PRINCIPAL FINANCIAL GROUP INC
Form 10-Q
August 03, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2016

OR

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

1-16725

(Commission file number)

PRINCIPAL FINANCIAL GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware	**42-1520346**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

711 High Street, Des Moines, Iowa 50392

(Address of principal executive offices)

(515) 247-5111

(Registrant s telephone number, including area code)

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 o

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 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 o

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. (Check one):

Large accelerated filer x	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The total number of shares of the registrant s Common Stock, $0.01 par value, outstanding as of July 27, 2016, was 287,593,449.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Principal Financial Group, Inc.

Consolidated Statements of Financial Position

	June 30, 2016	December 31, 2015
	(Unaudited)	
	(in millions)	
Assets		
Fixed maturities, available-for-sale (2016 and 2015 include \$242.6 million and \$257.4 million related to consolidated variable interest entities)	**\$ 55,281.3**	\$ 49,966.5
Fixed maturities, trading (2016 and 2015 include \$82.4 million and \$100.4 million related to consolidated variable interest entities)	**656.9**	686.8
Equity securities, available-for-sale	**105.2**	104.5
Equity securities, trading (2016 and 2015 include \$689.0 million and \$640.9 million related to consolidated variable interest entities)	**1,331.1**	1,202.7
Mortgage loans	**12,685.8**	12,339.4
Real estate (2016 and 2015 include \$411.9 million and \$354.5 million related to consolidated variable interest entities)	**1,474.0**	1,451.8
Policy loans	**831.6**	817.1
Other investments (2016 and 2015 include \$360.5 million and \$29.5 million related to consolidated variable interest entities and \$82.1 million and \$53.4 million measured at fair value under the fair value option)	**4,321.5**	3,251.7
Total investments	**76,687.4**	69,820.5
Cash and cash equivalents	**2,255.4**	2,564.8
Accrued investment income	**563.0**	545.6
Premiums due and other receivables	**1,504.8**	1,429.3
Deferred acquisition costs	**3,173.7**	3,276.1
Property and equipment	**667.9**	633.8
Goodwill	**1,037.2**	1,009.0
Other intangibles	**1,358.5**	1,359.2
Separate account assets (2016 and 2015 include \$35,839.9 million and \$33,300.4 million related to consolidated variable interest entities)	**134,736.0**	136,978.9
Other assets	**1,090.3**	1,043.1
Total assets	**\$ 223,074.2**	\$ 218,660.3
Liabilities		
Contractholder funds (2016 and 2015 include \$346.9 million and \$338.9 million related to consolidated variable interest entities)	**\$ 37,781.0**	\$ 35,716.1
Future policy benefits and claims	**27,996.1**	25,856.5
Other policyholder funds	**888.4**	805.4
Short-term debt	**25.9**	181.1
Long-term debt (2016 and 2015 include \$46.5 million and \$42.8 million related to consolidated variable interest entities)	**3,270.2**	3,265.2
Income taxes currently payable	**10.2**	18.4
Deferred income taxes	**1,234.7**	697.2
Separate account liabilities (2016 and 2015 include \$35,839.9 million and \$33,300.4 million related to consolidated variable interest entities)	**134,736.0**	136,978.9
	6,226.9	5,678.4

Other liabilities (2016 and 2015 include $317.0 million and $345.9 million related to consolidated variable interest entities, of which $58.6 million and $68.1 million are measured at fair value under the fair value option)				
Total liabilities		**212,169.4**		209,197.2
Redeemable noncontrolling interest (2016 includes $266.6 million related to consolidated variable interest entities)		**337.1**		85.7
Stockholders equity				
Series A preferred stock, par value $.01 per share with liquidation preference of $100 per share 0.0 million and 0.0 million shares authorized, issued and outstanding in 2016 and 2015				
Series B preferred stock, par value $.01 per share with liquidation preference of $25 per share 0.0 million and 0.0 million shares authorized, issued and outstanding in 2016 and 2015				
Common stock, par value $.01 per share 2,500.0 million shares authorized, 468.1 million and 466.2 million shares issued, and 288.0 million and 291.4 million shares outstanding in 2016 and 2015		**4.7**		4.7
Additional paid-in capital		**9,615.7**		9,544.8
Retained earnings		**7,339.6**		6,875.9
Accumulated other comprehensive loss		**(19.3)**		(882.5)
Treasury stock, at cost (180.1 million and 174.8 million shares in 2016 and 2015)		**(6,441.0)**		(6,231.3)
Total stockholders equity attributable to Principal Financial Group, Inc.		**10,499.7**		9,311.6
Noncontrolling interest		**68.0**		65.8
Total stockholders equity		**10,567.7**		9,377.4
Total liabilities and stockholders equity	**$**	**223,074.2**	$	218,660.3

See accompanying notes.

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Principal Financial Group, Inc.

Consolidated Statements of Operations

(Unaudited)

	For the three months ended June 30, 2016	For the three months ended June 30, 2015	For the six months ended June 30, 2016	For the six months ended June 30, 2015
	(in millions, except per share data)			
Revenues				
Premiums and other considerations	**$ 1,276.0**	$ 1,682.4	**$ 2,558.4**	$ 2,598.8
Fees and other revenues	**916.8**	901.5	**1,772.7**	1,852.3
Net investment income	**799.2**	789.9	**1,560.9**	1,513.8
Net realized capital gains (losses), excluding impairment losses on available-for-sale securities	**43.7**	(108.6)	**228.4**	(34.9)
Net other-than-temporary impairment (losses) recoveries on available-for-sale securities	**(3.4)**	(0.6)	**(59.0)**	13.4
Other-than-temporary impairment losses on fixed maturities, available-for-sale reclassified to (from) other comprehensive income	**(6.6)**	(5.4)	**0.9**	(26.9)
Net impairment losses on available-for-sale securities	**(10.0)**	(6.0)	**(58.1)**	(13.5)
Net realized capital gains (losses)	**33.7**	(114.6)	**170.3**	(48.4)
Total revenues	**3,025.7**	3,259.2	**6,062.3**	5,916.5
Expenses				
Benefits, claims and settlement expenses	**1,659.9**	2,054.6	**3,318.4**	3,290.9
Dividends to policyholders	**38.0**	41.1	**76.8**	82.8
Operating expenses	**927.9**	869.0	**1,827.4**	1,790.2
Total expenses	**2,625.8**	2,964.7	**5,222.6**	5,163.9
Income before income taxes	**399.9**	294.5	**839.7**	752.6
Income taxes	**72.9**	29.6	**143.5**	58.6
Net income	**327.0**	264.9	**696.2**	694.0
Net income attributable to noncontrolling interest	**4.7**	7.3	**5.9**	14.0
Net income attributable to Principal Financial Group, Inc.	**322.3**	257.6	**690.3**	680.0
Less:				
Preferred stock dividends		8.3		16.5
Excess of redemption value over carrying value of preferred shares redeemed		8.2		8.2
Net income available to common stockholders	**$ 322.3**	$ 241.1	**$ 690.3**	$ 655.3
Earnings per common share				
Basic earnings per common share	**$ 1.11**	$ 0.82	**$ 2.37**	$ 2.22
Diluted earnings per common share	**$ 1.10**	$ 0.81	**$ 2.35**	$ 2.20
Dividends declared per common share	**$ 0.39**	$ 0.38	**$ 0.77**	$ 0.74

See accompanying notes.

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Principal Financial Group, Inc.

Consolidated Statements of Comprehensive Income

(Unaudited)

	For the three months ended June 30,		For the six months ended June 30,	
	2016	**2015**	**2016**	**2015**
	(in millions)			
Net income	**$ 327.0**	$ 264.9	**$ 696.2**	$ 694.0
Other comprehensive income (loss), net:				
Net unrealized gains (losses) on available-for-sale securities	**303.2**	(306.4)	**707.6**	(249.3)
Noncredit component of impairment losses on fixed maturities, available-for-sale	**2.6**	3.4	**(1.6)**	16.9
Net unrealized gains (losses) on derivative instruments	**11.2**	(16.1)	**12.5**	11.7
Foreign currency translation adjustment	**14.1**	(42.5)	**143.8**	(175.1)
Net unrecognized postretirement benefit obligation	**8.0**	12.0	**16.0**	24.0
Other comprehensive income (loss)	**339.1**	(349.6)	**878.3**	(371.8)
Comprehensive income (loss)	**666.1**	(84.7)	**1,574.5**	322.2
Comprehensive income attributable to noncontrolling interest	**7.0**	8.9	**11.7**	9.3
Comprehensive income (loss) attributable to Principal Financial Group, Inc.	**$ 659.1**	$ (93.6)	**$ 1,562.8**	$ 312.9

See accompanying notes.

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Principal Financial Group, Inc.

Consolidated Statements of Stockholders Equity

(Unaudited)

	Series A preferred stock	Series B preferred stock	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Noncontrolling interest	Total stockholders equity
					(in millions)				
Balances as of January 1, 2015	$	$ 0.1	$ 4.6	$ 9,945.5	$ 6,114.1	$ 50.4	$ (5,930.7)	$ 48.0	$ 10,232.0
Common stock issued				29.6					29.6
Stock-based compensation and additional related tax benefits				53.4	(3.2)				50.2
Treasury stock acquired, common							(75.6)		(75.6)
Dividends to common stockholders					(218.3)				(218.3)
Dividends to preferred stockholders					(16.5)				(16.5)
Preferred stock redemption		(0.1)		(541.7)	(8.2)				(550.0)
Distributions to noncontrolling interest								(11.6)	(11.6)
Contributions from noncontrolling interest								4.9	4.9
Purchase of subsidiary shares from noncontrolling interest				(9.7)		(9.9)		15.1	(4.5)
Adjustments to redemption amount of redeemable noncontrolling interest				(3.3)					(3.3)
Net income (excludes $2.1 million attributable to redeemable noncontrolling interest)					680.0			11.9	691.9
Other comprehensive loss (excludes $(5.6) million attributable to redeemable noncontrolling interest)						(367.1)		0.9	(366.2)
Balances as of June 30, 2015	$	$	$ 4.6	$ 9,473.8	$ 6,547.9	$ (326.6)	$ (6,006.3)	$ 69.2	$ 9,762.6
Balances as of January 1, 2016	**$**	**$**	**$ 4.7**	**$ 9,544.8**	**$ 6,875.9**	**$ (882.5)**	**$ (6,231.3)**	**$ 65.8**	**$ 9,377.4**
Common stock issued				**11.2**					**11.2**
Stock-based compensation and additional related tax benefits				**44.2**	**(3.4)**			**0.2**	**41.0**
Treasury stock acquired, common							**(209.7)**		**(209.7)**
Dividends to common stockholders					**(223.2)**				**(223.2)**
Distributions to noncontrolling interest								**(2.7)**	**(2.7)**

Contributions from noncontrolling interest								**0.4**	**0.4**
Purchase of subsidiary shares from noncontrolling interest				**15.1**		**(9.3)**			**5.8**
Adjustments to redemption amount of redeemable noncontrolling interest				**0.4**					**0.4**
Net income (excludes $3.2 million attributable to redeemable noncontrolling interest)					**690.3**			**2.7**	**693.0**
Other comprehensive income (excludes $4.2 million attributable to redeemable noncontrolling interest)						**872.5**		**1.6**	**874.1**
Balances as of June 30, 2016	**$**	**$**	**$ 4.7**	**$ 9,615.7**	**$ 7,339.6**	**$ (19.3)**	**$ (6,441.0)**	**$ 68.0**	**$ 10,567.7**

See accompanying notes.

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Principal Financial Group, Inc.

Consolidated Statements of Cash Flows

(Unaudited)

	For the six months ended June 30, 2016	2015
	(in millions)	
Operating activities		
Net income	$ **696.2**	$ 694.0
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of deferred acquisition costs	**171.6**	101.6
Additions to deferred acquisition costs	**(201.5)**	(191.9)
Accrued investment income	**(17.4)**	7.2
Net cash flows for trading securities	**(41.1)**	(33.3)
Premiums due and other receivables	**57.7**	(48.2)
Contractholder and policyholder liabilities and dividends	**1,314.0**	1,546.2
Current and deferred income taxes (benefits)	**110.9**	(75.4)
Net realized capital (gains) losses	**(170.3)**	48.4
Depreciation and amortization expense	**93.2**	83.3
Real estate acquired through operating activities	**(21.9)**	(29.3)
Real estate sold through operating activities	**21.0**	51.6
Stock-based compensation	**40.1**	50.3
Other	**73.1**	(87.1)
Net adjustments	**1,429.4**	1,423.4
Net cash provided by operating activities	**2,125.6**	2,117.4
Investing activities		
Available-for-sale securities:		
Purchases	**(7,476.9)**	(4,828.5)
Sales	**557.4**	983.1
Maturities	**3,667.9**	3,636.1
Mortgage loans acquired or originated	**(1,198.0)**	(1,057.1)
Mortgage loans sold or repaid	**910.4**	775.3
Real estate acquired	**(66.4)**	(204.1)
Net purchases of property and equipment	**(74.7)**	(67.3)
Net change in other investments	**6.3**	(174.6)
Net cash used in investing activities	**(3,674.0)**	(937.1)
Financing activities		
Issuance of common stock	**11.2**	29.6
Acquisition of treasury stock	**(209.7)**	(75.6)
Proceeds from financing element derivatives	**0.2**	0.2
Payments for financing element derivatives	**(43.0)**	(39.5)
Excess tax benefits from share-based payment arrangements	**5.5**	14.1
Purchase of subsidiary shares from noncontrolling interest	**(2.3)**	(11.0)
Dividends to common stockholders	**(223.2)**	(218.3)
Dividends to preferred stockholders		(16.5)
Preferred stock redemption		(550.0)
Issuance of long-term debt	**3.7**	797.4
Principal repayments of long-term debt		(19.8)
Net repayments of short-term borrowings	**(156.9)**	
Investment contract deposits	**6,877.7**	2,722.9

Investment contract withdrawals	**(5,071.0)**	(3,414.7)
Net increase in banking operation deposits	**47.1**	8.2
Other	**(0.3)**	(6.8)
Net cash provided by (used in) financing activities	**1,239.0**	(779.8)
Net increase (decrease) in cash and cash equivalents	**(309.4)**	400.5
Cash and cash equivalents at beginning of period	**2,564.8**	1,863.9
Cash and cash equivalents at end of period	**$ 2,255.4**	$ 2,264.4

See accompanying notes.

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Principal Financial Group, Inc.

Notes to Consolidated Financial Statements

June 30, 2016
(Unaudited)

1. Nature of Operations and Significant Accounting Policies

Basis of Presentation

The accompanying unaudited consolidated financial statements of Principal Financial Group, Inc. (PFG) have been prepared in conformity with accounting principles generally accepted in the U.S. (U.S. GAAP) for interim financial statements and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2016, are not necessarily indicative of the results that may be expected for the year ended December 31, 2016. These interim unaudited consolidated financial statements should be read in conjunction with our annual audited financial statements as of December 31, 2015, included in our Form 10-K for the year ended December 31, 2015, filed with the United States Securities and Exchange Commission (SEC). The accompanying consolidated statement of financial position as of December 31, 2015, has been derived from the audited consolidated statement of financial position but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

Consolidation

We have relationships with various special purpose entities and other legal entities that must be evaluated to determine if the entities meet the criteria of a variable interest entity (VIE) or a voting interest entity (VOE). This assessment is performed by reviewing contractual, ownership and other rights, including involvement of related parties, and requires use of judgment. First, we determine if we hold a variable interest in an entity by assessing if we have the right to receive expected losses and expected residual returns of the entity. If we hold a variable interest, then the entity is assessed to determine if it is a VIE. An entity is a VIE if the equity at risk is not sufficient to support its activities, if the equity holders lack a controlling financial interest or if the entity is structured with non-substantive voting rights. In addition to the previous criteria, if the entity is a limited partnership or similar entity, it is a VIE if the limited partners do not have the power to direct the entity s most significant activities through substantive kick-out rights or participating rights. A VIE is evaluated to determine the primary beneficiary. The primary beneficiary of a VIE is the enterprise with (1) the power to direct the activities of a VIE that most significantly impact the entity s economic performance and (2) the obligation to absorb losses of the entity or the right to receive benefits from the entity that could potentially be significant to the VIE. When we are the primary beneficiary, we are required to consolidate the entity in our financial statements. We reassess our involvement with VIEs on a quarterly basis. For further information about VIEs, refer to Note 2, Variable Interest Entities.

If an entity is not a VIE, it is considered a VOE. VOEs are generally consolidated if we own a greater than 50% voting interest. If we determine our involvement in an entity no longer meets the requirements for consolidation under either the VIE or VOE models, the entity is deconsolidated. Entities in which we have significant management influence over the operating and financing decisions but are not required to consolidate, other than investments accounted for at fair value under the fair value option, are reported using the equity method.

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Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

June 30, 2016
(Unaudited)

Recent Accounting Pronouncements

Description	Date of adoption	Effect on our consolidated financial statements or other significant matters
Standards not yet adopted:		
Credit Losses This authoritative guidance requires entities to use a current expected credit loss (CECL) model to measure impairment for most financial assets that are not recorded at fair value through net income. Under the CECL model, an entity will estimate lifetime expected credit losses considering available relevant information about historical events, current conditions and reasonable and supportable forecasts. The CECL model does not apply to available-for-sale debt securities. This guidance also expands the required credit loss disclosures and will be applied using a modified retrospective approach by recording a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. Early adoption is permitted.	January 1, 2020	We are currently evaluating the impact this guidance will have on our consolidated financial statements.
Leases This authoritative guidance requires lessee recognition of lease assets and lease liabilities on the balance sheet. The concept of an operating lease, where the lease assets and liabilities are off balance sheet, is eliminated under the new guidance. For lessors, the guidance modifies lease classification criteria and accounting for certain types of leases. Other key aspects of the guidance relate to the removal of the current real estate- specific guidance and new presentation and disclosure requirements.	January 1, 2019	We are currently evaluating the impact this guidance will have on our consolidated financial statements.

Lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach, which includes certain optional practical expedients that may be elected. Early adoption is permitted.		
Financial instruments - recognition and measurements This authoritative guidance addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. The primary focus of this guidance is to supersede the guidance to classify equity securities with readily determinable fair values into different categories (trading or available-for-sale) and requires equity securities to be measured at fair value with changes in the fair value recognized through net income. This guidance requires adoption through a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption.	January 1, 2018	We are currently evaluating the impact this guidance will have on our consolidated financial statements.

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Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

June 30, 2016
(Unaudited)

Description	Date of adoption	Effect on our consolidated financial statements or other significant matters
Revenue recognition This authoritative guidance replaces all general and most industry specific revenue recognition guidance (excluding insurance) currently prescribed by U.S. GAAP. The core principle is that an entity recognizes revenue to reflect the transfer of a promised good or service to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for that good or service. This guidance also provides clarification on when an entity is a principal or an agent in a transaction. The guidance may be applied using one of the following two methods: (1) retrospectively to each prior reporting period presented, or (2) retrospectively with the cumulative effect of initially applying the standard recognized at the date of initial application.	January 1, 2018	We are currently evaluating the impact this guidance will have on our consolidated financial statements.
Employee share-based payment accounting This authoritative guidance changes certain aspects of accounting for and reporting share-based payments to employees including changes related to the income tax effects of share-based payments, tax withholding requirements and accounting for forfeitures. Various transition methods will apply depending on the situation being addressed.	January 1, 2017	We are currently evaluating the impact this guidance will have on our consolidated financial statements.
Short-duration insurance contracts This authoritative guidance requires additional disclosures related to short-duration insurance contracts. Retrospective application through comparative disclosures is required.	December 31, 2016	We are currently evaluating the impact this guidance will have on our consolidated financial statements.

Standards adopted:		
Net asset value per share as a practical expedient for fair value This authoritative guidance removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient.	January 1, 2016	The guidance was adopted retrospectively and did not have a material impact on our consolidated financial statements. See Note 10, Fair Value Measurements, for further details.
Simplifying the presentation of debt issuance costs This authoritative guidance requires debt issuance costs related to a recognized debt liability to be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts.	January 1, 2016	The guidance was adopted retrospectively and did not have a material impact on our consolidated financial statements. See Note 5, Long-Term Debt, for further details.

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Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

June 30, 2016

(Unaudited)

Description	Date of adoption	Effect on our consolidated financial statements or other significant matters
Consolidations This authoritative guidance makes changes to both the variable interest and voting interest consolidation models and eliminates the investment company deferral for portions of the variable interest model. The amendments in the standard impact the consolidation analysis for interests in investment companies and limited partnerships and similar entities.	January 1, 2016	The guidance was adopted using the modified retrospective approach. See Note 2, Variable Interest Entities, for further details.
Discontinued operations This authoritative guidance amends the definition of discontinued operations and requires entities to provide additional disclosures associated with discontinued operations, as well as disposal transactions that do not meet the discontinued operations criteria. The guidance requires discontinued operations treatment for disposals of a component or group of components of an entity that represents a strategic shift that has or will have a major impact on an entity s operations or financial results. The guidance also expands the scope to disposals of equity method investments and businesses that, upon initial acquisition, qualify as held for sale.	January 1, 2015	This guidance was adopted prospectively and did not have a material impact on our consolidated financial statements.
Fair value of financial assets and liabilities of a consolidated collateralized financing entity This authoritative guidance provides a measurement alternative for a reporting entity to measure both the financial assets and financial liabilities of consolidated collateralized financing entities (CCFEs) using the more observable of the fair value of the financial assets or of the financial liabilities for both the financial assets and financial liabilities.	January 1, 2015	This guidance was adopted using a modified retrospective approach and did not have a material impact on our consolidated financial statements. See Note 10, Fair Value Measurements, for further details.

Separate Accounts

The separate accounts are legally segregated and are not subject to the claims that arise out of any of our other business. The client, rather than us, directs the investments and bears the investment risk of these funds. The separate account assets represent the fair value of funds that are separately administered by us for contracts with equity, real estate and fixed income investments and are presented as a summary total within the consolidated statements of financial position. An equivalent amount is reported as separate account liabilities, which represent the obligation to return the monies to the client. We receive fees for mortality, withdrawal and expense risks, as well as administrative, maintenance and investment advisory services that are included in the consolidated statements of operations. Net deposits, net investment income and realized and unrealized capital gains and losses of the separate accounts are not reflected in the consolidated statements of operations.

Separate account assets and separate account liabilities include certain international retirement accumulation products where the segregated funds and associated obligation to the client are consolidated within our financial statements. We have determined that summary totals are the most meaningful presentation for these funds.

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Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

June 30, 2016
(Unaudited)

As of June 30, 2016 and December 31, 2015, the separate account assets included a separate account valued at $126.4 million and $158.2 million, respectively, which primarily included shares of our stock that were allocated and issued to eligible participants of qualified employee benefit plans administered by us as part of the policy credits issued under our 2001 demutualization. These shares are included in both basic and diluted earnings per share calculations. In the consolidated statements of financial position, the separate account shares are recorded at fair value and are reported as separate account assets with a corresponding separate account liability to eligible participants of the qualified plan. Changes in fair value of the separate account shares are reflected in both the separate account assets and separate account liabilities and do not impact our results of operations.

2. Variable Interest Entities

We have relationships with various types of entities which may be VIEs. Certain VIEs are consolidated in our financial results. See Note 1, Nature of Operations and Significant Accounting Policies, under the caption Consolidation for further details of our consolidation accounting policies. We did not provide financial or other support to investees designated as VIEs for the periods ended June 30, 2016 and December 31, 2015.

Adoption of New Consolidation Guidance

Both the variable interest and voting interest consolidation models were changed under authoritative guidance effective January 1, 2016. The guidance eliminated the investment company deferral for portions of the variable interest model. Prior to January 1, 2016, the primary beneficiary of an investment company VIE was the enterprise who absorbed the majority of the entity s expected losses, received a majority of the expected residual returns or both. The new guidance requires all VIEs to be assessed under one method to determine the primary beneficiary.

The determination of whether interests in limited partnerships and similar entities are VIEs or VOEs has also changed under the pronouncement, by requiring evaluation of the equity holders rights to determine if they have the power to direct the entity s most significant activities through substantive kick-out rights or participating rights. Limited partnerships and similar entities without these rights are VIEs.

We adopted the guidance using the modified retrospective approach effective January 1, 2016. Under the modified retrospective approach, the cumulative effect of initially applying the new guidance is recognized as of the date of initial application, and comparative periods are not restated. The changes resulting from the adoption were:

- The adoption resulted in the deconsolidation of $8.6 billion of both assets and liabilities of certain mandatory privatized social security funds in which we provide asset management services. Prior to January 1, 2016, the funds were consolidated as VOEs and the funds were presented in separate account assets and liabilities in the statement of financial position. The deconsolidation did not have a material impact to our consolidated statements of operations and did not result in a cumulative effect of the change on retained earnings.

- The adoption of the guidance resulted in consolidation of certain sponsored investment funds in which we provide asset management services. We consolidated $180.1 million of assets and $0.6 million of liabilities. Additionally, we recorded $179.5 million of redeemable noncontrolling interest related to these funds. The consolidation of these funds did not have a material impact to our consolidated statements of operations and did not result in a cumulative effect of the change on retained earnings.

- We invest in partnerships and other funds. Prior to new accounting guidance certain of these investments were VOEs. Upon adoption of new accounting guidance, some of these investments are now considered VIEs. We are not the primary beneficiary of these VIEs.

- We provide asset management and other services to certain investment structures for which we earn performance-based management fees. These structures were considered VIEs prior to new accounting guidance, and we had a variable interest. We were not the primary beneficiary of these entities as we did not have the obligation to absorb losses or the right to receive benefits of the entities that could be potentially significant to the VIE. Subsequent to new accounting guidance, we no longer consider our fees a variable interest for those investment structures where our fees are deemed to be commensurate with the services provided, consistent with fees for similar services negotiated at arms-length, and we do not have additional interests in the entity that would absorb a significant amount of the entity s expected losses and expected residual returns of the entity.

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Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

June 30, 2016
(Unaudited)

Consolidated Variable Interest Entities

Grantor Trusts

We contributed undated subordinated floating rate notes to three grantor trusts. The trusts separated their cash flows by issuing an interest-only certificate and a residual certificate related to each note contributed. Each interest-only certificate entitles the holder to interest on the stated note for a specified term, while the residual certificate entitles the holder to interest payments subsequent to the term of the interest-only certificate and to all principal payments. We retained the interest-only certificates and the residual certificates were subsequently sold to third parties. We have determined these grantor trusts are VIEs due to insufficient equity to sustain them. We determined we are the primary beneficiary as a result of our contribution of securities into the trusts and our significant continuing interest in the trusts.

Collateralized Private Investment Vehicles

We invest in cash and synthetic collateralized debt obligations, collateralized bond obligations, collateralized loan obligations and other collateralized structures, which are VIEs due to insufficient equity to sustain the entities (collectively known as collateralized private investment vehicles). The performance of the notes of these synthetic structures is primarily linked to a synthetic portfolio by derivatives; each note has a specific loss attachment and detachment point. The notes and related derivatives are collateralized by a pool of permitted investments. The investments are held by a trustee and can only be liquidated to settle obligations of the trusts. These obligations primarily include derivatives and the notes due at maturity or termination of the trusts. We determined we are the primary beneficiary for one of these synthetic entities because we act as the investment manager of the underlying portfolio and we have the power to make decisions and to receive benefits and the obligation to absorb losses that could be potentially significant to the VIE.

Commercial Mortgage-Backed Securities

We sold commercial mortgage loans to a real estate mortgage investment conduit trust. The trust issued various commercial mortgage-backed securities (CMBS) certificates using the cash flows of the underlying commercial mortgages it purchased. This is considered a VIE due to insufficient equity to sustain itself. We have determined we are the primary beneficiary as we retained the special servicing role for the assets within the trust as well as the ownership of the bond class that controls the unilateral kick-out rights of the special servicer.

Mandatory Retirement Savings Funds

We hold an equity interest in Chilean mandatory privatized social security funds in which we provide asset management services. We determined that the mandatory privatized social security funds, which also include contributions for voluntary pension savings, voluntary non-pension savings and compensation savings accounts, are VIEs. This is because the equity holders as a group lack the power, due to voting rights or similar rights, to direct the activities of the entity that most significantly impact the entity s economic performance and also because equity investors are protected from below-average market investment returns relative to the industry s return, due to a regulatory guarantee that we provide. Further we concluded that we are the primary beneficiary through our power to make decisions and our significant variable interest in the funds. The purpose of the funds, which reside in legally segregated entities, is to provide long-term retirement savings. The obligation to the customer is directly related to the assets held in the funds and, as such, we present the assets as separate account assets and the obligation as separate account liabilities within our consolidated statements of financial position.

Principal International Hong Kong offers retirement pension schemes in which we provide trustee, administration and asset management services to employers and employees under the Hong Kong Mandatory Provident Fund (MPF) and Occupational Retirement Schemes Ordinance (ORSO) pension schemes. Each pension scheme has various guaranteed and non-guaranteed constituent funds, or investment options, in which customers can invest their money. The guaranteed funds provide either a guaranteed rate of return to the customer or a minimum guarantee on withdrawals under certain qualifying events. We have determined the guaranteed funds are VIEs due to the fact the equity holders, as a group, lack the obligation to absorb expected losses due to the guarantee we provide. We concluded that we are the primary beneficiary because we have the power to make decisions and to receive benefits and the obligation to absorb losses that could be potentially significant to the VIE. Therefore, we consolidate the underlying assets and liabilities of the funds and present as separate accounts or within the general account, depending on the terms of the guarantee.

Principal Financial Group, Inc.

Notes to Consolidated Financial Statements (continued)

June 30, 2016
(Unaudited)

Real Estate

We invest in several real estate limited partnerships and limited liability companies. The entities invest in real estate properties. Certain of these entities are VIEs based on the combination of our significant economic interest and related voting rights. We determined we are the primary beneficiary as a result of our power to control the entities through our significant ownership. Due to the nature of these real estate investments, the investment balance will fluctuate as we purchase and sell interests in the entities and as capital expenditures are made to improve the underlying real estate.

Sponsored Investment Funds

We sponsor and invest in certain investment funds for which we provide asset management services. Although our asset management fee is commensurate with the services provided and consistent with fees for similar services negotiated at arms-length, we have a variable interest for funds where our other interests are more than insignificant. The funds are VIEs as the equity holders lack power through voting rights to direct the activities of the entity that most significantly impact its economic performance. We determined we are the primary beneficiary of the VIEs where our interest in the entity is more than insignificant and we are the asset manager.

Assets and Liabilities of Consolidated Variable Interest Entities

The carrying amounts of our consolidated VIE assets, which can only be used to settle obligations of consolidated VIEs, and liabilities of consolidated VIEs for which creditors do not have recourse are as follows:

	June 30, 2016		December 31, 2015	
	Total	Total	Total	Total