

HANOVER INSURANCE GROUP, INC.

Form 10-Q

November 09, 2006

Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2006

or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 1-13754

**THE HANOVER INSURANCE GROUP, INC.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or organization)

04-3263626  
(I.R.S. Employer Identification No.)

440 Lincoln Street, Worcester, Massachusetts 01653  
(Address of principal executive offices) (Zip Code)  
(508) 855-1000

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY

PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 51,005,156 shares of common stock outstanding, as of November 1, 2006.

Table of Contents

**TABLE OF CONTENTS**

PART I. FINANCIAL INFORMATION

Item 1.	Financial Statements	
	<u>Consolidated Statements of Income</u>	3
	<u>Consolidated Balance Sheets</u>	4
	<u>Consolidated Statements of Shareholders' Equity</u>	5
	<u>Consolidated Statements of Comprehensive Income</u>	6
	<u>Consolidated Statements of Cash Flows</u>	7
	<u>Notes to Interim Consolidated Financial Statements</u>	8-23
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	24-56
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	57
Item 4.	<u>Controls and Procedures</u>	57

PART II. OTHER INFORMATION

Item 1.	<u>Legal Proceedings</u>	58
Item 1A.	<u>Risk Factors</u>	58-61
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	62
Item 6.	<u>Exhibits</u>	62
	<u>SIGNATURES</u>	63

Table of Contents**PART I - FINANCIAL INFORMATION****ITEM 1 - FINANCIAL STATEMENTS****THE HANOVER INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF INCOME**

(In millions, except per share data)	(Unaudited)		(Unaudited)	
	Quarter Ended		Nine Months Ended	
	September 30,	September 30,	September 30,	September 30,
	2006	2005	2006	2005
<b>REVENUES</b>				
Premiums	\$ 568.2	\$ 525.7	\$ 1,682.4	\$ 1,650.3
Fees and other income	22.6	22.2	58.8	60.8
Net investment income	78.3	79.4	237.8	238.0
Net realized investment gains	2.1	1.9	10.6	18.1
<b>Total revenues</b>	<b>671.2</b>	<b>629.2</b>	<b>1,989.6</b>	<b>1,967.2</b>
<b>BENEFITS, LOSSES AND EXPENSES</b>				
Policy benefits, claims, losses and loss adjustment expenses	399.5	566.9	1,114.8	1,340.9
Policy acquisition expenses	121.7	116.5	352.8	347.9
Other operating expenses	106.7	86.6	315.0	290.5
<b>Total benefits, losses and expenses</b>	<b>627.9</b>	<b>770.0</b>	<b>1,782.6</b>	<b>1,979.3</b>
Income (loss) from continuing operations before federal income taxes	43.3	(140.8)	207.0	(12.1)
Federal income tax expense (benefit):				
Current	(4.5)	(0.8)	18.3	5.2
Deferred	19.3	(34.6)	46.5	(9.4)
<b>Total federal income tax expense (benefit)</b>	<b>14.8</b>	<b>(35.4)</b>	<b>64.8</b>	<b>(4.2)</b>
Income (loss) from continuing operations	28.5	(105.4)	142.2	(7.9)
Discontinued operations (See Note 3):				
Income from operations of discontinued variable life insurance and annuity business (net of income tax benefit of \$3.5 and \$14.1 for the quarter and nine months ended September 30, 2005)	-	17.6	-	38.6
Loss on disposal of variable life insurance and annuity business (net of income tax (expense) benefit of \$(2.5) and \$7.0 for the quarters ended September 30, 2006 and 2005, respectively, and \$5.3 and \$7.0 for the nine months ended September 30, 2006 and 2005, respectively)	(2.9)	(474.6)	(25.8)	(474.6)
Gain on sale of Financial Profiles, Inc. (net of income tax expense of \$1.2 for the quarter and nine months ended September 30, 2006)	7.8	-	7.8	-
Income before cumulative effect of change in accounting principle	33.4	(562.4)	124.2	(443.9)
Cumulative effect of change in accounting principle (net of income tax expense of \$0.3)	-	-	0.6	-
<b>Net income (loss)</b>	<b>\$ 33.4</b>	<b>\$ (562.4)</b>	<b>\$ 124.8</b>	<b>\$ (443.9)</b>
<b>PER SHARE DATA</b>				
<b>Basic</b>				
Income (loss) from continuing operations	\$ 0.56	\$ (1.97)	\$ 2.75	\$ (0.15)
Discontinued operations:				

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Income from operations of discontinued variable life insurance and annuity business (net of income tax benefit of \$0.07 and \$0.26 for the quarter and nine months ended September 30, 2005)	-	0.33	-	0.72
Loss on disposal of variable life insurance and annuity business (net of income tax (expense) benefit of \$(0.05) and \$0.13 for the quarters ended September 30, 2006 and 2005, respectively, and \$0.10 and \$0.13 for the nine months ended September 30, 2006 and 2005, respectively)	(0.05)	(8.87)	(0.49)	(8.88)
Gain on sale of Financial Profiles, Inc. (net of income tax expense of \$0.02 for the quarter and nine months ended September 30, 2006)	0.15	-	0.15	-
Income (loss) before cumulative effect of change in accounting principle	0.66	(10.51)	2.41	(8.31)
Cumulative effect of change in accounting principle	-	-	0.01	-
Net income (loss) per share	\$ 0.66	\$ (10.51)	\$ 2.42	\$ (8.31)
Weighted average shares outstanding	50.9	53.5	51.7	53.4
<u>Diluted</u>				
Income (loss) from continuing operations	\$ 0.56	\$ (1.97)	\$ 2.73	\$ (0.15)
Discontinued operations:				
Income from operations of discontinued variable life insurance and annuity business (net of income tax benefit of \$0.07 and \$0.26 for the quarter and nine months ended September 30, 2005)	-	0.33	-	0.72
Loss on disposal of variable life insurance and annuity business (net of income tax (expense) benefit of \$(0.05) and \$0.13 for the quarters ended September 30, 2006 and 2005, respectively, and \$0.10 and \$0.13 for the nine months ended September 30, 2006 and 2005, respectively)	(0.06)	(8.87)	(0.49)	(8.88)
Gain on sale of Financial Profiles, Inc. (net of income tax expense of \$0.02 for the quarter and nine months ended September 30, 2006)	0.15	-	0.14	-
Income (loss) before cumulative effect of change in accounting principle	0.65	(10.51)	2.38	(8.31)
Cumulative effect of change in accounting principle	-	-	0.01	-
Net income (loss) per share	\$ 0.65	\$ (10.51)	\$ 2.39	\$ (8.31)
Weighted average shares outstanding	51.3	53.5	52.2	53.4

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

**Table of Contents****THE HANOVER INSURANCE GROUP, INC.****CONSOLIDATED BALANCE SHEETS**

(In millions, except per share data)	(Unaudited) September 30, 2006	December 31, 2005
<b>ASSETS</b>		
Investments:		
Fixed maturities at fair value (amortized cost of \$5,498.4 and \$5,685.9)	\$ 5,474.9	\$ 5,708.2
Equity securities at fair value (cost of \$12.1 and \$13.0)	17.3	18.0
Mortgage loans	59.4	99.6
Policy loans	127.2	139.9
Other long-term investments	40.5	42.6
<b>Total investments</b>	<b>5,719.3</b>	<b>6,008.3</b>
Cash and cash equivalents	391.9	701.5
Accrued investment income	72.6	76.5
Premiums, accounts and notes receivable, net	606.9	493.2
Reinsurance receivable on paid and unpaid losses, benefits and unearned premiums	1,391.7	1,617.3
Deferred policy acquisition costs	237.9	209.0
Deferred federal income taxes	432.5	465.3
Goodwill	121.4	128.2
Other assets	345.6	362.8
Separate account assets	524.2	571.9
<b>Total assets</b>	<b>\$ 9,844.0</b>	<b>\$ 10,634.0</b>
<b>LIABILITIES</b>		
Policy liabilities and accruals:		
Future policy benefits	\$ 1,281.5	\$ 1,336.1
Outstanding claims, losses and loss adjustment expenses	3,279.9	3,551.6
Unearned premiums	1,141.6	1,011.3
Contractholder deposit funds and other policy liabilities	203.2	254.7
<b>Total policy liabilities and accruals</b>	<b>5,906.2</b>	<b>6,153.7</b>
Expenses and taxes payable	898.2	1,062.0
Reinsurance premiums payable	60.4	92.0
Trust instruments supported by funding obligations	36.9	294.3
Long-term debt	508.8	508.8
Separate account liabilities	524.2	571.9
<b>Total liabilities</b>	<b>7,934.7</b>	<b>8,682.7</b>
Commitments and contingencies (Note 12)		
<b>SHAREHOLDERS EQUITY</b>		
Preferred stock, \$0.01 par value, 20.0 million shares authorized, none issued	-	-
Common stock, \$0.01 par value, 300.0 million shares authorized, 60.5 million shares issued	0.6	0.6
Additional paid-in capital	1,809.0	1,785.1
Accumulated other comprehensive loss	(87.5)	(59.5)
Retained earnings	685.4	589.8
Treasury stock at cost (9.6 million and 6.8 million shares)	(498.2)	(364.7)

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Total shareholders' equity		<b>1,909.3</b>		1,951.3
Total liabilities and shareholders' equity		<b>\$ 9,844.0</b>	<b>\$</b>	10,634.0

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

Table of Contents

## THE HANOVER INSURANCE GROUP, INC.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

	(Unaudited)	
	Nine Months Ended	
	September 30,	
(In millions)	2006	2005
<b>PREFERRED STOCK</b>		
Balance at beginning and end of period	\$ -	\$ -
<b>COMMON STOCK</b>		
Balance at beginning and end of period	0.6	0.6
<b>ADDITIONAL PAID-IN CAPITAL</b>		
Balance at beginning of period	1,785.1	1,782.1
Tax benefit from exercise of stock options and other	7.1	2.4
Employee and director stock-based awards	16.8	(0.2)
Balance at end of period	1,809.0	1,784.3
<b>ACCUMULATED OTHER COMPREHENSIVE LOSS</b>		
<b>NET UNREALIZED (DEPRECIATION) APPRECIATION ON INVESTMENTS AND DERIVATIVE INSTRUMENTS:</b>		
Balance at beginning of period	9.9	87.1
Depreciation during the period:		
Net depreciation on available-for-sale securities and derivative instruments	(33.3)	(59.1)
Benefit for deferred federal income taxes	5.3	20.7
	(28.0)	(38.4)
Balance at end of period	(18.1)	48.7
<b>MINIMUM PENSION LIABILITY:</b>		
Balance at beginning and end of period	(69.4)	(84.1)
Total accumulated other comprehensive loss	(87.5)	(35.4)
<b>RETAINED EARNINGS</b>		
Balance at beginning of period	589.8	943.4
Net income (loss)	124.8	(443.9)
Treasury stock issued for less than cost	(29.2)	(13.3)
Balance at end of period	685.4	486.2
<b>TREASURY STOCK</b>		
Balance at beginning of period	(364.7)	(389.6)
Shares purchased at cost	(200.1)	-
Net shares reissued at cost under employee stock-based compensation plans	66.6	21.6
Balance at end of period	(498.2)	(368.0)



Total shareholders' equity	\$ 1,909.3	\$ 1,867.7
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The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

## THE HANOVER INSURANCE GROUP, INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In millions)	(Unaudited)		(Unaudited)	
	Quarter Ended		Nine Months Ended	
	September 30, 2006	2005	September 30, 2006	2005
Net income (loss)	\$ 33.4	\$ (562.4)	\$ 124.8	\$ (443.9)
Other comprehensive income (loss):				
Available-for-sale securities:				
Net appreciation (depreciation) during the period	95.5	(104.8)	(34.6)	(135.1)
Benefit for deferred federal income taxes	5.0	36.7	5.7	47.3
Total available-for-sale securities	100.5	(68.1)	(28.9)	(87.8)
Derivative instruments:				
Net (depreciation) appreciation during the period	(0.1)	1.7	1.3	76.0
Benefit (provision) for deferred federal income taxes	0.1	(0.6)	(0.4)	(26.6)
Total derivative instruments	-	1.1	0.9	49.4
Other comprehensive income (loss)	100.5	(67.0)	(28.0)	(38.4)
Comprehensive income (loss)	\$ 133.9	\$ (629.4)	\$ 96.8	\$ (482.3)

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

**Table of Contents****THE HANOVER INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In millions)	(Unaudited)	
	Nine Months Ended September 30,	
	2006	2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income (loss)	\$ 124.8	\$ (443.9)
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Loss on disposal of variable life insurance and annuity business	25.8	474.6
Gain on sale of Financial Profiles, Inc.	(7.8)	-
Net realized investment gains	(10.6)	(24.2)
Net amortization and depreciation	16.3	24.8
Stock-based compensation expense	13.0	-
Interest credited to contractholder deposit funds and trust instruments supported by funding obligations	6.0	17.8
Deferred federal income taxes	42.3	(19.4)
Change in deferred acquisition costs	(29.7)	107.4
Change in premiums and notes receivable, net of reinsurance premiums payable	(130.9)	2.4
Change in accrued investment income	3.9	18.1
Change in policy liabilities and accruals, net	(212.1)	320.9
Change in reinsurance receivable	225.6	(227.7)
Change in expenses and taxes payable	(99.0)	(62.2)
Other, net	(14.0)	(17.9)
Net cash (used in) provided by operating activities	(46.4)	170.7
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Proceeds from disposals and maturities of available-for-sale fixed maturities	1,105.8	1,729.1
Proceeds from disposals of equity securities and other investments	18.8	24.8
Proceeds from mortgages sold, matured or collected	40.2	13.1
Proceeds from collections of installment finance and notes receivable	259.3	240.7
Proceeds from sale of variable life insurance and annuity business	27.3	-
Proceeds from sale of Financial Profiles, Inc.	17.9	-
Purchase of available-for-sale fixed maturities	(923.5)	(1,209.6)
Purchase of equity securities and other investments	(5.8)	(5.9)
Capital expenditures	(6.0)	(5.1)
Net payments related to margin deposits on derivative instruments	(28.3)	(37.2)
Disbursements to fund installment finance and notes receivable	(273.7)	(231.9)
Net cash provided by investing activities	232.0	518.0
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Withdrawals from contractholder deposit funds	(25.8)	(1.7)
Withdrawals from trust instruments supported by funding obligations	(253.1)	(647.2)
Exercise of options	37.8	7.6
Proceeds from excess tax benefits related to share-based payments	7.1	-
Change in collateral related to securities lending program	(61.1)	27.3
Treasury stock purchased at cost	(200.1)	-
Net cash used in financing activities	(495.2)	(614.0)
Net change in cash and cash equivalents	(309.6)	74.7
Net change in cash held by discontinued operations	-	(19.2)

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Cash and cash equivalents, beginning of period	<b>701.5</b>	376.9
Cash and cash equivalents, end of period	<b>\$ 391.9</b>	<b>\$ 432.4</b>

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

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**Table of Contents**

**THE HANOVER INSURANCE GROUP, INC.**

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation and Principles of Consolidation**

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

The interim consolidated financial statements of THG include the accounts of The Hanover Insurance Company ( Hanover Insurance ) and Citizens Insurance Company of America ( Citizens ), THG's principal property and casualty companies; First Allmerica Financial Life Insurance Company ( FAFLIC ), THG's life insurance and annuity subsidiary; and certain other insurance and non-insurance subsidiaries. These legal entities conduct their operations through several business segments discussed in Note 9. All significant intercompany accounts and transactions have been eliminated. The Company's results of operations also include the accounts of Allmerica Financial Life Insurance and Annuity Company ( AFLIAC ) through December 30, 2005. As further described in Note 3 - Sale of Variable Life Insurance and Annuity Business, on December 30, 2005, the Company sold, as part of a stock purchase agreement, its run-off variable life insurance and annuity business.

The accompanying interim consolidated financial statements reflect, in the opinion of the Company's management, all adjustments necessary for a fair presentation of the financial position and results of operations. The results of operations for the nine months ended September 30, 2006 are not necessarily indicative of the results to be expected for the full year. These financial statements should be read in conjunction with the Company's 2005 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

The preparation of financial statements in conformity with generally accepted accounting principles requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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

**2. New Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB statements No. 87, 88, 106, and 132(R)* ( Statement No. 158 ). This statement requires an employer to recognize the funded status of its benefit plans in its statement of financial position and to recognize changes in that funded status through comprehensive income in the year in which they occur. The funded status of the plans should be measured as the difference between the fair value of plan assets and the benefit obligation. This statement also requires the recognition, as a component of other comprehensive income, net of taxes, of the gains or losses and prior service costs or credits that arise during the period but are not recognized as a component of net periodic benefit cost pursuant to Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* ( Statement No. 87 ) or Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* ( Statement No. 106 ). Amounts recognized in accumulated other comprehensive income shall continue to be subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization requirements of Statement No. 87 and Statement No. 106. In addition, the statement requires an employer to measure the funded status of its plans as of the date of its year-end statement of financial position. The statement also provides for enhanced disclosures which include, among other items, the estimated amount of actuarial gains or losses, prior services costs or credits, and transition assets or obligations that are included in accumulated other comprehensive income to be recognized as components of net periodic benefit cost in the next fiscal year. The effective date for a company to recognize the funded status of its plans and the related disclosure requirements is its fiscal year ending after December 15, 2006. Based on assessments of plan data available, the Company believes that the effect of adopting Statement No. 158 will not be material to its statement of financial position. The effective date for changing a company's measurement date for plan assets and benefit obligations to coincide with the date of its statement of financial position will be the fiscal year ending after December 15, 2008. Retrospective application of this statement is not permitted. The Company currently measures its funded status as of December 31.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ( Statement No. 157 ). This statement creates a common definition of fair value to be used throughout generally accepted accounting principles. Statement No. 157 will apply whenever another standard requires or permits assets or liabilities to be measured at fair value, with certain exceptions. The standard establishes a hierarchy for determining fair value which emphasizes



**Table of Contents**

the use of observable market data whenever available. The statement also requires expanded disclosures which include the extent to which assets and liabilities are measured at fair value, the methods and assumptions used to measure fair value and the effect of fair value measures on earnings. Statement No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The difference between the carrying amounts and fair values of those financial instruments held at the date this statement is initially applied should be recognized as a cumulative effect adjustment to the opening balance of retained earnings for the fiscal year in which this statement is initially applied. The Company is currently assessing the effect of adopting Statement No. 157.

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

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140* ( Statement No. 155 ). This Statement amends Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* ( Statement No. 133 ) and Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of FASB Statement No. 125*. Statement No. 155, among other things, permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, adds clarity regarding interest-only strips and principal-only strips that are not subject to the requirements of Statement No. 133, and requires companies to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments containing an embedded derivative that requires bifurcation. Statement No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. Since early adoption is permitted, the Company adopted Statement No. 155 on January 1, 2006 with no material impact to its financial statements.

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

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3* ( Statement No. 154 ). Statement No. 154 replaces Accounting Principles Board Opinion No. 20, *Accounting Changes* ( APB Opinion No. 20 ), and Statement of Financial Accounting Standards No. 3, *Reporting Accounting Changes in Interim Financial Statements*. This statement establishes, unless impracticable, retrospective application as the required method for all voluntary changes in accounting principle in the absence of specific transition provisions for the newly adopted accounting principle. Statement No. 154 requires companies to retrospectively apply the effect of the change to all prior periods practicable, and the financial statements for all periods presented shall be adjusted to reflect the change. Similarly, an error in the financial statements of a prior period that is discovered subsequent to their issuance shall be reported as a prior-period adjustment, and the financial statements for each period presented shall be adjusted to reflect the correction. This statement also provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and the necessary disclosures once that determination has been made. Additionally, changes in methods of depreciation, amortization or depletion of long-lived, non-financial assets must be accounted for as a change in accounting estimate. The statement also requires certain disclosures in the period in which a change in accounting principle or correction of an error is made. Statement No. 154 is effective for changes and correction of errors made in fiscal years beginning after December 15, 2005.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* ( Statement No. 123(R) ). This statement requires companies to measure and recognize the cost of employee services received in

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**Table of Contents**

exchange for an award of equity instruments based on the grant-date fair value. Statement No. 123(R) replaces Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* ( Statement No. 123 ), and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB Opinion No. 25 ). The Company has adopted Statement No. 123(R) effective January 1, 2006 using the modified prospective transition method. Prior to the adoption of Statement No. 123(R), the Company accounted for its stock-based compensation in accordance with APB Opinion No. 25; therefore, the Company had not previously recognized compensation expense for employee stock options in net income because the exercise price equaled the market value of the underlying common stock on the grant date. Upon adoption of Statement No. 123(R), the Company began recognizing expense related to employee stock options and modified its expense calculation associated with restricted shares and restricted share units. (See Note 11 Stock-Based Compensation Plans.) The cumulative effect adjustment of adopting Statement No. 123(R), net of tax, was a benefit of \$0.6 million.

3. Sale of Variable Life Insurance and Annuity Business

On December 30, 2005, the Company sold all of the outstanding shares of capital stock of AFLIAC, a life insurance subsidiary representing approximately 95% of the Company's run-off variable life insurance and annuity business to The Goldman Sachs Group, Inc. ( Goldman Sachs ). The transaction also included the reinsurance of 100% of the variable business of FAFLIC. In connection with these transactions, Allmerica Investment Trust ( AIT ) agreed to transfer certain assets and liabilities of its funds to certain Goldman Sachs Variable Insurance Trust managed funds through a fund reorganization transaction. Finally, the Company agreed to sell to Goldman Sachs all of the outstanding shares of capital stock of Allmerica Financial Investment Management Service, Inc. ( AFIMS ), its investment advisory subsidiary, concurrently with the consummation of a fund reorganization transaction. The fund reorganization transaction was consummated on January 9, 2006.

Total proceeds from the sale were \$318.8 million, of which \$46.7 million was deferred and expected to be paid over a three year period, with 50% being received in 2006 and 25% in each of the following two years. As of September 30, 2006, the Company had received proceeds from Goldman Sachs totaling \$272.1 million. As of September 30, 2005, prior to the closing, total proceeds from the sale were estimated at \$292.4 million, of which \$27.6 million would be deferred.

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

The Company and Goldman Sachs have made various representations, warranties and covenants in the Stock Purchase Agreement entered into in connection with the transaction. The Company has agreed to indemnify Goldman Sachs for the breaches of the Company's representations, warranties and covenants. THG has also agreed to indemnify Goldman Sachs for certain litigation, regulatory matters and other liabilities relating to the pre-closing activities of the business that was sold.

The Company determined that the disposal of AFLIAC should be reflected as a discontinued operation in accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* ( Statement No. 144 ). As such, the Company recognized a loss of \$474.6 million related to this transaction as of September 30, 2005, primarily from a change in certain actuarial assumptions related to the deferred acquisition cost and deferred sales inducement asset. This was adjusted on December 30, 2005, the closing date, to reflect the actual purchase price paid by Goldman Sachs and the book value of AFLIAC on that date. The Company adjusted its loss on the sale of AFLIAC to a loss of \$444.4 million at December 30, 2005. The loss is presented in the Consolidated Statements of Income as Loss on Disposal of Variable Life Insurance and Annuity Business, a component of Discontinued Operations.



**Table of Contents**

The following table summarizes the components of the estimated loss on the disposal of our variable life insurance and annuity business as of September 30, 2005 and December 31, 2005:

(In millions)		(unaudited)	
		September 30, 2005	December 31, 2005
Proceeds from Goldman Sachs	(1)	\$ 292.4	\$ 318.8
<u>Less:</u>			
Carrying value of AFLIAC	(2)	(726.0)	(719.3)
Estimated transaction costs	(3)	(11.0)	(10.5)
Deferred gain on FAFLIC coinsurance	(4)	(8.6)	(8.6)
Liability for certain legal indemnities	(5)	(13.0)	(13.0)
Hedge results	(6)	(8.4)	(27.9)
THG tax benefit	(7)	-	10.0
Realized gain on securities related to AFLIAC		-	6.1
Net loss		\$ (474.6)	\$ (444.4)

- (1) Proceeds from Goldman Sachs include deferred payments of \$27.6 million and \$46.7 million as of September 30, 2005 and December 31, 2005, respectively, to be received over three years.
- (2) Shareholder's equity of the AFLIAC variable life insurance and annuity business at December 31, 2005 (estimated as of September 30, 2005), prior to the impact of the sale transaction.
- (3) Transaction costs include investment banker, vendor contract licensing, legal and other professional fees.
- (4) Included in the proceeds from Goldman Sachs is the FAFLIC variable business coinsurance ceding commission of \$8.6 million. Upon closing of the FAFLIC coinsurance agreement, this gain was deferred and is being amortized over the remaining life of the policies in accordance with Statement of Financial Accounting Standards No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*.
- (5) Estimated liability to Goldman Sachs for certain contractual indemnities of AFLIAC related to the agreement recorded under FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45).
- (6) A hedging program was implemented on August 23, 2005 to reduce the volatility in the sales price calculation from the effect of equity market movements through the date of the closing.
- (7) At December 30, 2005, THG, the holding company, recognized a tax benefit primarily due to realized losses generated by the AFLIAC sale.

In the first nine months of 2006, THG incurred additional losses of \$25.8 million, net of taxes, related to the sale, of which \$2.9 million was recorded in the third quarter. Included in the \$25.8 million after-tax loss was a \$15.0 million expense related to the existing provision for the Company's estimated potential liability for certain contractual indemnities to Goldman Sachs relating to the pre-sale activities of the business.

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sold recorded under FIN 45. This additional provision relates to preliminary estimated expenses, reimbursements, penalties and other costs of remediating certain pre-closing processing errors relating to tax reporting to certain policyholders and others in connection with distributions under a subset of the Company's former variable annuity business. The estimate is based on, among other items, the Company's review of affected policies, mathematical extrapolations derived from such review, and management's preliminary view of possible settlement ranges with the Internal Revenue Service and affected policyholders. Although the Company believes its FIN 45 liability for legal and regulatory matter indemnities is appropriate, including with respect to this matter, such estimates are inherently uncertain and there can be no assurance that these estimates will not materially increase in the future.

Also included in the loss for the quarter and nine months ended September 30, 2006 was \$2.9 million and \$10.8 million, respectively, related to after-tax net costs incurred for severance, transition services, conversion activities and other litigation matters. The Company has agreed to provide transition services until the earlier of eighteen months from the December 30, 2005 closing or when the operations of AFLIAC, and the FAFLIC business to be reinsured, can be transferred to Goldman Sachs. These services include policy and claims processing, accounting and reporting, and other administrative services. In the third quarter and first nine months of 2006, the Company earned pre-tax revenues of \$4.1 million and \$13.4 million, respectively, and incurred pre-tax costs relating to transition services of \$8.2 million and \$29.7 million, respectively. This transition period is currently expected to extend into the fourth quarter of 2006.

In accordance with Statement No. 144, the Company has reclassified prior year results of operations related to the discontinued variable life insurance and annuity business from its operations, to discontinued operations. These results, including the related

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## **Table of Contents**

tax effect, are reflected in the Consolidated Statements of Income as Income from Operations of Discontinued Variable Life Insurance and Annuity Business. For the quarter and nine months ended September 30, 2005, total revenues were \$80.8 million and \$261.2 million, respectively, and income before federal income taxes were \$14.1 million and \$24.5 million, respectively.

### 4. Significant Transactions

On August 31, 2006, the Company sold all of the outstanding shares of Financial Profiles, Inc., a wholly-owned subsidiary, to Emerging Information Systems Incorporated. Financial Profiles, Inc. was originally acquired by the Company in 1998 in connection with the Company's then-ongoing life insurance and annuity operations. The Company received pre-tax proceeds of \$21.5 million from the transaction and recognized an after-tax gain of \$7.8 million during the third quarter of 2006.

On December 28, 2005, the Company's Board of Directors authorized a share repurchase program of up to \$200 million. As of May 3, 2006, the Company completed its repurchases under this program, having repurchased 4.0 million shares at an aggregate cost of \$200 million.

### 5. Federal Income Taxes

Federal income tax expense for the nine months ended September 30, 2006 and 2005 has been computed using estimated effective tax rates. These rates are revised, if necessary, at the end of each successive interim period to reflect the current estimates of the annual effective tax rates.

In the third quarter of 2006, the Company generated a tax gain of \$12.1 million from the sale of Financial Profiles, Inc. This tax gain was used to offset capital loss carryforwards and reduced the Company's valuation allowance by \$4.1 million. The reduction in the valuation allowance was recorded in the Consolidated Statements of Income as an increase in Gain on Sale of Financial Profiles, Inc., a component of Discontinued Operations.

During the nine months ended September 30, 2005, the Company reflected a \$12.9 million benefit representing a reduction in federal income tax reserves for prior years, resulting from ongoing Internal Revenue Service audits. Of this amount, \$10.6 million was reflected in Income from Operations of Discontinued Variable Life Insurance and Annuity Business on the Company's Consolidated Statements of Income and the remaining \$2.3 million was recorded in the Company's federal income tax expense.

The Company's Accumulated Other Comprehensive Loss included the additional minimum pension liability and net unrealized investment losses of \$124.8 million as of September 30, 2006. These unrealized losses resulted in a net deferred tax asset of \$43.7 million. The Company recorded a valuation allowance related to the unrealized losses associated with the Company's investment portfolio of \$6.4 million in the first nine months of 2006, as it is the Company's opinion that it is more likely than not that this asset will not be fully realized. The Company recorded this valuation allowance as an adjustment to Accumulated Other Comprehensive Loss, in the Shareholders' Equity section of the Consolidated Balance Sheets. At September 30, 2006 and December 31, 2005, the Company's deferred tax asset valuation allowance was \$167.6 million and \$165.3 million, respectively.

### 6. Pension and Other Postretirement Benefit Plans

Prior to 2005, THG provided retirement benefits to substantially all of its employees under defined benefit pension plans based on a cash balance formula. In addition, certain transition group employees who had met specified age and service requirements as of December 31, 1994, were eligible for a grandfathered benefit based on service and compensation. As of January 1, 2005, the defined benefit pension plans were frozen; therefore, no further cash balance allocations have been credited for plan years beginning on or after January 1, 2005. Additionally, the grandfathered benefits were frozen at January 1, 2005 levels with an annual transition pension adjustment. Additional unfunded pension plans and postretirement plans provide certain benefits to a portion of full-time employees, former agents, retirees and their dependents.

**Table of Contents**

The components of net periodic pension cost for pension and other postretirement benefit plans are as follows:

(Unaudited)

**Quarter Ended September 30,**

(In millions)	2006		2005	
	Pension Benefits		Postretirement Benefits	
Service cost benefits earned during the period	\$ -	\$ -	\$ 0.4	\$ 0.1
Interest cost	7.3	7.6	1.3	0.8
Expected return on plan assets	(6.8)	(6.5)	-	-
Recognized net actuarial loss	3.0	4.4	0.4	0.1
Amortization of transition asset	(0.4)	(0.4)	-	-
Amortization of prior service cost	-	0.1	(0.9)	(1.4)
<b>Net periodic benefit cost (benefit)</b>	<b>\$ 3.1</b>	<b>\$ 5.2</b>	<b>\$ 1.2</b>	<b>\$ (0.4)</b>

(Unaudited)

**Nine Months Ended September 30,**

	2006		2005	
	Pension Benefits		Postretirement Benefits	
Service cost benefits earned during the period	\$ -	\$ -	\$ 0.7	\$ 0.3
Interest cost	22.0	22.9	3.2	2.4
Expected return on plan assets	(20.6)	(19.5)	-	-
Recognized net actuarial loss	9.3	13.1	0.7	0.3
Amortization of transition asset	(1.1)	(1.0)	-	-
Amortization of prior service cost	0.2	0.4	(3.8)	(4.1)
<b>Net periodic benefit cost (benefit)</b>	<b>\$ 9.8</b>	<b>\$ 15.9</b>	<b>\$ 0.8</b>	<b>\$ (1.1)</b>

**Table of Contents**

## 7. Closed Block

Summarized financial information of the Closed Block is as follows for the periods indicated:

	(Unaudited)	
	September 30, December 31,	
(In millions)	2006	2005
<b>ASSETS</b>		
Fixed maturities at fair value (amortized cost of \$514.6 and \$514.5)	\$ 515.7	\$ 520.7
Mortgage loans	24.3	25.2
Policy loans	127.2	135.8
Cash and cash equivalents	0.4	4.4
Accrued investment income	11.0	11.5
Deferred policy acquisition costs	3.0	3.4
Deferred federal income taxes	2.0	3.9
Other assets	1.3	2.2
<b>Total assets</b>	<b>\$ 684.9</b>	<b>\$ 707.1</b>
<b>LIABILITIES</b>		
Policy liabilities and accruals	\$ 693.3	\$ 707.1
Policyholder dividends	17.9	34.4
Other liabilities	2.6	2.2
<b>Total liabilities</b>	<b>\$ 713.8</b>	<b>\$ 743.7</b>
Excess of Closed Block liabilities over assets designated to the Closed Block	\$ 28.9	\$ 36.6
Amounts included in accumulated other comprehensive income:		
Net unrealized investment gains (losses), net of deferred federal income tax (expense) benefit of \$(0.1) and \$1.8	-	(3.4)
<b>Maximum future earnings to be recognized from Closed Block assets and liabilities</b>	<b>\$ 28.9</b>	<b>\$ 33.2</b>

	(Unaudited)		(Unaudited)	
	Quarter Ended		Nine Months Ended	
(In millions)	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
<b>REVENUES</b>				
Premiums	\$ 5.5	\$ 5.7	\$ 29.0	\$ 30.2
Net investment income	9.7	10.4	29.8	31.0
Net realized investment gains (losses)	-	3.8	(0.9)	5.2
<b>Total revenues</b>	<b>15.2</b>	<b>19.9</b>	<b>57.9</b>	<b>66.4</b>
<b>BENEFITS AND EXPENSES</b>				
Policy benefits	12.7	17.2	51.3	59.0
Policy acquisition expenses	0.3	0.3	0.7	0.8

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Other operating expenses	<b>0.1</b>	0.1	-	0.1
Total benefits and expenses	<b>13.1</b>	17.6	<b>52.0</b>	59.9