**Total Equity**
Balance December 31, 2012	$ 6	$ 24,380	$ 16,138	$ (12,163)	$ 10,214	$ 38,575	$ 716	$ 39,291
Contributions from noncontrolling interests						0	1	1
Distributions to noncontrolling interests						0	(56)	(56)
Consolidations/deconsolidations								
Stock-based compensation programs		(26)	(36)	145		83		83
Dividends declared on Common Stock			(188)			(188)		(188)
Dividends declared on Class B Stock			(5)			(5)		(5)
Comprehensive income:								
Net income			(706)			(706)	42	(664)
Other comprehensive income (loss), net of tax					2,204	2,204	0	2,204
Total comprehensive income (loss)						1,498	42	1,540
Balance, March 31, 2013	$ 6	$ 24,354	$ 15,203	$ (12,018)	$ 12,418	$ 39,963	$ 703	$ 40,666

	Prudential Financial, Inc. Equity							
	Common Stock	**Additional Paid-in Capital**	**Retained Earnings**	**Common Stock Held In Treasury**	**Accumulated Other Comprehensive Income (Loss)**	**Total Prudential Financial, Inc. Equity**	**Noncontrolling Interests**	**Total Equity**
Balance, December 31, 2011	$ 6	$ 24,293	$ 16,629	$ (11,920)	$ 5,245	$ 34,253	$ 588	$ 34,841
Common Stock acquired				(250)		(250)		(250)
Contributions from noncontrolling interests						0	1	1
Stock-based compensation programs		(5)	(150)	253		98		98
Comprehensive income:								
Net income			(939)			(939)	11	(928)
Other comprehensive income (loss), net of tax					1,798	1,798	(4)	1,794
Total comprehensive income (loss)						859	7	866
Balance, March 31, 2012	$ 6	$ 24,288	$ 15,540	$ (11,917)	$ 7,043	$ 34,960	$ 596	$ 35,556

(1) Class B Stock is not presented as the amounts are immaterial.

See Notes to Unaudited Interim Consolidated Financial Statements

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PRUDENTIAL FINANCIAL, INC.

Unaudited Interim Consolidated Statements of Cash Flows

Three Months Ended March 31, 2013 and 2012 (in millions)

	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	$ (664)	$ (928)
Adjustments to reconcile net income to net cash provided by operating activities:		
Realized investment (gains) losses, net	723	1,384
Policy charges and fee income	(514)	(326)
Interest credited to policyholders account balances	1,050	966
Depreciation and amortization	109	105
Gains on trading account assets supporting insurance liabilities, net	(93)	(234)
Change in:		
Deferred policy acquisition costs	(645)	(1,047)
Future policy benefits and other insurance liabilities	2,545	2,689
Other trading account assets	(10)	(48)
Income taxes	(1,653)	281
Other, net	(661)	(2,075)
Cash flows from operating activities	187	767
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from the sale/maturity/prepayment of:		
Fixed maturities, available-for-sale	11,805	10,967
Fixed maturities, held-to-maturity	125	123
Trading account assets supporting insurance liabilities and other trading account assets	5,658	4,512
Equity securities, available-for-sale	1,003	1,088
Commercial mortgage and other loans	1,287	784
Policy loans	572	577
Other long-term investments	499	554
Short-term investments	9,311	7,399
Payments for the purchase/origination of:		
Fixed maturities, available-for-sale	(13,564)	(13,573)
Fixed maturities, held-to-maturity	(14)	0
Trading account assets supporting insurance liabilities and other trading account assets	(6,498)	(4,360)
Equity securities, available-for-sale	(985)	(941)
Commercial mortgage and other loans	(2,008)	(1,380)
Policy loans	(441)	(451)
Other long-term investments	(633)	(277)
Short-term investments	(9,053)	(7,262)
Acquisition of business, net of cash acquired	(488)	0
Other, net	(228)	16
Cash flows used in investing activities	(3,652)	(2,224)
CASH FLOWS FROM FINANCING ACTIVITIES		
Policyholders account deposits	5,881	5,404
Policyholders account withdrawals	(6,438)	(6,074)
Net change in securities sold under agreements to repurchase and cash collateral for loaned securities	344	970
Cash dividends paid on Common Stock	(206)	(44)
Cash dividends paid on Class B Stock	(5)	0
Net change in financing arrangements (maturities 90 days or less)	591	145
Common Stock acquired	0	(225)
Common Stock reissued for exercise of stock options	46	63
Proceeds from the issuance of debt (maturities longer than 90 days)	1,233	1,130

Repayments of debt (maturities longer than 90 days)	(1,240)	(191)
Excess tax benefits from share-based payment arrangements	8	44
Change in bank deposits	0	(49)
Other, net	135	346
Cash flows from financing activities	349	1,519
Effect of foreign exchange rate changes on cash balances	(507)	(112)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(3,623)	(50)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	18,100	14,251
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 14,477	$ 14,201
NON-CASH TRANSACTIONS DURING THE PERIOD		
Treasury Stock shares issued for stock-based compensation programs	$ 101	$ 205

See Notes to Unaudited Interim Consolidated Financial Statements

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PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements

1. BUSINESS AND BASIS OF PRESENTATION

Prudential Financial, Inc. (Prudential Financial) and its subsidiaries (collectively, Prudential or the Company) provide a wide range of insurance, investment management, and other financial products and services to both individual and institutional customers throughout the United States and in many other countries. Principal products and services provided include life insurance, annuities, retirement-related services, mutual funds, and investment management. 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: U.S. Retirement Solutions and Investment Management, U.S. Individual Life and Group Insurance, and International Insurance. The Company s businesses that are not sufficiently material to warrant separate disclosure and divested businesses, are included in Corporate and Other operations within the Financial Services Businesses. The Closed Block Business, which includes the Closed Block (see Note 6), 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 policyholders 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 ceased offering these participating products.

Basis of Presentation

The Unaudited Interim Consolidated Financial Statements include the accounts of Prudential Financial, entities over which the Company exercises control, including majority-owned subsidiaries and minority-owned entities such as limited partnerships in which the Company is the general partner, and variable interest entities in which the Company is considered the primary beneficiary. See Note 5 for more information on the Company s consolidated variable interest entities. The Unaudited Interim Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) on a basis consistent with reporting interim financial information in accordance with instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission (SEC). Intercompany balances and transactions have been eliminated.

In the opinion of management, all adjustments necessary for a fair statement of the financial position and results of operations have been made. All such adjustments are of a normal, recurring nature. Interim results are not necessarily indicative of the results that may be expected for the full year. These financial statements should be read in conjunction with the Company s Audited Consolidated Financial Statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2012.

The Company s Gibraltar Life Insurance Company, Ltd. (Gibraltar Life) consolidated operations, use a November 30 fiscal year end for purposes of inclusion in the Company s Consolidated Financial Statements. Therefore, the Unaudited Interim Consolidated Financial Statements as of March 31, 2013, include the assets and liabilities of Gibraltar Life as of February 28, 2013 and the results of operations for Gibraltar Life for the three months ended February 28, 2013.

Use of Estimates

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

PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements (Continued)

The most significant estimates include those used in determining deferred policy acquisition costs and related amortization; value of business acquired and its amortization; amortization of sales inducements; measurement of goodwill and any related impairment; valuation of investments including derivatives and the recognition of other-than-temporary impairments; future policy benefits including guarantees; pension and other postretirement benefits; provision for income taxes and valuation of deferred tax assets; and reserves for contingent liabilities, including reserves for losses in connection with unresolved legal matters.

Reclassifications

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

2. SIGNIFICANT ACCOUNTING POLICIES AND PRONOUNCEMENTS

Investments in Debt and Equity Securities and Commercial Mortgage and Other Loans

The Company s investments in debt and equity securities include fixed maturities; equity securities; and short-term investments. The accounting policies related to these, as well as commercial mortgage and other loans, are as follows:

Fixed maturities are comprised of bonds, notes and redeemable preferred stock. Fixed maturities classified as available-for-sale are carried at fair value. See Note 13 for additional information regarding the determination of fair value. Fixed maturities that the Company has both the positive intent and ability to hold to maturity are carried at amortized cost and classified as held-to-maturity. The amortized cost of fixed maturities is adjusted for amortization of premiums and accretion of discounts to maturity. Interest income, as well as the related amortization of premium and accretion of discount, is included in Net investment income under the effective yield method. For mortgage-backed and asset-backed securities, the effective yield is based on estimated cash flows, including interest rate and prepayment assumptions based on data from widely accepted third-party data sources or internal estimates. In addition to interest rate and prepayment assumptions, cash flow estimates also vary based on other assumptions regarding the underlying collateral, including default rates and changes in value. These assumptions can significantly impact income recognition and the amount of other-than-temporary impairments recognized in earnings and other comprehensive income. For high credit quality mortgage-backed and asset-backed securities (those rated AA or above), cash flows are provided quarterly, and the amortized cost and effective yield of the security are adjusted as necessary to reflect historical prepayment experience and changes in estimated future prepayments. The adjustments to amortized cost are recorded as a charge or credit to net investment income in accordance with the retrospective method. For mortgage-backed and asset-backed securities rated below AA or those for which an other than temporary impairment has been recorded, the effective yield is adjusted prospectively for any changes in estimated cash flows. 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, value of business acquired, deferred sales inducements, 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) (AOCI).

Trading account assets supporting insurance liabilities, at fair value includes invested assets that support certain products included in the Retirement segment, as well as certain products included in the International Insurance segment, which are experience rated, meaning that the investment results associated with these products are expected to ultimately accrue to contractholders. Realized and unrealized gains and losses for these investments are reported in Asset management fees and other income. Interest and dividend income from these investments is reported in Net investment income.

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PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements (Continued)

Other trading account assets, at fair value consist primarily of fixed maturities, equity securities, including certain perpetual preferred stock, and certain derivatives, including those used by the Company in its capacity as a broker-dealer and derivative hedging positions, used in a non-broker-dealer capacity primarily to hedge the risks related to certain products. These instruments are carried at fair value. Realized and unrealized gains and losses on these investments and on derivatives used by the Company in its capacity as a broker-dealer are reported in Asset management fees and other income and, for those related to the Company s global commodities group, in Income from discontinued operations, net of taxes. Interest and dividend income from these investments is reported in Net investment income and, for those related to the Company s global commodities group, in Income from discontinued operations, net of taxes.

Equity securities available-for-sale are comprised of common stock, mutual fund shares, non-redeemable preferred stock, and certain perpetual 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, value of business acquired, deferred sales inducements, future policy benefits and policyholders dividends that would result from the realization of unrealized gains and losses, are included in AOCI. 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. Dividends from these investments are recognized in Net investment income when earned.

Commercial mortgage and other loans consist of commercial mortgage loans, agricultural loans, loans backed by residential properties, as well as certain other collateralized and uncollateralized loans. Loans backed by residential properties primarily include recourse loans held by the Company s international insurance businesses. Other collateralized loans primarily include senior loans made by the Company s international insurance businesses and loans made to the Company s former real estate franchisees. Uncollateralized loans primarily represent reverse dual currency loans and corporate loans held by the Company s international insurance businesses.

Commercial mortgage and other loans originated and held for investment are generally carried at unpaid principal balance, net of unamortized deferred loan origination fees and expenses and net of an allowance for losses. Commercial mortgage loans originated within the Company s commercial mortgage operations include loans held for sale which are reported at the lower of cost or fair value; loans held for investment which are reported at amortized cost net of unamortized deferred loan origination fees and expenses and net of an allowance for losses; and loans reported at fair value under the fair value option. Commercial mortgage and other loans acquired, including those related to the acquisition of a business, are recorded at fair value when purchased, reflecting any premiums or discounts to unpaid principal balances.

Interest income, as well as prepayment fees and the amortization of the related premiums or discounts, related to commercial mortgage and other loans, are included in Net investment income.

Impaired loans include those loans for which it is probable that amounts due will not all be collected according to the contractual terms of the loan agreement. The Company defines past due as principal or interest not collected at least 30 days past the scheduled contractual due date. Interest received on loans that are past due, including impaired and non-impaired loans as well as loans that were previously modified in a troubled debt restructuring, is either applied against the principal or reported as net investment income based on the Company s assessment as to the collectability of the principal. See Note 4 for additional information about the Company s past due loans.

The Company discontinues accruing interest on loans after the loans become 90 days delinquent as to principal or interest payments, or earlier when the Company has doubts about collectability. When the Company

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PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements (Continued)

discontinues accruing interest on a loan, any accrued but uncollectible interest on the loan and other loans backed by the same collateral, if any, is charged to interest income in the same period. 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, or the loan has been modified, a regular payment performance has been established.

The Company reviews the performance and credit quality of the commercial mortgage and other loan portfolio on an on-going basis. Loans are placed on watch list status based on a predefined set of criteria and are assigned one of three categories. Loans are placed on early warning status in cases where, based on the Company s analysis of the loan s collateral, the financial situation of the borrower or tenants or other market factors, it is believed a loss of principal or interest could occur. Loans are classified as closely monitored when it is determined that there is a collateral deficiency or other credit events that may lead to a potential loss of principal or interest. Loans not in good standing are those loans where the Company has concluded that there is a high probability of loss of principal, such as when the loan is delinquent or in the process of foreclosure. As described below, in determining the allowance for losses, the Company evaluates each loan on the watch list to determine if it is probable that amounts due will not be collected according to the contractual terms of the loan agreement.

Loan-to-value and debt service coverage ratios are measures commonly used to assess the quality of commercial mortgage loans. The loan-to-value ratio compares the amount of the loan to the fair value of the underlying property collateralizing the loan, and is commonly expressed as a percentage. Loan-to-value ratios greater than 100% indicate that the loan amount exceeds the collateral value. A smaller loan-to-value ratio indicates a greater excess of collateral value over the loan amount. The debt service coverage ratio compares a property s net operating income to its debt service payments. Debt service coverage ratios less than 1.0 times indicate that property operations do not generate enough income to cover the loan s current debt payments. A larger debt service coverage ratio indicates a greater excess of net operating income over the debt service payments. The values utilized in calculating these ratios are developed as part of the Company s periodic review of the commercial mortgage loan and agricultural loan portfolio, which includes an internal appraisal of the underlying collateral value. The Company s periodic review also includes a quality re-rating process, whereby the internal quality rating originally assigned at underwriting is updated based on current loan, property and market information using a proprietary quality rating system. The loan-to-value ratio is the most significant of several inputs used to establish the internal credit rating of a loan which in turn drives the allowance for losses. Other key factors considered in determining the internal credit rating include debt service coverage ratios, amortization, loan term, estimated market value growth rate and volatility for the property type and region. See Note 4 for additional information related to the loan-to-value ratios and debt service coverage ratios related to the Company s commercial mortgage and agricultural loan portfolios.

Loans backed by residential properties, other collateralized loans, and uncollateralized loans are also reviewed periodically. Each loan is assigned an internal or external credit rating. Internal credit ratings take into consideration various factors including financial ratios and qualitative assessments based on non-financial information. In cases where there are personal or third party guarantors, the credit quality of the guarantor is also reviewed. These factors are used in developing the allowance for losses. Based on the diversity of the loans in these categories and their immateriality, the Company has not disclosed the credit quality indicators related to these loans in Note 4.

For those loans not reported at fair value, the allowance for losses includes a loan specific reserve for each impaired loan that has a specifically identified loss and a portfolio reserve for probable incurred but not specifically identified losses. For impaired commercial mortgage and other loans the allowances for losses are

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determined based on the present value of expected future cash flows discounted at the loan s effective interest rate, or based upon the fair value of the collateral if the loan is collateral dependent. The portfolio reserves for probable incurred but not specifically identified losses in the commercial mortgage and agricultural loan portfolio segments considers the current credit composition of the portfolio based on an internal quality rating (as described above). The portfolio reserves are determined using past loan experience, including historical credit migration, loss probability and loss severity factors by property type. These factors are reviewed each quarter and updated as appropriate.

The allowance for losses on commercial mortgage and other loans can increase or decrease from period to period based on the factors noted above. Realized investment gains (losses), net includes changes in the allowance for losses and changes in value for loans accounted for under the fair value option. Realized investment gains (losses), net also includes gains and losses on sales, certain restructurings, and foreclosures.

When a commercial mortgage or other loan is deemed to be uncollectible, any specific valuation allowance associated with the loan is reversed and a direct write down to the carrying amount of the loan is made. The carrying amount of the loan is not adjusted for subsequent recoveries in value.

Commercial mortgage and other loans are occasionally restructured in a troubled debt restructuring. These restructurings generally include one or more of the following: full or partial payoffs outside of the original contract terms; changes to interest rates; extensions of maturity; or additions or modifications to covenants. Additionally, the Company may accept assets in full or partial satisfaction of the debt as part of a troubled debt restructuring. When restructurings occur, they are evaluated individually to determine whether the restructuring or modification constitutes a troubled debt restructuring as defined by authoritative accounting guidance. If the borrower is experiencing financial difficulty and the Company has granted a concession, the restructuring, including those that involve a partial payoff or the receipt of assets in full satisfaction of the debt is deemed to be a troubled debt restructuring. Based on the Company s credit review process described above, these loans generally would have been deemed impaired prior to the troubled debt restructuring, and specific allowances for losses would have been established prior to the determination that a troubled debt restructuring has occurred.

In a troubled debt restructuring where the Company receives assets in full satisfaction of the debt, any specific valuation allowance is reversed and a direct write down of the loan is recorded for the amount of the allowance, and any additional loss, net of recoveries, or any gain is recorded for the difference between the fair value of the assets received and the recorded investment in the loan. When assets are received in partial settlement, the same process is followed, and the remaining loan is evaluated prospectively for impairment based on the credit review process noted above. When a loan is restructured in a troubled debt restructuring, the impairment of the loan is remeasured using the modified terms and the loan s original effective yield, and the allowance for loss is adjusted accordingly. Subsequent to the modification, income is recognized prospectively based on the modified terms of the loans in accordance with the income recognition policy noted above. Additionally, the loan continues to be subject to the credit review process noted above.

In situations where a loan has been restructured in a troubled debt restructuring and the loan has subsequently defaulted, this factor is considered when evaluating the loan for a specific allowance for losses in accordance with the credit review process noted above.

See Note 4 for additional information about commercial mortgage and other loans that have been restructured in a troubled debt restructuring.

Short-term investments primarily consist of highly liquid debt instruments with a maturity of twelve months or less and greater than three months when purchased, other than those debt instruments meeting this

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Notes to Unaudited Interim Consolidated Financial Statements (Continued)

definition that are included in Trading account assets supporting insurance liabilities, at fair value. These investments are generally carried at fair value and include certain money market investments, short-term debt securities issued by government sponsored entities and other highly liquid debt instruments. Short-term investments held in the Company s former broker-dealer operations were marked-to-market through Income from discontinued operations, net of taxes.

Realized investment gains (losses) are computed using the specific identification method with the exception of some of the Company s International Insurance businesses portfolios, where the average cost method is used. Realized investment gains and losses are generated from numerous sources, including the sale of fixed maturity securities, equity securities, investments in joint ventures and limited partnerships and other types of investments, as well as adjustments to the cost basis of investments for net other-than-temporary impairments recognized in earnings. Realized investment gains and losses are also generated from prepayment premiums received on private fixed maturity securities, allowance for losses on commercial mortgage and other loans, fair value changes on commercial mortgage loans carried at fair value, and fair value changes on embedded derivatives and free-standing derivatives that do not qualify for hedge accounting treatment, except those derivatives used in the Company s capacity as a broker or dealer.

The Company s available-for-sale and held-to-maturity securities with unrealized losses are reviewed quarterly to identify other-than-temporary impairments in value. 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 and the duration of the decline; (2) the reasons for the decline in value (credit event, currency or interest-rate related, including general credit spread widening); and (3) the financial condition of and near-term prospects of the issuer. With regard to available-for-sale equity securities, the Company also considers the ability and intent to hold the investment for a period of time to allow for a recovery of value. When it is determined that a decline in value of an equity security is other-than-temporary, the carrying value of the equity security is reduced to its fair value, with a corresponding charge to earnings.

An other-than-temporary impairment is recognized in earnings for a debt security in an unrealized loss position when the Company either (a) has the intent to sell the debt security or (b) more likely than not will be required to sell the debt security before its anticipated recovery. For all debt securities in unrealized loss positions that do not meet either of these two criteria, the Company analyzes its ability to recover the amortized cost by comparing the net present value of projected future cash flows with the amortized cost of the security. The net present value is calculated by discounting the Company s best estimate of projected future cash flows at the effective interest rate implicit in the debt security prior to impairment. The Company may use the estimated fair value of collateral as a proxy for the net present value if it believes that the security is dependent on the liquidation of collateral for recovery of its investment. If the net present value is less than the amortized cost of the investment, an other-than-temporary impairment is recognized. In addition to the above mentioned circumstances, the Company also recognizes an other-than-temporary impairment in earnings when a non-functional currency denominated security in an unrealized loss position due to currency exchange rates approaches maturity.

When an other-than-temporary impairment of a debt security has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether the Company intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis. If the debt security meets either of these two criteria or the foreign currency translation loss is not expected to be recovered before maturity, the other-than-temporary impairment recognized in earnings is equal to the entire difference between the security s amortized cost basis and its fair value at the impairment measurement date. For other-than-temporary impairments of debt securities that do not meet these criteria, the net amount recognized in

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Notes to Unaudited Interim Consolidated Financial Statements (Continued)

earnings is equal to the difference between the amortized cost of the debt security and its net present value calculated as described above. Any difference between the fair value and the net present value of the debt security at the impairment measurement date is recorded in Other comprehensive income (loss). Unrealized gains or losses on securities for which an other-than-temporary impairment has been recognized in earnings is tracked as a separate component of AOCI.

For debt securities, the split between the amount of an other-than-temporary impairment recognized in other comprehensive income and the net amount recognized in earnings is driven principally by assumptions regarding the amount and timing of projected cash flows. For mortgage-backed and asset-backed securities, cash flow estimates consider the payment terms of the underlying assets backing a particular security, including interest rate and prepayment assumptions, based on data from widely accepted third-party data sources or internal estimates. In addition to interest rate and prepayment assumptions, cash flow estimates also include other assumptions regarding the underlying collateral including default rates and recoveries, which vary based on the asset type and geographic location, as well as the vintage year of the security. For structured securities, the payment priority within the tranche structure is also considered. For all other debt securities, cash flow estimates are driven by assumptions regarding probability of default and estimates regarding timing and amount of recoveries associated with a default. The Company has developed these estimates using information based on its historical experience as well as using market observable data, such as industry analyst reports and forecasts, sector credit ratings and other data relevant to the collectability of a security, such as the general payment terms of the security and the security s position within the capital structure of the issuer.

The new cost basis of an impaired security is not adjusted for subsequent increases in estimated fair value. In periods subsequent to the recognition of an other-than-temporary impairment, the impaired security is accounted for as if it had been purchased on the measurement date of the impairment. For debt securities, the discount (or reduced premium) based on the new cost basis may be accreted into net investment income in future periods, including increases in cash flow on a prospective basis. In certain cases where there are decreased cash flow expectations, the security is reviewed for further cash flow impairments.

Derivative Financial Instruments

Derivatives are financial instruments whose values are derived from interest rates, foreign exchange rates, financial indices, values of securities or commodities, credit spreads, market volatility, expected returns, and liquidity. Values can also be affected by changes in estimates and assumptions, including those related to counterparty behavior and non-performance risk used in valuation models. 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 valuation models.

Derivatives are used in a non-broker-dealer capacity to manage the interest rate and currency characteristics of assets or liabilities and to mitigate volatility of expected non-U.S. earnings and net investments in foreign operations resulting from changes in currency exchange rates. Additionally, derivatives may be used to seek to reduce exposure to interest rate, credit, foreign currency and equity risks associated with assets held or expected to be purchased or sold, and liabilities incurred or expected to be incurred. As discussed in detail below and in Note 14, all realized and unrealized changes in fair value of derivatives are recorded in current earnings, with the exception of the effective portion of cash flow hedges and effective hedges of net investments in foreign operations. Cash flows from derivatives are reported in the operating, investing, or financing activities sections in the Unaudited Interim Consolidated Statements of Cash Flows based on the nature and purpose of the derivative.

Derivatives are recorded either as assets, within Other trading account assets, at fair value or Other long-term investments, or as liabilities, within Other liabilities, except for embedded derivatives which are

PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements (Continued)

recorded with the associated host contract. The Company nets the fair value of all derivative financial instruments with counterparties for which a master netting arrangement has been executed.

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.

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 is recorded in Realized investment gains (losses), net.

The Company formally documents at inception 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.

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 AOCI 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 either in current period earnings if the hedge transaction is a fair value hedge (e.g., a hedge of a recognized foreign currency asset or liability) or in AOCI if the hedge transaction is 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 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." In this scenario, the hedged 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 AOCI related to discontinued cash flow hedges is reclassified to the income statement line associated with the hedged cash flows consistent with the earnings impact of the original hedged cash flows.

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Notes to Unaudited Interim Consolidated Financial Statements (Continued)

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 AOCI pursuant to the hedge of a forecasted transaction are recognized immediately in Realized investment gains (losses), net.

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 contain derivative instruments that are embedded in the financial instruments. At inception, the Company assesses whether the economic characteristics of the embedded instrument 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 instrument 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 instrument qualifies as an embedded derivative that is separated from the host contract, carried at fair value, and changes in its fair value are included in Realized investment gains (losses), net. For certain financial instruments that contain an embedded derivative that otherwise would need to be bifurcated and reported at fair value, the Company may elect to classify the entire instrument as a trading account asset and report it within Other trading account assets, at fair value.

Adoption of New Accounting Pronouncements

In December 2011 and January 2013, the FASB issued updated guidance regarding the disclosure of recognized derivative instruments (including bifurcated embedded derivatives), repurchase agreements and securities borrowing/lending transactions that are offset in the statement of financial position or are subject to an enforceable master netting arrangement or similar agreement (irrespective of whether they are offset in the statement of financial position). This new guidance requires an entity to disclose information on both a gross and net basis about instruments and transactions within the scope of this guidance. This new guidance is effective for interim or annual reporting periods beginning on or after January 1, 2013, and should be applied retrospectively for all comparative periods presented. The disclosures required by this guidance are included in Note 14.

In February 2013, the FASB issued updated guidance regarding the presentation of comprehensive income. Under the guidance, an entity is required to separately present information about significant items reclassified out of accumulated other comprehensive income by component as well as changes in accumulated other comprehensive income balances by component in either the financial statements or the notes to the financial statements. The guidance does not change the items that are reported in other comprehensive income, does not change when an item of other comprehensive income must be reclassified to net income, and does not amend any existing requirements for reporting net income or other comprehensive income. The guidance is effective for the first interim or annual reporting period beginning after December 15, 2012 and should be applied prospectively. The disclosures required by this guidance are included in Note 7.

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Notes to Unaudited Interim Consolidated Financial Statements (Continued)

Future Adoption of New Accounting Pronouncements

In March 2013, the FASB issued updated guidance regarding the recognition in net income of the cumulative translation adjustment upon the sale or loss of control of a business or group of assets residing in a foreign subsidiary, or a loss of control of a foreign investment. Under this guidance, the reporting entity is required to recognize in net income the proportionate share of the cumulative translation adjustment attributable to the respective investment upon the loss of control or sale. The guidance is effective for the first interim or annual reporting period beginning after December 15, 2013 and should be applied prospectively. This guidance is not expected to have a significant effect on the Company s consolidated financial position, results of operations, and financial statement disclosures.

3. ACQUISITIONS AND DISPOSITIONS

Acquisition of The Hartford s Individual Life Insurance Business

On January 2, 2013, the Company acquired The Hartford s individual life insurance business through a reinsurance transaction. Under the agreement, the Company paid The Hartford cash consideration of $615 million, primarily in the form of a ceding commission to provide reinsurance for approximately 700,000 life insurance policies with a net retained face amount in force of approximately $141 billion. This acquisition increases the Company s scale in the U.S. individual life insurance market, particularly universal life products, and provides complementary distribution opportunities through expanded wirehouse and bank distribution channels.

The assets and liabilities assumed have been included in the Company s Consolidated Financial Statements as of the acquisition date. Total assets assumed were $11.3 billion, which includes $1.3 billion of value of business acquired and $0.1 billion of cash, and total liabilities assumed were $10.7 billion. There is no goodwill, including tax deductible goodwill, associated with the acquisition.

Acquisition of AIG Star Life Insurance Co., Ltd., AIG Edison Life Insurance Company and Related Entities from AIG

On February 1, 2011, Prudential Financial completed the acquisition from American International Group, Inc. (AIG) of AIG Star Life Insurance Co., Ltd. (Star), AIG Edison Life Insurance Company (Edison), AIG Financial Assurance Japan K.K., and AIG Edison Service Co., Ltd. (collectively, the Star and Edison Businesses) pursuant to the stock purchase agreement dated September 30, 2010 between Prudential Financial and AIG. The total purchase price was $4,709 million, comprised of $4,213 million in cash and $496 million in assumed third party debt, substantially all of which is expected to be repaid, over time, with excess capital of the acquired entities. The acquisition of these businesses included the purchase by the Company of all of the shares of these entities, which became indirect wholly-owned subsidiaries of the Company. All acquired entities were Japanese corporations and their businesses were in Japan, increasing the Company s scale in the Japanese insurance market. On January 1, 2012, Star and Edison were merged into Gibraltar Life.

Sale of Wealth Management Services

In April 2013, the Company signed a definitive agreement to sell its wealth management services unit to Envestnet Inc. The transaction, which will not have a material impact to the Company s financial results, is expected to close in 2013, subject to customary closing conditions.

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Notes to Unaudited Interim Consolidated Financial Statements (Continued)

Discontinued Operations

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

	Three Months Ended March 31, 2013	Three Months Ended March 31, 2012
	(in millions)	
Real estate investments sold or held for sale(1)	$ 0	$ 10
Global commodities business	2	0
Income from discontinued operations before income taxes	2	10
Income tax expense	1	3
Income from discontinued operations, net of taxes	$ 1	$ 7

(1) Reflects the income from discontinued real estate investments.

Charges recorded in connection with the disposals of businesses include estimates that are subject to subsequent adjustment.

The Company s Unaudited Interim Consolidated Statements of Financial Position include total assets and total liabilities related to discontinued businesses as follows:

	March 31, 2013	December 31, 2012
	(in millions)	
Total assets	$ 33	$ 13
Total liabilities	$ 0	$ 0

4. INVESTMENTS

Fixed Maturities and Equity Securities

The following tables provide information relating to fixed maturities and equity securities (excluding investments classified as trading) as of the dates indicated:

	March 31, 2013				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses (in millions)	Fair Value	Other-than-temporary Impairments in AOCI(3)
Fixed maturities, available-for-sale					
U.S. Treasury securities and obligations of U.S. government authorities and agencies	$ 13,102	$ 3,296	$ 44	$ 16,354	$ 0
Obligations of U.S. states and their political subdivisions	3,381	533	9	3,905	0
Foreign government bonds	76,284	8,611	62	84,833	1
Corporate securities	149,825	15,252	1,744	163,333	(5)
Asset-backed securities(1)	11,263	257	479	11,041	(880)
Commercial mortgage-backed securities	11,659	651	24	12,286	5
Residential mortgage-backed securities(2)	8,164	489	23	8,630	(11)
Total fixed maturities, available-for-sale	$ 273,678	$ 29,089	$ 2,385	$ 300,382	$ (890)
Equity securities, available-for-sale	$ 6,613	$ 2,321	$ 16	$ 8,918	

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	March 31, 2013				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses (in millions)	Fair Value	Other-than-temporary Impairments in AOCI(3)
Fixed maturities, held-to-maturity					
Foreign government bonds	$ 1,050	$ 172	$ 0	$ 1,222	$ 0
Corporate securities(4)	987	39	46	980	0
Asset-backed securities(1)	864	59	0	923	0
Commercial mortgage-backed securities	278	38	0	316	0
Residential mortgage-backed securities(2)	699	46	0	745	0
Total fixed maturities, held-to-maturity(4)	$ 3,878	$ 354	$ 46	$ 4,186	$ 0

(1) Includes credit-tranched securities collateralized by sub-prime mortgages, auto loans, credit cards, education loans and other asset types.
(2) Includes publicly-traded agency pass-through securities and collateralized mortgage obligations.
(3) Represents the amount of other-than-temporary impairment losses in Accumulated other comprehensive income (loss), or AOCI, which were not included in earnings. Amount excludes $913 million of net unrealized gains on impaired available-for-sale securities and less than $1 million of net unrealized gains on impaired held-to-maturity securities relating to changes in the value of such securities subsequent to the impairment measurement date.
(4) Excludes notes with amortized cost of $1,500 million (fair value, $1,644 million) which have been offset with the associated payables under a netting agreement.

	December 31, 2012				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses (in millions)	Fair Value	Other-than-temporary Impairments in AOCI(3)
Fixed maturities, available-for-sale					
U.S. Treasury securities and obligations of U.S. government authorities and agencies	$ 13,973	$ 3,448	$ 35	$ 17,386	$ 0
Obligations of U.S. states and their political subdivisions	2,952	505	5	3,452	0
Foreign government bonds	81,578	6,778	66	88,290	1
Corporate securities	146,924	13,996	1,589	159,331	(2)
Asset-backed securities(1)	11,846	221	731	11,336	(964)
Commercial mortgage-backed securities	11,228	726	17	11,937	5
Residential mortgage-backed securities(2)	9,153	484	33	9,604	(11)
Total fixed maturities, available-for-sale	$ 277,654	$ 26,158	$ 2,476	$ 301,336	$ (971)
Equity securities, available-for-sale	$ 6,759	$ 1,573	$ 55	$ 8,277	

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Notes to Unaudited Interim Consolidated Financial Statements (Continued)

	December 31, 2012				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses (in millions)	Fair Value	Other-than-temporary Impairments in AOCI(3)
Fixed maturities, held-to-maturity					
Foreign government bonds	$ 1,142	$ 108	$ 0	$ 1,250	$ 0
Corporate securities(4)	1,065	37	67	1,035	0
Asset-backed securities(1)	1,001	66	0	1,067	0
Commercial mortgage-backed securities	302	49	0	351	0
Residential mortgage-backed securities(2)	758	50	0	808	0
Total fixed maturities, held-to-maturity(4)	$ 4,268	$ 310	$ 67	$ 4,511	$ 0

(1) Includes credit-tranched securities collateralized by sub-prime mortgages, auto loans, credit cards, education loans, and other asset types.
(2) Includes publicly-traded agency pass-through securities and collateralized mortgage obligations.
(3) Represents the amount of other-than-temporary impairment losses in AOCI, which were not included in earnings. Amount excludes $778 million of net unrealized gains on impaired available-for-sale securities and $1 million of net unrealized gains on impaired held-to-maturity securities relating to changes in the value of such securities subsequent to the impairment measurement date.
(4) Excludes notes with amortized cost of $1,500 million (fair value, $1,660 million) which have been offset with the associated payables under a netting agreement.

The amortized cost and fair value of fixed maturities by contractual maturities at March 31, 2013, are as follows:

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value (in millions)	Amortized Cost	Fair Value
Due in one year or less	$ 15,725	$ 16,341	$ 0	$ 0
Due after one year through five years	48,878	53,141	90	91
Due after five years through ten years	56,682	63,286	329	343
Due after ten years(1)	121,307	135,657	1,618	1,768
Asset-backed securities	11,263	11,041	864	923
Commercial mortgage-backed securities	11,659	12,286	278	316
Residential mortgage-backed securities	8,164	8,630	699	745
Total	$ 273,678	$ 300,382	$ 3,878	$ 4,186

(1) Excludes notes with amortized cost of $1,500 million (fair value, $1,644 million) which have been offset with the associated payables under a netting agreement.

Actual maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Asset-backed, commercial mortgage-backed, and residential mortgage-backed securities are shown separately in the table above, as they are not due at a single maturity date.

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PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements (Continued)

The following table depicts the sources of fixed maturity proceeds and related investment gains (losses), as well as losses on impairments of both fixed maturities and equity securities:

	Three Months Ended March 31, 2013	Three Months Ended March 31, 2012
	(in millions)	
Fixed maturities, available-for-sale		
Proceeds from sales	$ 6,495	$ 5,663
Proceeds from maturities/repayments	5,739	4,989
Gross investment gains from sales, prepayments, and maturities	229	127
Gross investment losses from sales and maturities	(106)	(78)
Fixed maturities, held-to-maturity		
Gross investment gains from prepayments	$ 0	$ 0
Proceeds from maturities/repayments	125	123
Equity securities, available-for-sale		
Proceeds from sales	$ 1,048	$ 1,082
Gross investment gains from sales	107	122
Gross investment losses from sales	(23)	(86)
Fixed maturity and equity security impairments		
Net writedowns for other-than-temporary impairment losses on fixed maturities recognized in earnings(1)	$ (70)	$ (112)
Writedowns for impairments on equity securities	(7)	(49)

(1) Excludes the portion of other-than-temporary impairments recorded in Other comprehensive income (loss), representing any difference between the fair value of the impaired debt security and the net present value of its projected future cash flows at the time of impairment.

As discussed in Note 2, a portion of certain other-than-temporary impairment (OTTI) losses on fixed maturity securities are recognized in Other comprehensive income (loss) (OCI). For these securities, the net amount recognized in earnings (credit loss impairments) represents the difference between the amortized cost of the security and the net present value of its projected future cash flows discounted at the effective interest rate implicit in the debt security prior to impairment. Any remaining difference between the fair value and amortized cost is recognized in OCI. The following table sets forth the amount of pre-tax credit loss impairments on fixed maturity securities held by the Company as of the dates indicated, for which a portion of the OTTI loss was recognized in OCI, and the corresponding changes in such amounts.

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PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements (Continued)

Credit losses recognized in earnings on fixed maturity securities held by the Company for which a portion of the OTTI loss was recognized in OCI

	Three Months Ended March 31, 2013	Three Months Ended March 31, 2012
	(in millions)	
Balance, beginning of period	$ 1,166	$ 1,475
Credit loss impairments previously recognized on securities which matured, paid down, prepaid or were sold during the period	(97)	(18)
Credit loss impairments previously recognized on securities impaired to fair value during the period(1)	0	(59)
Credit loss impairment recognized in the current period on securities not previously impaired	1	24
Additional credit loss impairments recognized in the current period on securities previously impaired	12	37
Increases due to the passage of time on previously recorded credit losses	12	13
Accretion of credit loss impairments previously recognized due to an increase in cash flows expected to be collected	(5)	(7)
Balance, end of period	$ 1,089	$ 1,465

(1) Represents circumstances where the Company determined in the current period that it intends to sell the security or it is more likely than not that it will be required to sell the security before recovery of the security s amortized cost.

Trading Account Assets Supporting Insurance Liabilities

The following table sets forth the composition of Trading account assets supporting insurance liabilities as of the dates indicated:

	March 31, 2013 Amortized Cost	March 31, 2013 Fair Value	December 31, 2012 Amortized Cost	December 31, 2012 Fair Value
	(in millions)			
Short-term investments and cash equivalents	$ 1,126	$ 1,126	$ 938	$ 938
Fixed maturities:				
Corporate securities	11,222	12,168	11,076	12,107
Commercial mortgage-backed securities	2,331	2,441	2,096	2,229
Residential mortgage-backed securities(1)	1,884	1,932	1,965	2,026
Asset-backed securities(2)	1,048	1,047	1,179	1,116
Foreign government bonds	631	668	683	708
U.S. government authorities and agencies and obligations of U.S. states	346	410	369	426

Total fixed maturities	17,462	18,666	17,368	18,612
Equity securities	857	1,098	943	1,040
Total trading account assets supporting insurance liabilities	$ 19,445	$ 20,890	$ 19,249	$ 20,590

(1) Includes publicly-traded agency pass-through securities and collateralized mortgage obligations.
(2) Includes credit tranched securities collateralized by sub-prime mortgages, auto loans, credit cards, education loans and other asset types.

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PRUDENTIAL FINANCIAL, INC.

Notes to Unaudited Interim Consolidated Financial Statements (Continued)

The net change in unrealized gains (losses) from trading account assets supporting insurance liabilities still held at period end, recorded within Asset management fees and other income , was $104 million and $263 million during the three months ended March 31, 2013 and 2012, respectively.

Other Trading Account Assets

The following table sets forth the composition of the Other trading account assets as of the dates indicated:

	March 31, 2013		December 31, 2012	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
		(in millions)		
Short-term investments and cash equivalents	$ 58	$ 59	$ 42	$ 42
Fixed maturities	2,614	2,595	2,196	2,132
Equity securities	1,236	1,338	1,363	1,437
Other	3	6	3	6
Subtotal	3,911	Our operating results and, in particular, our ability to generate additional revenues are dependent on many factors, including our success in establishing new collaborations and licenses, the success rate of our development efforts leading to opportunities for new collaborations and licenses, the timing and willingness of collaborators to commercialize products that would result in milestone payments and royalties and their success in such efforts, and general and industry-specific economic conditions which may affect research and development expenditures. Future revenues from our existing collaborations are		

uncertain because they depend, to a large degree, on the achievement of milestones and payment of royalties we earn from any future products developed under the collaboration. As a result, we depend, in part, on securing new collaborations and license agreements. Our ability to secure future revenue-generating agreements will depend upon our ability to address the needs of our potential future collaborators and licensees, and to negotiate agreements that we believe are in our long-term best interests. We may determine, as we have with certain of our clinical drug candidates, that our interests are better served by retaining rights to our discoveries and advancing our therapeutic programs to a later stage, which could limit our near-term revenues. Because of these and other factors, our operating results have fluctuated in the past and are likely to do so in the future, and we do not believe that period-to-period comparisons of our operating results are a good indication of our future performance.

Since our inception, we have incurred significant losses and, as of June 30, 2014, we had an accumulated deficit of $1.1 billion. Our losses have resulted principally from costs incurred in research and development, general and administrative costs associated with our operations, and non-cash stock-based compensation expenses associated with stock options and restricted stock granted to employees and consultants. Research and development expenses consist primarily of salaries and related personnel costs, external research costs related to our preclinical and clinical efforts, material costs, facility costs, depreciation on property and equipment, and other expenses related to our drug discovery and development programs. General and administrative expenses consist primarily of salaries and related expenses for executive and administrative personnel, professional fees and other corporate expenses, including information technology, facilities costs and general legal activities. We expect to continue to incur significant research and development costs in connection with the continuing development of our drug candidates. As a result, we will need to generate significantly higher revenues to achieve profitability.

Critical Accounting Policies

The preparation of financial statements in conformity with generally accepted accounting principles requires us to make judgments, estimates and assumptions in the preparation of our consolidated financial statements and accompanying

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notes. Actual results could differ from those estimates. We believe there have been no significant changes in our critical accounting policies as discussed in our Annual Report on Form 10-K for the year ended December 31, 2013.

Recent Accounting Pronouncements

See Note 4, Recent Accounting Pronouncements, of the Notes to Consolidated Financial Statements, for a discussion of the impact of the new accounting standards on our consolidated financial statements.

Results of Operations

Revenues

Total revenues and dollar and percentage changes as compared to the corresponding periods in the prior year are as follows (dollar amounts are presented in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Total revenues	$0.7	$0.2	$1.0	$0.6
Dollar increase	$0.5		$0.4	
Percentage increase	216 %		66 %	

- Collaborative research – Revenue from collaborative research for the three months ended June 30, 2014 increased from $0.2 million to $0.6 million, and for the six months ended June 30, 2014 increased from $0.5 million to $0.8 million, primarily due to revenues recognized from a collaboration with a non-profit institute supporting the Phase 2 development of LX4211 in type 1 diabetes and increased revenues from other functional genomics.

- Subscription and license fees – Revenue from subscriptions and license fees for the six months ended June 30, 2014 increased from $0.1 million to $0.2 million.

Research and Development Expenses

Research and development expenses and dollar and percentage changes as compared to the corresponding periods in the prior year are as follows (dollar amounts are presented in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Total research and development expense	$21.2	$23.7	$45.1	$44.0
Dollar increase (decrease)	$(2.5)		$1.1	
Percentage increase (decrease)	(11)%		3%	

Research and development expenses consist primarily of third-party and other services principally related to preclinical and clinical development activities, salaries and other personnel-related expenses, facility and equipment costs, stock-based compensation expense, and laboratory supplies costs.

- Third-party and other services – Third-party and other services for the three months ended June 30, 2014 increased from $11.5 million to $11.6 million, as compared to the corresponding period in 2013. Third-party and other services for the six months ended June 30, 2014 increased 12% to $21.0 million, as compared to the corresponding period in 2013, primarily due to increases in external clinical and preclinical research and development costs. Third-party and other services relate principally to our clinical trial and related development activities, such as preclinical and clinical studies and contract manufacturing.

- Personnel – Personnel costs for the three months ended June 30, 2014 decreased 21% to $5.5 million, as compared to the corresponding period in 2013, primarily due to reductions in our personnel in 2014, partially offset by increased severance costs as a result of those reductions (see Note 11, Restructuring Charges, of the Notes to Consolidated Financial Statements, for more information). Personnel costs for the six months ended June 30, 2014 increased 6% to $15.2 million, as compared to the corresponding period in 2013, primarily due to increased severance costs as a result of reductions in personnel in 2014. Salaries, bonuses, employee benefits, payroll taxes, recruiting and relocation costs are included in personnel costs.

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- Facilities and equipment – Facilities and equipment costs for the three months ended June 30, 2014 decreased 12% to $1.9 million, and for the six months ended June 30, 2014 decreased 8% to $4.0 million, as compared to the corresponding periods in 2013, primarily due to reductions in depreciation expense.

- Stock-based compensation – Stock-based compensation expense for the three months ended June 30, 2014 decreased 8% to $0.9 million, and for the six months ended June 30, 2014 was $2.4 million, consistent with the corresponding period in 2013.

- Laboratory supplies – Laboratory supplies expense for the three months ended June 30, 2014 decreased 93% to $0.1 million, and for the six months ended June 30, 2014 decreased 88% to $0.2 million, as compared to the corresponding periods in 2013, primarily due to reductions in research activities.

- Other – Other costs for the three months ended June 30, 2014 increased 20% to $1.2 million, and for the six months ended June 30, 2014 decreased 7% to $2.3 million, as compared to the corresponding periods in 2013.

Increase in Fair Value of Symphony Icon Liability

The increase in fair value of the Symphony Icon purchase liability was $0.4 million and $0.5 million for the three months ended June 30, 2014 and 2013, respectively, and was $1.6 million and $1.7 million for the six months ended June 30, 2014 and 2013, respectively (see Note 8, Arrangements with Symphony Icon, Inc., of the Notes to Consolidated Financial Statements, for more information).

General and Administrative Expenses

General and administrative expenses and dollar and percentage changes as compared to the corresponding periods in the prior year are as follows (dollar amounts are presented in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Total general and administrative expense	$5.2	$4.7	$10.8	$9.0
Dollar increase	$0.5		$1.8	
Percentage increase	10 %		20 %	

General and administrative expenses consist primarily of salaries and other personnel-related expenses, professional fees such as legal and consulting fees, stock-based compensation expenses, and facility and equipment costs.

- Personnel – Personnel costs for the three months ended June 30, 2014 increased 14% to $2.6 million, and for the six months ended June 30, 2014 increased 29% to $5.6 million, as compared to the corresponding periods in 2013, primarily due to increased severance costs as a result of reductions in personnel in 2014 (see Note 11, Restructuring Charges, of the Notes to Consolidated Financial Statements, for more information). Salaries, bonuses, employee benefits, payroll taxes, recruiting and relocation costs are included in personnel costs.

- Professional fees – Professional fees for the three months ended June 30, 2014 were $0.8 million, consistent with the corresponding period in 2013. Professional fees for the six months ended June 30, 2014 increased 32% to $1.9 million, as compared to the corresponding period in 2013, primarily due to increased consulting costs in preparation for commercialization.

- Stock-based compensation – Stock-based compensation expense for the three months ended June 30, 2014 increased 6% to $0.9 million, as compared to the corresponding period in 2013. Stock-based compensation expense for the six months ended June 30, 2014 increased 4% to $1.7 million, as compared to the corresponding period in 2013.

- Facilities and equipment – Facilities and equipment costs for the three months ended June 30, 2014 were $0.4 million, consistent with the corresponding period in 2013. Facilities and equipment costs for the six months ended June 30, 2014 increased 2% to $0.9 million, as compared to the corresponding period in 2013.

- Other – Other costs for the three months ended June 30, 2014 were $0.4 million, and for the six months ended June 30, 2014 was $0.7 million, consistent with the corresponding periods in 2013.

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Interest Income and Interest Expense

Interest Income. Interest income for the three months ended June 30, 2014 and 2013 was $4,000 and $44,000, respectively, and for the six months ended June 30, 2014 and 2013 was $12,000 and $97,000, respectively.

Interest Expense. Interest expense for the three months ended June 30, 2014 was $0.5 million, consistent with the corresponding period in 2013. Interest expense for the six months ended June 30, 2014 and 2013 was $0.9 million and $1.0 million, respectively.

Consolidated Net Loss and Consolidated Net Loss per Common Share

Consolidated Net Loss and Consolidated Net Loss per Common Share. Consolidated net loss decreased to $26.0 million in the three months ended June 30, 2014 from $29.1 million in the corresponding period in 2013. Consolidated net loss per common share decreased to $0.05 in the three months ended June 30, 2014 from $0.06 in the corresponding period in 2013. Consolidated net loss increased to $56.9 million in the six months ended June 30, 2014 from $55.1 million in the corresponding period in 2013. Consolidated net loss per common share was $0.11 in the six months ended June 30, 2014, consistent with the corresponding period in 2013.

Our quarterly operating results have fluctuated in the past and are likely to do so in the future, and we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance.

Liquidity and Capital Resources

We have financed our operations from inception primarily through sales of common and preferred stock, contract and milestone payments to us under our drug discovery and development collaborations, target validation, database subscription and technology license agreements, government grants and contracts, and financing obtained under debt and lease arrangements. We have also financed certain of our research and development activities under our agreements with Symphony Icon, Inc. From our inception through June 30, 2014, we had received net proceeds of $987.1 million from issuances of common and preferred stock. In addition, from our inception through June 30, 2014, we received $458.7 million in cash payments from drug discovery and development collaborations, target validation, database subscription and technology license agreements, sales of compound libraries and reagents, and government grants and contracts, of which $445.7 million had been recognized as revenues through June 30, 2014.

As of June 30, 2014, we had $79.0 million in cash, cash equivalents and investments. As of December 31, 2013, we had $129.1 million in cash, cash equivalents and investments. We used cash of $50.0 million in operations in the six months ended June 30, 2014. This consisted primarily of the consolidated net loss for the period of $56.9 million, partially offset by non-cash charges of $4.1 million related to stock-based compensation expense, $1.6 million related to the increase in fair value of the Symphony Icon purchase liability and $1.2 million related to depreciation expense. Investing activities provided cash of $41.8 million in the six months ended June 30, 2014, primarily due to net maturities of investments of $40.3 million and proceeds from disposal of property and equipment of $1.5 million. Financing activities used cash of $1.6 million primarily due to repurchase of common stock of $0.9 million and repayment of debt borrowings of $0.8 million.

Symphony Drug Development Financing Agreements. In June 2007, we entered into a series of related agreements providing for the financing of the clinical development of certain drug programs, including LX1032 and LX1033, along with any other pharmaceutical compositions modulating the same targets as those drug candidates. Under the financing arrangement, we licensed to Symphony Icon, Inc., a then wholly-owned subsidiary of Symphony Icon Holdings LLC, our intellectual property rights related to the programs and Holdings contributed $45 million to Symphony Icon in order to fund the clinical development of the programs. We also issued and sold to Holdings shares of our common stock in exchange for $15 million and received an exclusive option to acquire all of the equity of Symphony Icon, thereby allowing us to reacquire the programs. Upon the recommendation of Symphony Icon's development committee, which was comprised of an equal number of representatives from us and Symphony Icon, Symphony Icon's board of directors had the right to require us to pay Symphony Icon up to $15 million for Symphony Icon's use in the development of the programs in accordance with the specified development plan and related development budget. Symphony Icon's board of directors requested us to pay Symphony Icon $9.3 million under the agreement, all of which was paid prior to the exercise of the purchase option in July 2010.

In July 2010, we entered into an amended and restated purchase option agreement with Symphony Icon and Holdings and simultaneously exercised our purchase option. Pursuant to the amended terms of the purchase option, we paid Holdings

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$10 million in July 2010 and issued 13,237,519 shares of common stock to designees of Holdings in July 2012 in satisfaction of an additional $35 million base payment obligation.

We also agreed to make up to $45 million in additional contingent payments, which will consist of 50% of any consideration we receive pursuant to any licensing transaction under which we grant a third party rights to commercialize LX1032, LX1033 or other pharmaceutical compositions modulating the same target as those drug candidates, which we refer to as the "LG103 programs," subject to certain exceptions. The contingent payments will be due if and when we receive such consideration from such a licensing transaction. In the event we receive regulatory approval in the United States for the marketing and sale of any product resulting from the LG103 programs prior to entering into such a licensing transaction for the commercialization of such product in the United States, in lieu of any contingent payment from such a licensing transaction, we will pay Holdings the sum of $15 million and the amount of certain expenses we incurred after our exercise of the purchase option which are attributable to the development of such product, reduced by up to 50% of such sum for the amount of any contingent payments paid prior to such United States regulatory approval attributable to any such licensing transaction outside of the United States with respect to such product. In the event we make any such payment upon United States regulatory approval, we will have no obligation to make subsequent contingent payments attributable to any such licensing transactions for the commercialization of such product outside the United States until the proceeds of such licensing transactions exceed 50% of the payment made as a result of such United States regulatory approval.

The contingent payments may be paid in cash or a combination of cash and common stock, in our discretion, provided that no more than 50% of any contingent payment will be paid in common stock.

Texas Institute for Genomic Medicine. In July 2005, we received an award from the Texas Enterprise Fund for the creation of a knockout mouse embryonic stem cell library containing 350,000 cell lines for the Texas Institute for Genomic Medicine, or TIGM, using our proprietary gene trapping technology, which we completed in 2007. We also equipped TIGM with the bioinformatics software required for the management and analysis of data relating to the library. The Texas Enterprise Fund made an additional award to the Texas A&M University System for the creation of facilities and infrastructure to house the library.

Under the terms of our award, we are responsible for the creation of a specified number of jobs beginning in 2012, reaching an aggregate of 1,616 new jobs in Texas by December 31, 2016. We will receive credits against those job obligations based on funding received by TIGM and certain related parties from sources other than the State of Texas. We will also receive credits against those jobs obligations for any surplus jobs we create. We may be required to repay the state a portion of the award if we fail to meet those job obligations. Subject to these credits, if we fail to create the specified number of jobs, the State may require us to repay $2,415 for each job we fall short beginning in 2013. Our maximum aggregate exposure for such payments, if we fail to create any new jobs, is approximately $14.2 million, including $1.5 million through 2014, without giving effect to any credits to which we may be entitled.

Facilities. In April 2004, we obtained a $34.0 million mortgage on our facilities in The Woodlands, Texas. The mortgage loan originally had a ten-year term with a 20-year amortization and a fixed interest rate of 8.23%. The mortgage was amended in September 2013 to extend the maturity date from April 2014 to April 2017, with the mortgage loan's monthly payment amount and fixed interest rate each remaining unchanged. The mortgage had a principal balance outstanding of $21.0 million as of June 30, 2014.

In May 2002, our subsidiary Lexicon Pharmaceuticals (New Jersey), Inc. leased a 76,000 square-foot laboratory and office space in Hopewell, New Jersey. Effective December 31, 2012, this lease was amended to decrease the space to approximately 42,000 square feet. The term of the amended lease extends until June 30, 2018. The amended lease provides for escalating yearly base rent payments starting at $836,000 and increasing to $941,000 in the final year of the lease. We are the guarantor of the obligations of our subsidiary under the lease.

Our future capital requirements will be substantial and will depend on many factors, including our ability to obtain drug discovery and development collaborations and other collaborations and technology license agreements, the amount and timing of payments under such agreements, the level and timing of our research and development expenditures, market acceptance of our products, the resources we devote to developing and supporting our products and other factors. Our capital requirements will also be affected by any expenditures we make in connection with license agreements and acquisitions of and investments in complementary technologies and businesses. We expect to devote substantial capital resources to continue our development efforts, to expand our support and product development activities, and for other general corporate activities. We believe that our current unrestricted cash and investment balances and cash and revenues we expect to derive from drug discovery and development collaborations, other collaborations and technology licenses and other sources will be sufficient to fund our operations for at least the next 12 months. During or after this period, if cash generated by operations is insufficient to satisfy our liquidity requirements, we will need to sell additional equity or debt securities or obtain additional credit

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arrangements. Additional financing may not be available on terms acceptable to us or at all. The sale of additional equity or convertible debt securities may result in additional dilution to our stockholders. Although we have previously been successful in obtaining financing through our equity securities offerings, we may not be able to do so in the future. If we are not able to secure adequate additional financings we may be forced to make reductions in spending and/or liquidate assets where possible. Any of these actions could harm our business and our results of operations.

Disclosure about Market Risk

We are exposed to limited market and credit risk on our cash equivalents which have maturities of three months or less at the time of purchase. We maintain a short-term investment portfolio which consists of U.S. Treasury bills, money market accounts, and certificates of deposit that mature three to 12 months from the time of purchase, which we believe are subject to limited market and credit risk. We currently do not hedge interest rate exposure or hold any derivative financial instruments in our investment portfolio.

We had approximately $79.0 million in cash and cash equivalents and short-term investments as of June 30, 2014. We believe that our current unrestricted cash and investment balances and cash and revenues we expect to derive from drug discovery and development collaborations, other collaborations and technology licenses and other sources will be sufficient to fund our operations for at least the next 12 months.

We have operated primarily in the United States and substantially all sales to date have been made in U.S. dollars. Accordingly, we have not had any material exposure to foreign currency rate fluctuations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

See “Disclosure about Market Risk” under “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations” for quantitative and qualitative disclosures about market risk.

Item 4. Controls and Procedures

Our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) are effective to ensure that the information required to be disclosed by us in the reports we file under the Securities Exchange Act is gathered, analyzed and disclosed with adequate timeliness, accuracy and completeness, based on an evaluation of such controls and procedures as of the end of the period covered by this report.

Subsequent to our evaluation, there were no significant changes in internal controls or other factors that could significantly affect internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

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Part II -- Other Information

Item 1. Legal Proceedings

We are from time to time party to claims and legal proceedings that arise in the normal course of our business and that we believe will not have, individually or in the aggregate, a material adverse effect on our results of operations, financial condition or liquidity.

Item 1A. Risk Factors

The following risks and uncertainties are important factors that could cause actual results or events to differ materially from those indicated by forward-looking statements. The factors described below are not the only ones we face and additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations.

Risks Related to Our Need for Additional Financing and Our Financial Results

- We will need additional capital in the future and, if it is unavailable, we will be forced to significantly curtail or cease our operations. If it is not available on reasonable terms, we will be forced to obtain funds by entering into financing agreements on unattractive terms.

- We have a history of net losses, and we expect to continue to incur net losses and may not achieve or maintain profitability.

- Our operating results have been and likely will continue to fluctuate, and we believe that period-to-period comparisons of our operating results are not a good indication of our future performance.

Risks Related to Development of Our Drug Candidates

- We have not proven our ability to successfully develop and commercialize our drug candidates.

- Clinical testing of our drug candidates in humans is an inherently risky and time-consuming process that may fail to demonstrate safety and efficacy, which could result in the delay, limitation or prevention of regulatory approval.

Risks Related to Regulatory Approval of Our Drug Candidates

- Our drug candidates are subject to a lengthy and uncertain regulatory process that may not result in the necessary regulatory approvals, which could adversely affect our ability to commercialize products.

- If our potential products receive regulatory approval, we or our collaborators will remain subject to extensive and rigorous ongoing regulation.

Risks Related to Commercialization of Products

- The commercial success of any products that we may develop will depend upon the degree of market acceptance of our products among physicians, patients, health care payors, private health insurers and the medical community.

- If we are unable to establish sales and marketing capabilities or enter into agreements with third parties to market and sell our drug candidates, we may be unable to generate product revenues.

- If we are unable to obtain adequate coverage and reimbursement from third-party payors for any products that we may develop, our revenues and prospects for profitability will suffer.

- Current and future healthcare laws and regulations may negatively affect our revenues and prospects for profitability.

- Our competitors may develop products that make our products obsolete.

- We may not be able to manufacture our drug candidates in commercial quantities, which would prevent us from commercializing our drug candidates.

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Risks Related to Our Relationships with Third Parties

- We are dependent in many ways upon our collaborations with major pharmaceutical companies. If we are unable to establish new collaborations, if milestones are not achieved under our collaborations or if our collaborators' efforts fail to yield pharmaceutical products on a timely basis, our opportunities to generate revenues and earn royalties will be reduced.
- Conflicts with our collaborators could jeopardize the success of our collaborative agreements and harm our product development efforts.
- We rely on third parties to carry out drug development activities.
- We lack the capability to manufacture materials for preclinical studies, clinical trials or commercial sales and rely on third parties to manufacture our drug candidates, which may harm or delay our product development and commercialization efforts.

Risks Related to Our Intellectual Property

- If we are unable to adequately protect our intellectual property, third parties may be able to use our products and technologies, which could adversely affect our ability to compete in the market.
- We may be involved in patent litigation and other disputes regarding intellectual property rights and may require licenses from third parties for our planned preclinical and clinical development and commercialization activities. We may not prevail in any such litigation or other dispute or be able to obtain required licenses.
-

We have not sought patent protection outside of the United States for some of our inventions, and some of our licensed patents only provide coverage in the United States. As a result, our international competitors could be granted foreign patent protection with respect to our discoveries.

- We may be subject to damages resulting from claims that we, our employees or independent contractors have wrongfully used or disclosed alleged trade secrets of their former employers.

Risks Related to Employees, Advisors and Facilities Operations

- The loss of key personnel or the inability to attract and retain additional personnel could impair our ability to expand our operations.

- Our collaborations with outside scientists may be subject to restriction and change.

- Security breaches may disrupt our operations and harm our operating results.

- Because most of our operations are located at a limited number of facilities, the occurrence of a disaster could significantly disrupt our business.

Risks Related to Environmental and Product Liability

- We use hazardous chemicals and radioactive and biological materials in our business. Any claims relating to improper handling, storage or disposal of these materials could be time consuming and costly.

- We face potential product liability exposure in excess of our insurance coverage.

Risks Related to Our Common Stock

- Invus, L.P., Invus C.V. and their affiliates own a controlling interest in our outstanding common stock and may have interests which conflict with those of our other stockholders.

- Invus has additional rights under our stockholders' agreement with Invus, L.P. which provides Invus with substantial influence over certain significant corporate matters.

- Our stock price may be extremely volatile.

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- We may engage in future acquisitions, which may be expensive and time consuming and from which we may not realize anticipated benefits.
- Future sales of our common stock may depress our stock price.
- If we are unable to meet Nasdaq continued listing requirements, Nasdaq may take action to delist our common stock.

For additional discussion of the risks and uncertainties that affect our business, see "Item 1A. Risk Factors" included in our annual report on Form 10-K for the year ended December 31, 2013 as filed with the Securities and Exchange Commission.

Item 6. Exhibits

Exhibit No.		Description
31.1	—	Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	—	Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
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101.SCH	—	XBRL Taxonomy Extension Schema Document
101.CAL	—	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	—	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	—	XBRL Taxonomy Extension Label Linkbase Document

101.PRE —	XBRL Taxonomy Extension Presentation Linkbase Document

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Signatures

Pursuant to the requirements 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.

			Lexicon Pharmaceuticals, Inc.
Date:	August 7, 2014	By:	/s/ Lonnel Coats Lonnel Coats President and Chief Executive Officer
Date:	August 7, 2014	By:	/s/ Jeffrey L. Wade Jeffrey L. Wade Executive Vice President, Corporate Development and Chief Financial Officer

Index to Exhibits

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