10-Q 1 q601edg.txt 2ND QUARTER FORM 10-Q SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 FORM 10-Q QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT of 1934 For the quarter ended June 30, 2001 Commission File No. 1-7434 AFLAC INCORPORATED --- GEORGIA 58-1167100 ------------------------------- ------------------- (State or other jurisdiction of (I.R.S. Employer incorporation or organization) Identification No.) 1932 WYNNTON ROAD, COLUMBUS, GEORGIA 31999 --- (Address of principal executive offices and zip code) Registrant's telephone number, including area code (706) 323-3431 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 the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. Class August 6, 2001 ---------------------------- ------------------ Common Stock, $.10 Par Value 524,716,745 shares AFLAC INCORPORATED AND SUBSIDIARIES INDEX Page No. ---- Part I. Financial Information: Item 1. Financial Statements Consolidated Balance Sheets June 30, 2001 and December 31, 2000 . . . . 1 Consolidated Statements of Earnings Three Months Ended June 30, 2001 and 2000 Six Months Ended June 30, 2001 and 2000. . . . . 3 Consolidated Statements of Shareholders' Equity Six Months Ended June 30, 2001 and 2000. . . . . 5 Consolidated Statements of Cash Flows Six Months Ended June 30, 2001 and 2000. . . . . 6 Consolidated Statements of Comprehensive Income Three Months Ended June 30, 2001 and 2000 Six Months Ended June 30, 2001 and 2000. . . . . 8 Notes to the Consolidated Financial Statements . . . . . . 9 Review by Independent Auditors . . . . 19 Independent Auditors' Review Report. . . . . 20 Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations. . . . . . . 21 Item 3. Quantitative and Qualitative Disclosures about Market Risk. . . . . 35 Part II. Other Information: Item 1. Legal Proceedings . . . . 39 Item 6. Exhibits and Reports on Form 8-K. . . . . 40 Items other than those listed above are omitted because they are not required or are not applicable. i Part I. Financial Information AFLAC INCORPORATED AND SUBSIDIARIES Consolidated Balance Sheets (In millions) June 30, December 31, 2001 2000 (Unaudited) ------------ ------------ Assets: Investments and cash: Securities available for sale, at fair value: Fixed maturities (amortized cost $18,980 in 2001 and $20,405 in 2000) $ 21,963 $ 22,172 Perpetual debentures (amortized cost $2,655 in 2001 and $2,347 in 2000) 2,828 2,046 Equity securities (cost $184 in 2001 and $161 in 2000) 230 236 Securities held to maturity, at amortized cost: Fixed maturities (fair value $5,155 in 2001 and $3,702 in 2000) 4,881 3,645 Perpetual debentures (fair value $3,416 in 2001 and $3,323 in 2000) 3,148 3,442 Other investments 19 17 Cash and cash equivalents 736 609 -------- -------- Total investments and cash 33,805 32,167 Receivables, primarily premiums 297 300 Accrued investment income 389 380 Deferred policy acquisition costs 3,619 3,685 Property and equipment, at cost less accumulated depreciation 474 481 Other 209 218 -------- -------- Total assets $ 38,793 $ 37,231 ======== ======== (continued) 1 AFLAC INCORPORATED AND SUBSIDIARIES Consolidated Balance Sheets (continued) (In millions, except for share and per-share amounts) June 30, December 31, 2001 2000 (Unaudited) ------------ ------------ Liabilities and Shareholders' Equity: Liabilities: Policy liabilities: Future policy benefits $ 25,696 $ 26,101 Unpaid policy claims 1,771 1,745 Unearned premiums 348 355 Other policyholders' funds 433 364 -------- -------- Total policy liabilities 28,248 28,565 Notes payable 1,356 1,079 Income taxes 2,177 1,894 Payables for return of cash collateral on loaned securities 342 127 Payable for security transactions 455 - Other 779 872 -------- -------- Total liabilities 33,357 32,537 -------- -------- Shareholders' equity: Common stock of $.10 par value. In thousands: authorized 1,000,000 shares; issued 645,872 shares in 2001 and 644,813 shares in 2000 65 32 Additional paid-in capital 320 336 Retained earnings 4,239 3,956 Accumulated other comprehensive income: Unrealized foreign currency translation gains 211 194 Unrealized gains on investment securities 2,080 1,474 Treasury stock, at average cost (1,479) (1,298) -------- -------- Total shareholders' equity 5,436 4,694 -------- -------- Total liabilities and shareholders' equity $ 38,793 $ 37,231 ======== ======== Shareholders' equity per share $ 10.35 $ 8.87 ======== ======== See the accompanying Notes to the Consolidated Financial Statements. Share and per-share amounts reflect the two-for-one stock split distributed March 16, 2001. Certain reclassifications have been made to prior period amounts to conform to current period reporting classifications. These reclassifications had no impact on net earnings. 2 AFLAC INCORPORATED AND SUBSIDIARIES Consolidated Statements of Earnings

(In millions - Unaudited) Three Months Ended June 30, Six Months Ended June 30, --------- ------------ ------ ------ ------------- -------- 2001 2000 2001 2000 - ------- ----- --- -------- --------

~~Revenues: Premiums, principally supplemental health insurance $ 1,980 $ 2,050 $ 3,990 $ 4,069 Net investment income 382 385 763 761 Realized investment gains (losses) (4) (91) (5) (94) Other income (loss) (10) 11 1 16 ----~~

~~11 1 16 ---- --- -------- - ------ ------ - Total revenues 2,348 2,355 4,749 4,752 ------ ----- -- -------- -- -----~~

~~Benefits and expenses: Benefits and claims 1,550 1,647 3,136 3,266 Acquisition and operating expenses: Amortization of deferred policy acquisition costs 84 77 164 146 Insurance commissions 252 258 502 513 Insurance expenses 188 193 372 382 Interest expense 5 5 10 10 Release of retirement liability - (101) - (101) Other operating expenses 20 17 42 33 --- ---- ------- ------- ----- -- Total acquisition and operating expenses 549 449 1,090 983 - ------ ------ - -------- --- ---- Total benefits and expenses 2,099 2,096 4,226 4,249 ------ ----- -- -------- -- -----~~

~~Earnings before income taxes 249 259 523 503 Income taxes 96 57 191 145 --- ---- ------- ------- -----~~

~~--- Net earnings $ 153 $ 202 $ 332 $ 358~~

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~~(continued)~~

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AFLAC INCORPORATED AND SUBSIDIARIES Consolidated Statements of Earnings (continued)

(In millions, except for share and Three Months Ended June 30, Six Months Ended June 30, per-share amounts - Unaudited) --- --------------- ---------- ---- --------------- -------- 2001 2000 2001 2000 -------- -------- ------ -- -------- ~~Net earnings per share: Basic $ .29 $ .38 $ .63 $ .67 Diluted .28 .37 .61 .66~~

~~======= ======= ======= =======~~

~~Shares used in computing earnings per share (In thousands): Basic 525,786 531,143 526,976 531,171 Diluted 539,151 544,861 540,453 544,692~~

~~======= ======= ======= =======~~

~~Cash dividends per share $ .05 $ .043 $ .093 $ .081~~

~~======= ======= ======= =======~~ ~~See the accompanying Notes to the Consolidated Financial Statements. Share and per-share amounts reflect the two-for-one stock~~

~~for one stock split distributed March 16, 2001. Certain reclassifications have been made to prior period amounts to conform to current period reporting classifications. These reclassifications had no impact on net earnings. 4~~

AFLAC INCORPORATED AND SUBSIDIARIES Consolidated Statements of Shareholders' Equity (In millions, except for per-share amounts - Unaudited) Six Months Ended June 30, --------------------------- 2001 2000 Common Stock: ------ ------ Balance at beginning of period $ 32 $ 32 Exercise of stock options 1 - Two-for-one stock split 32 - - ----- ------ Balance at end of period 65 32 ------ ------ Additional paid-in capital: Balance at beginning of period 336 310 Exercise of stock options 5 11 Gain on treasury stock reissued 11 3 Two-for-one stock split (32) - ------ ------ Balance at end of period 320 324 ------ ------ Retained earnings: Balance at beginning of period 3,956 3,356 Net earnings 332 358 Dividends to shareholders ($.093 per share in 2001 and $.081 in 2000) (49) (42) ------ ------ Balance at end of period 4,239 3,672 ------ ------ Accumulated other comprehensive income: Balance at beginning of period 1,668 1,264 Change in unrealized foreign currency translation gains (losses) during period, net of income taxes 17 (50) Change in unrealized gains (losses) on investment securities during period, net of income taxes 606 123 ------ ------ Balance at end of period 2,291 1,337 ------ ------ Treasury stock: Balance at beginning of period (1,298) (1,094) Purchases of treasury stock (205) (133) Cost of shares issued 24 23 ------ ------ Balance at end of period (1,479) (1,204) ------ ------ Total shareholders' equity $ 5,436 $ 4,161 ====== ====== See the accompanying Notes to the Consolidated Financial Statements. Per-share amounts reflect the two-for-one stock split distributed March 16, 2001. Certain reclassifications have been made to prior period amounts to conform to current period reporting classifications. These reclassifications had no impact on net earnings. 5 AFLAC INCORPORATED AND SUBSIDIARIES Consolidated Statements of Cash Flows (In millions - Unaudited) Six Months Ended June 30, 2001 2000 ------ ------ Cash flows from operating activities: Net earnings $ 332 $ 358 Adjustments to reconcile net earnings to net cash provided by operating activities: Increase in policy liabilities 1,200 1,354 Deferred income taxes 37 47 Change in income taxes payable 306 103 Increase in deferred policy acquisition costs (150) (146) Change in receivables and advance premiums 15 (14) Realized investment (gains) losses 5 94 Change in fair value of interest component of cross-currency swaps 19 - Release of retirement liability - (101) Other, net (371) (93) ------ ------ Net cash provided by operating activities 1,393 1,602 ------ ------ Cash flows from investing activities: Proceeds from investments sold or matured: Securities available for sale: Fixed maturities sold 941 400 Fixed maturities matured 249 215 Equity securities 67 22 Securities held to maturity: Fixed maturities matured 50 - Other investments, net (2) (1) Costs of investments acquired: Securities available for sale: Fixed maturities (1,226) (2,559) Perpetual debentures (500) (21) Equity securities (79) (42) Securities held to maturity: Fixed maturities (1,079) - Perpetual debentures (42) - Cash received as collateral on loaned securities, net 266 880 Additions to property and equipment, net (64) (7) Other, net (6) (8) ------ ------ Net cash used by investing activities $(1,425) $(1,121) ------ ------ (continued) 6 AFLAC INCORPORATED AND SUBSIDIARIES Consolidated Statements of Cash Flows (continued) (In millions - Unaudited) Six Months Ended June 30, 2001 2000 ------ ------ Cash flows from financing activities: Proceeds from borrowings $ 333 $ 15 Principal payments under debt obligations (6) (5) Change in deposit funds 98 14 Dividends paid to shareholders (46) (39) Purchases of treasury stock (205) (133) Treasury stock reissued 24 19 Other, net 5 10 ------ ------ Net cash provided (used) by financing activities 203 (119) ------ ------ Effect of exchange rate changes on cash and cash equivalents (44) (12) ------ ------ Net change in cash and cash equivalents 127 351 Cash and cash equivalents, beginning of period 609 616 ------ ------ Cash and cash equivalents, end of period $ 736 $ 967 ====== ====== Supplemental disclosures of cash flow information: Cash payments during the period for: Interest paid $ 11 $ 11 Income taxes paid 186 78 Impairment loss on available-for-sale security 42 57 Noncash financing activities: Capital lease obligations 12 9 Treasury shares issued to AFL stock plan for: Shareholder dividend reinvestment 3 3 Associates stock bonus 9 4 See the accompanying Notes to the Consolidated Financial Statements. Certain reclassifications have been made to prior period amounts to conform to current period reporting classifications. These reclassifications had no impact on net earnings. 7 AFLAC INCORPORATED AND SUBSIDIARIES Consolidated Statements of Comprehensive Income (In millions - Unaudited)

Three Months Ended June 30, Six Months Ended June 30, --------------------- ------- ------------------- 2001 2000 2001 2000 -------- -------- -------- -------- ~~Net earnings $ 153 $ 202 $ 332 $ 358 ------- ------- ------- ------- Other comprehensive income, before income taxes: Change in unrealized foreign currency translation gains (losses) during the period 15 (4)~~

~~77 28 Unrealized gains (losses) on investment securities: Unrealized holding gains (losses) arising during the period 159 (135) 854 97 Reclassification adjustment for realized (gains) losses included in net earnings 4 92 5 93 Unrealized gains (losses) on interest rate swap contracts: Unrealized holding gains (losses) arising during the period - - (1) - Reclassification adjustment for (gains) losses included in net earnings 1 - 1 - -------- ------ -------- ------ - Total other comprehensive income (loss), before income taxes 179 (47) 936 218 Income tax expense related to items of other comprehensive income 66 5 313 145 ------ - ------- ------ - -------- Other comprehensive income (loss), net of income taxes 113 (52) 623 73 ------- ------- ------- ------- Total comprehensive income $ 266 $ 150 $ 955 $ 431 ======= ======= ======= ======= See the accompanying Notes to the Consolidated Financial Statements. 8~~

AFLAC INCORPORATED AND SUBSIDIARIES Notes to the Consolidated Financial Statements 1. Basis of Presentation In the opinion of management, the accompanying unaudited consolidated financial statements of AFLAC Incorporated and subsidiaries (the "Company") contain all adjustments necessary to fairly present the consolidated balance sheet as of June 30, 2001, and the consolidated statements of earnings and comprehensive income for the three and six month periods ended June 30, 2001 and 2000, and consolidated statements of cash flows and shareholders' equity for the six months ended June 30, 2001 and 2000. Results of operations for interim periods are not necessarily indicative of results for the entire year. We prepare our financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP). These principles are established primarily by the Financial Accounting Standards Board and the American Institute of Certified Public Accountants. The preparation of financial statements in conformity with GAAP requires us to make estimates when recording transactions resulting from business operations, based on information currently available. The most significant items on our balance sheet that involve a greater degree of accounting estimates and actuarial determinations subject to changes in the future are: deferred policy acquisition costs and liabilities for future policy benefits and unpaid policy claims. As additional information becomes available (or actual amounts are determinable), the recorded estimates will be revised and reflected in operating results. Although some variability is inherent in these estimates, we believe the amounts provided are adequate. The financial statements should be read in conjunction with the financial statements included in our annual report to shareholders for the year ended December 31, 2000. Certain reclassifications have been made to prior period amounts to conform to current period reporting classifications. These reclassifications had no impact on net earnings. 2. Accounting Pronouncements We adopted Statement of Financial Accounting Standards (SFAS) No. 133 as amended, Accounting for Derivative Instruments and Hedging Activities, on January 1, 2001. This statement establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in investment securities and other contracts, and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the balance sheet and measure those instruments at fair value. The accounting for changes in the fair value of a derivative is included in either earnings or other comprehensive income depending on the intended use of the derivative instrument and the nature of any hedge designation thereon. This standard changed the accounting for our interest rate swaps and the interest component of our cross-currency swaps. In accordance with SFAS No. 133, we now recognize in net earnings the change in fair value of the 9 interest component of our cross-currency swaps. Unrealized gains and losses related to the change in fair value of our interest rate swaps are included in accumulated other comprehensive income until the hedged transaction terminates. The changes described above affect only the pattern and the timing of non-cash accounting recognition. The cumulative transition effect of adopting this new accounting standard as of January 1, 2001, was immaterial. See Note 5 for additional information on our derivative and nonderivative financial instruments. 10 3. Segment Information Information regarding components of operations follows: (In millions) Three Months Ended Six Months Ended June 30, June 30, 2001 2000 2001 2000 -------- -------- -------- -------- Revenues: AFLAC Japan: Earned premiums $ 1,528 $ 1,673 $ 3,099 $ 3,318 Net investment income 304 314 609 621 Other income 1 6 1 5 ------- ------- ------- ------- Total AFLAC Japan revenues 1,833 1,993 3,709 3,944 ------- ------- ------- ------- AFLAC U.S.: Earned premiums 451 377 890 751 Net investment income 75 68 148 135 Other income 3 2 4 2 ------- ------- ------- ------- Total AFLAC U.S. revenues 529 447 1,042 888 ------- ------- ------- ------- Other business segments 9 7 17 13 ------- ------- ------- ------- Total business segment revenues 2,371 2,447 4,768 4,845 Realized investment gains (losses) (4) (91) (5) (94) Corporate* (12) 7 (2) 17 Intercompany eliminations (7) (8) (12) (16) ------- ------- ------- ------- Total revenues $ 2,348 $ 2,355 $ 4,749 $ 4,752 ======= ======= ======= ======= Earnings before income taxes: AFLAC Japan $ 201 $ 191 $ 405 $ 379 AFLAC U.S. 85 71 167 141 Other business segments (1) (2) (1) (2) ------- ------- ------- ------- Total business segment earnings 285 260 571 518 Realized investment gains (losses) (4) (91) (5) (94) Release of retirement liability - 101 - 101 Interest expense, noninsurance operations (4) (4) (8) (8) Corporate* (28) (7) (35) (14) ------- ------- ------- ------- Total earnings before income taxes $ 249 $ 259 $ 523 $ 503 ======= ======= ======= ======= *Includes investment income of $3 in both 2001 and 2000 for the three-month period and $7 in 2001 and $6 in 2000 for the six-month period. In 2001, includes a $21 loss for the three-month period and a $19 loss for the six- month period related to the change in fair value of the interest component of our cross-currency swaps. 11 Assets were as follows: June 30, December 31, (In millions) 2001 2000 ------------ ----------- Assets: AFLAC Japan $ 32,846 $ 31,881 AFLAC U.S. 5,456 4,964 Other business segments 42 46 -------- -------- Total business segment assets 38,344 36,891 Corporate 6,986 5,993 Intercompany eliminations (6,537) (5,653) -------- -------- Total assets $ 38,793 $ 37,231 ======== ======== 4. Notes Payable A summary of notes payable is as follows: June 30, December 31, (In millions) 2001 2000 ---------- ---------- 6.50% senior notes due April 2009 (principal amount $450) $ 449 $ 449 Yen-denominated Samurai notes: 1.55% notes due October 2005 (principal amount 30 billion yen) 241 261 .87% notes due June 2006 (principal amount 40 billion yen) 321 - Unsecured, yen-denominated notes payable to banks: Reducing revolving credit agreement, due July 2001: 2.29% fixed interest rate 91 99 Variable interest rate (.35% at June 30, 2001) 13 14 Revolving credit agreement, due November 2002: 1.24% fixed interest rate 62 68 Variable interest rate (.30% at June 30, 2001) 145 157 Obligations under capitalized leases payable monthly through 2006, secured by computer equipment in Japan 34 31 ------ ------ Total notes payable $ 1,356 $ 1,079 ====== ====== For those loans denominated in yen, the principal amount of the loans as stated in dollar terms will fluctuate from period to period due to changes in the yen/dollar exchange rate. In September 2000, we filed a shelf registration statement with Japanese regulatory authorities to issue up to 100 billion yen of yen- denominated Samurai notes. These securities are not for sale to United States residents or entities. In October 2000, we issued in Japan 30 billion yen of 1.55% Samurai notes due October 2005 ($241 million using the June 30, 2001 exchange rate). In June 2001, we issued in Japan 40 billion yen of .87% Samurai notes due June 2006 ($321 million using the June 30, 2001 exchange rate). Both issues are redeemable at our option at any time with a redemption price equal to the principal amount of the notes being redeemed plus a premium. 12 In April 1999, we issued $450 million of 6.50% senior notes, due April 2009. The current outstanding balance after discount is $449 million. The notes are redeemable at our option at any time with a redemption price equal to the principal amount of the notes being redeemed plus a make-whole amount. We have entered into cross-currency swaps that have the effect of converting the dollar-denominated principal and interest into yen- denominated obligations (see Note 5). In July 2001, we paid in full (12.9 billion yen, or $104 million at the June 30, 2001 exchange rate) the unsecured reducing, revolving credit agreement. We have an unsecured revolving credit agreement that provides for bank borrowings through November 2002 in either U.S. dollars or Japanese yen. The borrowing limit is $250 million. The debt is currently payable in Japanese yen. At June 30, 2001, 7.8 billion yen ($62 million) was outstanding at a fixed interest rate and 18.1 billion yen ($145 million) was outstanding at a variable interest rate under this agreement. At June 30, 2001, we had outstanding interest rate swaps on 19.1 billion yen ($153 million) of our variable-interest-rate yen-denominated borrowings (see Note 5). In July 2001, 15.2 billion yen ($122 million) of the interest rate swaps expired. 5. Financial Instruments We have only limited activity with derivative financial instruments. We do not use them for trading purposes, nor do we engage in leveraged derivative transactions. Our risk management objectives are to minimize the exposure of our shareholders' equity to foreign currency translation fluctuations and also reduce our interest expense by converting the principal and interest of our dollar-denominated debt into yen-denominated obligations. We currently use two types of derivatives: interest rate swaps and cross-currency swaps. AFLAC documents all relationships between hedging instruments and hedged items, as well as its risk-management objectives and strategy for undertaking various hedge transactions. This process includes linking all derivatives that are designated as hedges to specific assets or liabilities on the balance sheet or specific forecasted transactions. We also assess, both at hedge inception and on an ongoing basis, whether the derivatives and nonderivatives used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of the hedged items. 13 The assessment of hedge effectiveness determines the non-cash accounting treatment of changes in fair value. Our accounting for changes in the fair value of derivatives is as follows: Derivative's Change in Fair Value Nature of Hedge Designation Reflected in: --- Cash flow Other comprehensive income, with subsequent reclassifications to earnings when the hedged transaction impacts earnings Net investment in foreign Other comprehensive income as part of operations the cumulative translation adjustment; ineffective portions of the hedge are included in other income Derivative Hedging Instruments We have cross-currency swaps outstanding related to our $450 million senior notes (see Note 4). These cross-currency swaps have the effect of converting the dollar-denominated principal and interest into yen- denominated obligations. Our interest expense is reduced from 6.50% payable in dollars to 1.67% payable in yen. The notional amount and terms of the swaps match the principal amount and terms of the senior notes. The cross- currency swaps have been designated as a hedge of the foreign currency exposure of our net investment in AFLAC Japan. The fair value of the cross-currency swaps includes three components: the effect of changes in foreign currency exchange rates, the accrued interest at the valuation date, and the effect of changes in interest rates in the United States and Japan. The foreign currency portion of our cross-currency swaps is included at fair value in other assets at $5 million as of June 30, 2001, and in other liabilities at $34 million as of December 31, 2000. The related $39 million increase in fair value during the six months ended June 30, 2001 (a $19 million increase during the six months ended June 30, 2000) is reflected in accumulated other comprehensive income - unrealized foreign currency translation gains (losses). The ineffective portion of the hedging instruments is the fair value of the interest components of the cross-currency swaps. At June 30, 2001, the accrued interest receivable was $5 million. The balance was $4 million at December 31, 2000. The change in the accrued interest receivable is included in interest expense. The decrease in fair value related to changes in interest rates was $21 million for the three-month period and $19 million for the six-month period. These losses are reflected in other liabilities and other income (loss). The fair value of the interest components, not related to accrued interest, was not reflected in the financial statements prior to January 1, 2001. At June 30, 2001, we had outstanding interest rate swaps on 19.1 billion yen ($153 million) of our variable-interest-rate yen-denominated 14 borrowings (Note 4). In July 2001, 15.2 billion yen ($122 million) of the 19.1 billion yen outstanding as of quarter end expired. The remaining swap agreements expire in July 2002. These swaps reduce the impact of changes in interest rates on our borrowing costs and effectively change our interest rate from variable to fixed. After the effect of the remaining swap agreements, we make fixed-rate payments at 1.24% and receive floating-rate payments (.08% at June 30, 2001, plus loan costs of 20 basis points) based on three-month Japanese yen LIBOR. We do not expect to reclassify a significant amount of gains/losses from accumulated other comprehensive income to earnings during the next 12 months related to our interest rate swaps. For additional information on the credit agreements, see Note 4. Our risk management objective is to fix the net interest cash outflows on a portion of our debt obligations. We have designated these interest rate swaps as a cash flow hedge of our exposure to the variability in future cash flows attributable to the variable interest payments due. These interest rate swaps are included in other liabilities at a fair value of $1 million at June 30, 2001, and the change in such fair value during the six months ended June 30, 2001 is reflected in accumulated other comprehensive income. The change in accrued interest payable is included in interest expense. The fair value of the interest rate swaps was not reflected in the financial statements prior to January 1, 2001. For additional information on the adoption of SFAS No. 133 and our accounting for derivatives, see Note 2. Nonderivative Hedging Instruments The following yen-denominated debt instruments (see Note 4) have been designated as hedges of the foreign currency exposure of our net investment in AFLAC Japan - the 1.55% Samurai notes due October 2005, principal amount 30.0 billion yen; the .87% Samurai notes due June 2006, principal amount 40.0 billion yen; the unsecured reducing, revolving credit agreement due July 2001, currently payable in Japanese yen, principal amount 12.9 billion yen; and the unsecured, revolving credit agreement due November 2002, currently payable in Japanese yen, principal amount 25.8 billion yen. Other Nonderivative Instruments We lend fixed-maturity securities to financial institutions in short- term security lending transactions. These securities continue to be carried as investment assets on our balance sheet during the term of the loans and are not recorded as sales. We receive cash or other securities as collateral for such loans. These short-term security lending arrangements increase investment income with minimal risk. At June 30, 2001, and December 31, 2000, we had security loans outstanding in the amounts of $334 million and $123 million at fair value, respectively. At June 30, 2001, and December 31, 2000, we held cash in the amount of $342 million and $127 million, respectively, as collateral for loaned securities. For loans involving unrestricted cash collateral, the collateral is recorded as an asset with a corresponding liability for the return of the collateral. For loans collateralized by securities, the collateral is not recorded as an asset or liability. Our security lending policy requires that the fair value of the securities received as collateral and cash received as collateral be 102% and 100% or more, respectively, of the fair value of the loaned securities as of the date the securities are loaned and not less than 100% thereafter. 15 6. Investment Securities Realized Investment Gains and Losses In March 2001, we recognized a pretax impairment loss of $42 million in realized investment gains and losses on the corporate debt securities of a U.S. issuer, which experienced a significant credit rating downgrade during the first quarter of 2001. These debt securities are carried in the available-for-sale category. We also executed several bond sales and purchase transactions during the first quarter in an effort to increase investment income and extend investment maturities. The sales of these debt securities resulted in pretax realized investment gains of $21 million. Also, in the first quarter of 2001, we realized a pretax investment gain of $18 million related to the sale of a portion of our U.S. equity securities portfolio in connection with a change in outside investment managers. During the first half of 2000, the North American issuers of two debt securities held in our debt portfolio experienced significant credit rating downgrades. In the second quarter, we sold one security at a realized loss of $34 million. We recorded an impairment loss of $57 million on the other security. These losses decreased net earnings by $58 million ($.11 per basic and diluted share) for the three months and six months ended June 30, 2000. Unrealized Investment Gains and Losses The unrealized gains and losses on debt securities, less amounts applicable to policy liabilities and deferred income taxes, are reported in accumulated other comprehensive income. The portion of unrealized gains credited to policy liabilities represents gains that would not inure to the benefit of our shareholders if such gains were actually realized. The net effect on shareholders' equity of unrealized gains and losses from investment securities at the following dates was: (In millions) June 30, December 31, 2001 2000 ------------ ------------ Unrealized gains on securities available for sale $ 3,202 $ 1,541 Unamortized unrealized gains on securities transferred to held to maturity 677 1,001 Less: Policy liabilities 478 - Deferred income taxes 1,321 1,068 --------- --------- Shareholders' equity, net unrealized gains on investment securities $ 2,080 $ 1,474 ========= ========= 16 As of March 31, 2001, new Japanese accounting principles and regulatory requirements became effective, which impact investment classifications and solvency margin calculations on a Japanese accounting basis. As a result of these new regulatory requirements, we re-evaluated AFLAC Japan's investment portfolio and our holding period intent related to certain investment securities. In order to minimize future unfavorable solvency margin results under the new Japanese accounting methods, debt securities with amortized cost of $1.8 billion were reclassified from the held-to-maturity category to the available-for-sale category as of March 31, 2001. The related unamortized unrealized gain, included in accumulated other comprehensive income immediately prior to the transfer, was $327 million. We also reclassified debt securities with a fair value of $2.3 billion from the available-for-sale category to the held-to-maturity category as of March 31, 2001. The related unrealized gain of $118 million is being amortized from accumulated other comprehensive income to investment income over the remaining term of the securities. The related premium in the carrying value of the debt securities that was created when the reclassification occurred is also being amortized as an offsetting charge to investment income. 7. Common Stock The following is a reconciliation of the number of shares of our common stock for the six months ended June 30: (In thousands of shares) 2001 2000 ---------- ---------- Common stock - issued: Balance at beginning of period 644,813 640,698 Exercise of stock options 1,059 3,149 -------- -------- Balance at end of period 645,872 643,847 -------- -------- Treasury stock: Balance at beginning of period 115,603 109,216 Purchases of treasury stock: Open market 6,675 6,209 Other 165 175 Shares issued to AFL Stock Plan (944) (727) Exercise of stock options (1,048) (1,449) -------- -------- Balance at end of period 120,451 113,424 -------- -------- Shares outstanding at end of period 525,421 530,423 ======== ======== On February 13, 2001, the board of directors declared a two-for-one stock split, consisting of 323 million shares, payable to shareholders of record at the close of business on February 27, 2001. The stock split was distributed on March 16, 2001. Share and per-share amounts have been retroactively adjusted to reflect this split. For the three months ended June 30, 2001 and 2000, there were approximately 539,200 and 489,800 weighted average shares, respectively, for 17 outstanding stock options that were not included in the weighted average shares used in the computation of diluted earnings per share because the exercise price for these options was greater than the average market price during the second three months of 2001 and 2000. For the six months ended June 30, 2001 and 2000, there were approximately 543,700 and 1,873,100 weighted average shares, respectively, for outstanding stock options that were not included in the weighted average shares used in the computation of diluted earnings per share because the exercise price for these options was greater than the average market price during the first six months of 2001 and 2000. 8. Litigation We are a defendant in various litigation considered to be in the normal course of business. Some of this litigation is pending in Alabama, where large punitive damages bearing little relation to the actual damages sustained by plaintiffs have been awarded against other companies, including insurers, in recent years. Although the final results of any litigation cannot be predicted with certainty, we believe the outcome of pending litigation will not have a material adverse effect on our financial position, results of operations, or cash flows. 9. Release of Retirement Liability In May 2000, the surviving spouse of John B. Amos, former chairman of the board, unexpectedly passed away. The Company had accrued an unfunded liability under a shareholder-approved employment contract for projected retirement payments based on a normal life expectancy. The release of the remaining accrued liability increased net earnings by $99 million ($.19 per basic share and $.18 per diluted share) for the three and six months ended June 30, 2000. 18 REVIEW BY INDEPENDENT AUDITORS The June 30, 2001, and 2000, financial statements included in this filing have been reviewed by KPMG LLP, independent auditors, in accordance with established professional standards and procedures for such a review. The report of KPMG LLP commenting upon their review is included on page 20. 19 KPMG LLP Certified Public Accountants 303 Peachtree Street, N.E. Telephone: (404) 222-3000 Suite 2000 Telefax: (404) 222-3050 Atlanta, GA 30308 INDEPENDENT AUDITORS' REVIEW REPORT The shareholders and board of directors AFLAC Incorporated: We have reviewed the consolidated balance sheet of AFLAC Incorporated and subsidiaries as of June 30, 2001, and the related consolidated statements of earnings and comprehensive income for the three-month and six-month periods ended June 30, 2001 and 2000, and the consolidated statements of shareholders' equity and cash flows for the six-month periods ended June 30, 2001 and 2000. These consolidated financial statements are the responsibility of the Company's management. We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion. Based on our review, we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America. We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the accompanying consolidated balance sheet of AFLAC Incorporated and subsidiaries as of December 31, 2000, and the related consolidated statements of earnings, shareholders' equity, cash flows and comprehensive income for the year then ended (not presented herein); and in our report dated January 26, 2001, we expressed an unqualified opinion on those financial statements. KPMG LLP Atlanta, GA July 24, 2001 20 ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS AFLAC Incorporated is the parent company of American Family Life Assurance Company of Columbus, AFLAC. Our principal business is supplemental health and life insurance, which is marketed and administered through AFLAC. Most of AFLAC's policies are individually underwritten and marketed at worksites through independent agents, with premiums paid by the employee. Our operations in Japan (AFLAC Japan) and the United States (AFLAC U.S.) service the two markets for our insurance business. On February 13, 2001, the board of directors declared a two-for-one stock split, effectively increasing the issued and outstanding shares by 100%. All share and per-share amounts have been restated for the split. RESULTS OF OPERATIONS The following nonoperating items affected our net earnings during 2001 and 2000. The second quarter of 2001 included a $21 million pretax loss ($21 million after tax, or $.04 per basic and diluted share) in connection with Statement of Financial Accounting Standards (SFAS) No. 133. The year-to- date impact of SFAS No. 133 was to reduce pretax earnings by $19 million ($18 million after tax, or $.04 per basic and diluted share). These losses, which are included in other income, arose from the change in fair value of the interest component of cross-currency swaps related to the Company's debt. (See Notes 2 and 5 of the Notes to the Consolidated Financial

Statements.) In the second quarter of 2000, the release of an accrued unfunded liability for projected retirement payments increased pretax earnings by $101 million ($99 million after tax, or $.19 per basic share and $.18 per diluted share) for the three months and six months ended June 30, 2000. (See Note 9 of the Notes to the Consolidated Financial Statements.) During the second quarter of 2000, we sold one security at a pretax loss of $34 million. We also recorded a pretax impairment loss of $57 million on another security. These losses are included in realized investment gains and losses. The combined effect of these losses decreased net earnings by $58 million ($.11 per basic and diluted share) for the three months and six months ended June 30, 2000. (See Note 6 of the Notes to the Consolidated Financial Statements.) 21 The following table sets forth the results of operations by business segment for the periods shown.

SUMMARY OF OPERATING RESULTS BY BUSINESS SEGMENT (In millions, except for per-share amounts) Three Months Ended June 30, Six Months Ended June 30, -- -- Percentage Change 2001 2000 Percentage Change 2001 2000 ----------------- ----------------- ----------------- ----------------- Operating earnings: AFLAC Japan. . . . . 5.3% $ 201 $ 191 6.7% $ 405 $ 379 AFLAC U.S. . . . . 19.6 85 71 18.2 167 141 Other business segments. . . . . . (1) (2) (1) (2) ----- ----- ----- ----- Total business segments. . . . . 9.8 285 260 10.1 571 518 Interest expense, noninsurance operations. . . . . .4 (4) (4) (2.2) (8) (8) Corporate and eliminations . . . . (18.4) (7) (6) (6.4) (16) (15) ----- ----- ----- ----- Pretax operating earnings. . . . 9.7 274 250 10.4 547 495 Income taxes . . . . 8.9 97 89 9.6 193 175 ----- ----- ----- ----- Operating earnings . . . . 10.2 177 161 10.8 354 320 Nonoperating items: Change in fair value of the interest component of cross-currency swaps, net of tax . . . (21) - (18) - Realized investment gains (losses), net of tax . . . . . . (3) (58) (4) (61) Release of retirement liability, net of tax . . . . - 99 - 99 ----- ----- ----- ----- Net earnings . . . . (24.0)% $ 153 $ 202 (7.4)% $ 332 $ 358 ===== ===== ===== ===== Operating earnings per basic share . 13.3% $ .34 $ .30 11.7% $ .67 $ .60 Operating earnings per diluted share 10.0 .33 .30 11.9 .66 .59 ===== ===== ===== ===== Net earnings per basic share . . . . (23.7)% $ .29 $ .38 (6.0)% $ .63 $ .67 Net earnings per diluted share . . . (24.3) .28 .37 (7.6) .61 .66 ===== ===== ===== =====

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The following discussion of earnings comparisons focuses on operating earnings and excludes realized investment gains/losses, the change in fair value of the interest component of cross-currency swaps in 2001 and the gain from the release of the retirement accrual in 2000. Operating earnings per share amounts referenced in the following discussion are based on the diluted number of average outstanding shares and retroactively reflect the two-for-one stock split distributed March 16, 2001. For the first half of 2001, the weakening yen, or strengthening dollar, masked our true operating performance. Our business, in functional currency terms, continued to be strong, and we believe it is more appropriate to measure our performance excluding the effect of the yen in order to understand the basic operating results of the business. FOREIGN CURRENCY TRANSLATION Due to the relative size of AFLAC Japan, fluctuations in the yen/dollar exchange rate can have a significant effect on our reported results. In years when the yen weakens, translating yen into dollars causes fewer dollars to be reported. When the yen strengthens, translating yen into dollars causes more dollars to be reported. The following table illustrates the effect of foreign currency translation by comparing our reported operating results with those that would have been reported had foreign currency rates remained unchanged from the comparable period in the prior year. AFLAC Incorporated and Subsidiaries Foreign Currency Translation Effect on Operating Results Percentage Changes Over Previous Period (For the periods ended June 30, 2001) Three Months Six Months Operating Results Operating Results -------------------- -------------------- Including Excluding Including Excluding Currency Currency Currency Currency Changes Changes* Changes Changes* --------- --------- --------- --------- Premium income (3.4)% 7.8% (1.9)% 7.7% Net investment income (.9) 7.5 .3 7.4 Operating revenues (3.0) 7.7 (1.5) 7.7 Total benefits and expenses (4.5) 6.7 (2.9) 6.7 Operating earnings 10.2 16.8 10.8 16.4 Operating earnings per diluted share 10.0 16.7 11.9 16.9 -- *Amounts excluding foreign currency changes were determined using the same yen/dollar exchange rate for the current period as the comparable period in the prior year.

== The yen weakened in relation to the dollar during 2000 and the first half of 2001. The average yen/dollar exchange rates were 122.71 and 106.69 for the three months ended June 30, 2001 and 2000, and 120.43 and 106.91 for the six months ended June 30, 2001 and 2000, respectively. The weakening of the yen in 2001 decreased operating earnings by approximately $.02 per share 23 for the three months ended June 30, 2001, and $.03 per share for the six months ended June 30, 2001. Operating earnings per share increased 10.0% to $.33 for the three-month period ended June 30, 2001, compared with the same period in 2000 and increased 11.9% to $.66 for the six-month period ended June 30, 2001, compared with the same period in 2000. Operating earnings per share, excluding the effect of foreign currency translation, increased 16.7%, to $.35 for the quarter and increased 16.9% to $.69 for the six months ended June 30, 2001 compared with the same periods in 2000. Our primary financial objective is the growth of operating earnings per share excluding the effect of foreign currency fluctuations. Our objective for 2001 through 2003 is to increase operating earnings per share by 15% to 17% excluding the impact of currency translation. We expect to achieve the high end of our objective for 2001. If we achieve a 17% increase, the following table shows the likely results for operating earnings per share in 2001 using various yen/dollar exchange rate scenarios. 2001 Operating EPS Scenarios --------------------------- Annual Average Yen Annual Operating % Growth Yen Impact Exchange Rate Diluted EPS Over 2000 on EPS ------------- ---------------- --------- ---------- 100.00 $ 1.45 20.8% $ .05 105.00 1.42 18.3 .02 107.83* 1.40 16.7 - 110.00 1.39 15.8 (.01) 115.00 1.36 13.3 (.04) 120.00 1.33 10.8 (.07) 125.00 1.31 9.2 (.09) 130.00 1.29 7.5 (.11) *Actual 2000 average exchange rate. If we reach the high end of our earnings objective and the yen averages 120 to 125 to the dollar for the remainder of the year, we would expect operating earnings for the full year to be in the range of $1.33 to $1.31 per share. SHARE REPURCHASE PROGRAM During the second quarter, we acquired 1.3 million shares of AFLAC stock, bringing the total number of shares purchased in the first six months to 6.7 million. At the end of June 2001, we had 9.8 million shares remaining for purchase under authorization from the board of directors. INCOME TAXES Our combined U.S. and Japanese effective income tax rates on operating earnings for the six months ended June 30, 2001 and 2000 were 35.2% and 35.4%, respectively. 24 INSURANCE OPERATIONS, AFLAC JAPAN AFLAC Japan, a branch of AFLAC and the principal contributor to our earnings, ranks number one in terms of premium income and profits among all foreign life and non-life insurance companies operating in Japan. Among all life insurance companies operating in Japan, AFLAC Japan ranked second in terms of individual policies in force and 12th in terms of assets according to Financial Services Agency (FSA) data as of March 31, 2001. The following table presents a summary of AFLAC Japan's operating results. AFLAC JAPAN SUMMARY OF OPERATING RESULTS Three Months Ended Six Months Ended June 30, June 30, (In millions) 2001 2000 2001 2000 ----------------- ----------------- Premium income. . . . . $ 1,528 $ 1,673 $ 3,099 $ 3,318 Investment income . . . . 304 314 609 621 Other income. . . . . 1 6 1 5 ------ ------ ------ ------ Total revenues. . . . . 1,833 1,993 3,709 3,944 ------ ------ ------ ------ Benefits and claims . . . . . . 1,272 1,411 2,586 2,794 Operating expenses. . . . . . . 360 391 718 771 ------ ------ ------ ------ Total benefits and expenses . 1,632 1,802 3,304 3,565 ------ ------ ------ ------ Pretax operating earnings . $ 201 $ 191 $ 405 $ 379 ====== ====== ====== ====== -- Percentage changes in dollars over previous period: Premium income. . . . . (8.7)% 21.9% (6.6)% 19.8% Investment income . . . . . . (3.4) 20.0 (1.9) 18.5 Total revenues. . . . . (8.0) 21.9 (6.0) 19.7 Pretax operating earnings . . 5.3 25.7 6.7 22.3 -- Percentage changes in yen over previous period: Premium income. . . . . 5.1% 7.5% 5.2% 7.8% Investment income . . . . . . 11.1 5.8 10.5 6.6 Total revenues. . . . . 5.9 7.4 5.9 7.7 Pretax operating earnings . . 21.0 10.8 20.2 10.0 -- Ratios to total revenues: Benefits and claims . . . . . 69.4% 70.8% 69.7% 70.9% Operating expenses. . . . . . 19.6 19.6 19.4 19.5 Pretax operating earnings . . 11.0 9.6 10.9 9.6

== 25 The benefit ratio has decreased slightly as the mix of business continues to shift to newer products, which have lower loss ratios than the earlier versions of our cancer life products. In the second quarter of 2001, the average yen/dollar exchange rate used to translate AFLAC Japan's income statement was 122.71, compared with an average rate of 106.69 in the second quarter of 2000. For the six-month period ended June 30, 2001 the average exchange rate was 120.43, compared with 106.91 for the six-month period ended June 30, 2000. This weakening of the average exchange rate held down rates of growth for AFLAC Japan in dollar terms and inflated rates of growth in yen terms. Because approximately one-fourth of AFLAC Japan's investment income is dollar- denominated, increases as reported in yen for total revenues, net investment income and pretax operating earnings were magnified. The following table illustrates the effect of foreign currency translation on dollar-denominated items in AFLAC Japan's operating results by comparing certain operating results in yen with those that would have been reported had foreign currency exchange rates remained unchanged from the comparable period in the previous year: Percentage Changes in Yen Over Previous Period --- Three Months Six Months Operating Results Operating Results -------------------- -------------------- Including Excluding Including Excluding Currency Currency Currency Currency Changes Changes* Changes Changes* --------- --------- --------- --------- Net investment income 11.1% 6.8% 10.5% 6.9% Total revenues 5.9 5.2 5.9 5.4 Pretax operating earnings 21.0 14.7 20.2 14.8 -- *Amounts excluding foreign currency changes on dollar-denominated items were determined using the same yen/dollar exchange rate for the current period as the comparable period in the prior year.

== JAPANESE ECONOMY For the last several years, Japan has been working to overcome its depressed economy. The financial strength of many Japanese businesses continued to deteriorate with some experiencing bankruptcy or requesting financial protection or assistance. As we have indicated in the past, Japan's weak economy has created a challenging environment for AFLAC Japan, as yields available for new yen-denominated investments remain at very low levels and consumer confidence continues to lag. The time required for the Japanese economy to fully recover remains uncertain. AFLAC JAPAN SALES AFLAC Japan's new annualized premium sales rose .6% to 25.6 billion yen, or $208 million in the second quarter, which was below our expectations. For the first half of 2001, new sales increased 2.0% to 48.7 billion yen, or $403 million. Second-quarter sales were negatively 26 impacted by a 45% decline in Rider MAX production. Rider MAX provides accident and medical/sickness benefits as an attachment to our cancer life policy. Instead of Rider MAX, we emphasized sales of Rider Pack and 21st Century Cancer Life, our newest cancer life policy. Rider Pack was introduced in January to offer our existing cancer life policyholders additional benefits that bring their coverage up to the level of 21st Century Cancer Life. This new cancer life product gives customers a wide variety of benefit options when buying our product. Total cancer life annualized premium sales rose 31.4% in the second quarter including sales through Dai-ichi Mutual Life. However, we believe cancer life policy sales were somewhat suppressed in the first half of the year because many of our agencies had difficulty marketing the new cancer life product due to the dramatic change in policy benefit combinations. As a result, we are in the process of packaging the benefit options and redesigning our sales literature and applications, which we expect to help future sales. We were pleased with the initial sales efforts of our marketing partner, Dai-ichi Mutual Life. In the second quarter, Dai-ichi Life sold 62,000 of our cancer life policies, accounting for 10.5% of new annualized premium sales in the quarter. During the second quarter, we also carefully analyzed our annuity business. We concluded that our best-selling annuity product, sold as business insurance, while profitable, did not meet our profit objectives. As a result, we have stopped selling that type of annuity business. In light of our sales results for the first half of the year, the discontinuation of the business-insurance annuity product, and the redesign of the marketing literature and applications for 21st Century Cancer Life, we have revised our sales outlook for the full year. We believe sales will likely be flat to up slightly for the year. Our previous objective had been a 15% increase in new annualized premium sales for the year in yen. However, we continue to believe that Japan remains a sizable market for quality, affordable supplemental insurance products. And due to AFLAC Japan's many competitive strengths including distribution, product innovation, brand recognition and operating efficiency, we believe we are in a good position to benefit from that potential. AFLAC JAPAN INVESTMENTS Reflecting the continued weakness in Japan's economy, rates of return on yen-denominated debt securities remained low in the second quarter. For instance, the yield of a composite index of 20-year Japanese government bonds averaged 1.90% during the second quarter, compared with 1.84% in the first quarter of 2001. However, we purchased yen-denominated securities at an average yield of 3.54% in the quarter by focusing on selected sectors of the fixed-maturity market. Including dollar-denominated investments, our blended new money yield was 3.84% for the quarter. At the end of the second quarter, the yield on AFLAC Japan's fixed- maturity portfolio was 4.95%, compared with 5.07% a year ago. The return on average invested assets, net of investment expenses, was 4.85% for the six months ended June 30, 2001, compared with 4.83% a year ago. 27 INSURANCE DEREGULATION IN JAPAN Trade talks in 1994 and 1996 between the governments of the United States and Japan, and Japan's 1996 plan for a financial "Big Bang," produced a framework for the deregulation of the Japanese insurance industry. These measures called for the gradual liberalization of the industry through the year 2001 and included provisions to avoid "radical change" in the third sector of the insurance industry. AFLAC and other foreign-owned insurers, as well as many small to medium-sized Japanese insurers, operate primarily in the third sector. As of January 1, 2001, additional insurance companies were permitted to sell the type of third-sector products that AFLAC Japan currently offers. On July 1, 2001, all insurance companies were permitted to compete in the third sector. We recognize that we will face increased competition in the future, however, we continue to believe we will be a very strong competitor because our low-cost structure allows us to provide competitive benefits and services to policyholders and above-average compensation to our sales force. INSURANCE OPERATIONS, AFLAC U.S. The following table presents a summary of AFLAC U.S. operating results. AFLAC U.S. SUMMARY OF OPERATING RESULTS Three Months Ended Six Months Ended June 30, June 30, (In millions) 2001 2000 2001 2000 ------------------ ------------------ Premium income. . . . . $ 451 $ 377 $ 890 $ 751 Investment income . . . . 75 68 148 135 Other income. . . . . 3 2 4 2 ----- ----- ----- ----- Total revenues. . . . . 529 447 1,042 888 ----- ----- ----- ----- Benefits and claims . . . . . . 277 236 548 471 Operating expenses. . . . . . . 167 140 327 276 ----- ----- ----- ----- Total benefits and expenses . 444 376 875 747 ----- ----- ----- ----- Pretax operating earnings . $ 85 $ 71 $ 167 $ 141 ===== ===== ===== ===== -- Percentage changes over previous period: Premium income. . . . . 19.5% 13.0% 18.4% 13.2% Investment income . . . . . . 10.4 14.4 9.8 14.8 Total revenues. . . . . 18.4 13.3 17.3 13.5 Pretax operating earnings . . 19.6 12.3 18.2 11.9 -- Ratios to total revenues: Benefits and claims . . . . . 52.3% 52.8% 52.6% 53.0% Operating expenses. . . . . . 31.6 31.3 31.4 31.1 Pretax operating earnings . . 16.1 15.9 16.0 15.9 == 28 AFLAC U.S. SALES New annualized premium sales rose 27.8% in the second quarter to $214 million. Year-to-date, new sales as of June 30, 2001, were up 31.0% to $417 million, surpassing our sales for the entire year of 1997. Accident/ disability insurance again led our sales for the quarter, accounting for 53.0% of total sales. Cancer expense insurance also produced strong results, accounting for 21.9% of total sales. AFLAC's indemnity dental coverage continued to sell extremely well, accounting for 7.1% of the quarter's sales. Introduced in July 2000, the dental product is already our third best selling product category. We expect sales in the United States to be up 20-25% for the year over 2000. AFLAC U.S. continues to rapidly expand its sales force. During the second quarter, the average number of associates producing business on a monthly basis increased 26.1%, compared with the three months ended June 30, 2000, to more than 12,800 agents. We believe the rapid growth of our distribution system is due in part to the ongoing popularity of our current advertising campaign, which has dramatically increased awareness of AFLAC and its products. AFLAC U.S. INVESTMENTS During the first six months of 2001, available cash flow was invested at an average yield-to-maturity of 8.02% compared with 8.44% during the first half of 2000. The overall return on average invested assets, net of investment expenses, was 7.68% for the first six months of 2001 compared with 7.58% for the first six months of 2000. AFLAC U.S. OTHER We expect the operating expense ratio, excluding discretionary advertising expenses, to remain relatively level in the future. By improving administrative systems and controlling other costs, we have been able to redirect funds to our advertising programs without significantly affecting the operating expense ratio. The aggregate benefit ratio has been relatively stable. The mix of business has shifted toward accident/disability policies, which have lower benefit ratios than other products. We expect future benefit ratios for some of our supplemental products to increase slightly due to our ongoing efforts to improve policy persistency and enhance policyholder benefits. We also expect the pretax operating profit margin to be approximately 16% for the full year. FINANCIAL ACCOUNTING STANDARDS BOARD STATEMENTS We adopted Statement of Financial Accounting Standard No. 133 effective January 1, 2001. Under this standard, we are required to record in net earnings the change in the fair value of the interest component of our cross-currency swaps. This new accounting standard will increase volatility in reported net earnings in the future. For additional information, see Notes 2 and 5 of the Notes to the Consolidated Financial Statements. 29 ANALYSIS OF FINANCIAL CONDITION Since December 31, 2000, our financial condition has remained strong in the functional currencies of our operations. The investment portfolios of AFLAC Japan and AFLAC U.S. have continued to grow with 99.5% classified as investment-grade securities. The yen/dollar exchange rate at the end of each period is used to translate yen-denominated balance sheet items to U.S. dollars for reporting purposes. The exchange rate at June 30, 2001, was 124.60 yen to one U.S. dollar, or 7.9% weaker than the December 31, 2000 exchange rate of 114.75. The weaker yen decreased reported investments and cash by $2.3 billion, total assets by $2.6 billion, and total liabilities by $2.6 billion, compared with the amounts that would have been reported for 2001 if the exchange rate had remained unchanged from year-end 2000. INVESTMENTS AND CASH The continued growth in investments and cash reflects the substantial cash flows in the functional currencies of our operations. Net unrealized gains of $3.7 billion on investment securities at June 30, 2001, consisted of $4.0 billion in gross unrealized gains and $261 million in gross unrealized losses. AFLAC invests primarily within the Japanese, U.S. and Euroyen debt securities markets. We are exposed to credit risk in our investment activity. Credit risk is a consequence of extending credit and/or carrying investment positions. We require that all securities have an initial rating of Class 1 or 2 as determined by the Securities Valuation Office of the National Association of Insurance Commissioners (NAIC). We use specific criteria to judge the credit quality and liquidity of our investments and use a variety of credit rating services to monitor these criteria. Applying those various credit ratings to a standardized rating system based on the categories of a nationally recognized rating service, the percentages of our debt securities, at amortized cost, were as follows: June 30, December 31, 2001 2000 ------------ ------------ AAA 3.4% 25.0% AA 41.4 22.4 A 36.5 36.8 BBB 18.2 15.1 BB .5 .7 ----- ----- 100.0% 100.0% ===== ===== The decrease in AAA-rated debt securities is primarily due to a credit rating change on Japanese government bonds during the first quarter. In March 2001, we recognized a pretax impairment loss of $42 million in realized investment gains and losses on the corporate debt securities of a U.S. issuer, which experienced a significant credit rating downgrade during the first quarter of 2001. These debt securities are carried in the available-for-sale category. 30 We also executed several bond sales and purchase transactions during the first quarter in an effort to increase investment income and extend investment maturities. The sales of these debt securities resulted in pretax realized investment gains of $21 million. Also, in the first quarter of 2001, we realized a pretax investment gain of $18 million related to the sale of a portion of our U.S. equity securities portfolio in connection with a change in outside investment managers. As of March 31, 2001, new Japanese accounting principles and regulatory requirements became effective, which impact investment classifications and solvency margin calculations on a Japanese accounting basis. As a result of these new regulatory requirements, we re-evaluated AFLAC Japan's investment portfolio and our holding period intent related to certain investment securities. In order to minimize future unfavorable solvency margin results under the new Japanese accounting methods, debt securities with amortized cost of $1.8 billion were reclassified from the held-to-maturity category to the available-for-sale category as of March 31, 2001. The related unamortized unrealized gain, included in accumulated other comprehensive income immediately prior to the transfer, was $327 million. We also reclassified debt securities with a fair value of $2.3 billion from the available-for-sale category to the held-to-maturity category as of March 31, 2001. The related unrealized gain of $118 million is being amortized from accumulated other comprehensive income to investment income over the remaining term of the securities. See Note 6 of the Notes to the Consolidated Financial Statements. Private placement investments, at amortized cost, accounted for 54.2% and 51.5% of our total debt securities as of June 30, 2001 and December 31, 2000, respectively. Of the total private placements, reverse-dual currency debt securities (principal payments in yen, interest payments in dollars) accounted for 27.7% and 31.5% of total private placement investments as of June 30, 2001 and December 31, 2000, respectively. AFLAC Japan has invested in the private placement market to secure higher yields than those available from Japanese government bonds. At the same time, we have adhered to prudent standards for credit quality. Most of AFLAC's private placements are issued under medium-term note programs and have standard covenants commensurate with credit rankings, except when internal credit analysis indicates that additional protective and/or event-risk covenants are required. During the first half of 2000, the North American issuers of two debt securities held in our debt portfolio experienced significant credit rating downgrades. In the second quarter, we sold one security at a realized loss of $34 million. We recorded an impairment loss of $57 million on the other security. These losses decreased net earnings by $58 million ($.11 per basic and diluted share) for the three months and six months ended June 30, 2000. 31 The following table presents an analysis of investment securities:

(In millions)	AFLAC Japan June 30, 2001	AFLAC Japan December 31, 2000	AFLAC U.S. June 30, 2001	AFLAC U.S. December 31, 2000
Securities available for sale, at fair value:				
Fixed maturities	$18,016	$18,616	$ 3,947*	$ 3,556*
Perpetual debentures	2,649	1,877	179	169
Equity securities	86	68	144	168
Total available for sale	20,751	20,561	4,270	3,893
Securities held to maturity, at amortized cost:				
Fixed maturities	4,881	3,645	-	-
Perpetual debentures	3,148	3,442	-	-
Total held to maturity	8,029	7,087	-	-
Total investment securities	$28,780	$27,648	$ 4,270	$ 3,893

*Includes securities held by the parent company of $391 at June 30, 2001, and $262 at December 31, 2000

POLICY LIABILITIES Policy liabilities decreased $317 million, or 1.1%, during the first six months of 2001. AFLAC Japan decreased $477 million, or 1.8% (6.6% increase in yen), and AFLAC U.S. increased $160 million, or 6.3%. The weaker yen at June 30, 2001, compared with December 31, 2000, decreased reported policy liabilities by $2.2 billion. The decrease in policy liabilities due to the weaker yen was partially offset by increases from new business, the aging of policies in force, and the market value adjustment for securities available for sale (see Note 6 of the Notes to the Consolidated Financial Statements). DEBT In September 2000, we filed a shelf registration statement with Japanese regulatory authorities to issue up to 100 billion yen of yen- denominated Samurai notes. These securities are not for sale to United States residents or entities. In October 2000, we issued in Japan 30 billion yen of 1.55% Samurai notes due October 2005 ($241 million using the June 30, 2001 exchange rate). In June 2001, we issued in Japan 40 billion yen of .87% Samurai notes due June 2006 ($321 million using the June 30, 32 2001 exchange rate). Both issues are redeemable at our option at any time with a redemption price equal to the principal amount of the notes being redeemed plus a premium. The ratio of debt to total capitalization (debt plus shareholders' equity, excluding the unrealized gains on investment securities) was 28.8% and 25.1% as of June 30, 2001 and December 31, 2000, respectively. On July 17, 2001, we paid in full the reducing revolving credit agreement (see Note 4 of the Notes to the Consolidated Financial Statements). The effect of this transaction reduced our ratio of debt to total capitalization to 27.2%. See Note 4 of the Notes to the Consolidated Financial Statements for information on debt outstanding at June 30, 2001. SECURITY LENDING AFLAC Japan uses short-term security lending arrangements to increase investment income with minimal risk. For further information regarding such arrangements, see Note 5 of the Notes to the Consolidated Financial Statements. POLICYHOLDER GUARANTY FUNDS Under insurance guaranty fund laws in most U.S. states, insurance companies doing business in those states can be assessed for policyholder losses up to prescribed limits that are incurred by insolvent companies with similar lines of business. Such assessments have not been material to us in the past. We believe that future assessments relating to companies in the United States currently involved in insolvency proceedings will not materially impact the consolidated financial statements. In 1998, the Japanese government established the Life Insurance Policyholders Protection Corporation. Funding by the life insurance industry, as determined by government legislation, is made over a 10-year period. We recognize charges for our estimated share of any assessment as funding legislation is enacted. We periodically review our estimated liability for policyholder protection fund assessments based on updated information and any adjustments are reflected in net earnings. SHAREHOLDERS' EQUITY Our insurance operations continue to provide the primary sources of liquidity. Capital needs are also supplemented by borrowed funds. The principal sources of cash from insurance operations are premiums and investment income. The primary uses of cash for insurance operations are policy claims, commissions, operating expenses, income taxes and payments to AFLAC Incorporated for management fees and dividends. Both the sources and uses of cash are reasonably predictable. Our investment objectives provide for liquidity through the ownership of investment-grade debt securities. AFLAC insurance policies generally are not interest-sensitive and therefore are not subject to unexpected policyholder redemptions due to investment yield changes. Also, the majority of our policies provide indemnity benefits rather than reimbursement for actual medical costs and therefore generally are not subject to the risks of medical-cost inflation. 33 The achievement of continued long-term growth will require growth in AFLAC's statutory capital and surplus. We may secure additional statutory capital through various sources, such as internally generated statutory earnings or equity contributions by AFLAC Incorporated from funds generated through debt or equity offerings. We believe outside sources for additional debt and equity capital, if needed, will continue to be available for capital expenditures, business expansion and the funding of our share repurchase program. AFLAC Incorporated capital resources are largely dependent upon the ability of AFLAC to pay management fees and dividends. The Georgia insurance department imposes certain limitations and restrictions on payments of dividends, management fees, loans and advances by AFLAC to AFLAC Incorporated. The Georgia insurance statutes require prior approval for dividend distributions that exceed the greater of statutory earnings for the previous year, or 10% of statutory capital and surplus as of the previous year-end. In addition, the Georgia insurance department must approve service arrangements and other transactions within the affiliated group. These regulatory limitations are not expected to affect the level of management fees or dividends paid by AFLAC to AFLAC Incorporated. A life insurance company's statutory capital and surplus is determined according to rules prescribed by the National Association of Insurance Commissioners (NAIC), as modified by the insurance department in the insurance company's state of domicile. Statutory accounting rules are different from generally accepted accounting principles and are intended to emphasize policyholder protection and company solvency. The NAIC has recodified Statutory Accounting Principles (SAP) to promote standardization throughout the industry. These new accounting principles, to be applied prospectively, were effective January 1, 2001. Previously, prescribed or permitted SAP could vary among states and among companies. The transition adjustments to adopt the new accounting principles increased AFLAC statutory capital and surplus by approximately $130 million as of January 1, 2001. The NAIC uses a risk-based capital formula relating to insurance risk, business risk, asset risk and interest rate risk to facilitate identification by insurance regulators of inadequately capitalized insurance companies based upon the types and mixtures of risks inherent in the insurer's operations. AFLAC's NAIC risk-based capital ratio remains high and reflects a very strong capital and surplus position. Also, there are various ongoing regulatory initiatives by the NAIC relating to insurance products, investments, revisions to the risk-based capital formula and other actuarial and accounting matters. In addition to restrictions by U.S. insurance regulators, the Japanese Financial Services Agency (FSA) may impose restrictions on transfers of funds from AFLAC Japan. Payments are made from AFLAC Japan to AFLAC Incorporated for management fees and to AFLAC U.S. for allocated expenses and remittances of earnings. Total funds received from AFLAC Japan were approximately $104 million for the first six months of 2001 and $23 million for the same period in 2000. AFLAC Japan repatriated profits to AFLAC U.S. in the amounts of 10.0 billion yen ($81 million) in June 2001 and 12.9 billion yen ($103 million) in July 2001. The FSA may not allow transfers of funds if the payment would cause AFLAC Japan to lack sufficient financial strength for the protection of policyholders. The FSA maintains its own solvency standards, a version of risk-based capital requirements. AFLAC 34 Japan's solvency margin significantly exceeds regulatory minimums. For additional information on regulatory restrictions on dividends, profit transfers and other remittances, see Note 9 of the Notes to the Consolidated Financial Statements in our annual report to shareholders for the year ended December 31, 2000. For the Japanese reporting fiscal year ending March 31, 2002, AFLAC Japan will be required to adopt a new Japanese statutory accounting standard regarding fair value accounting for investments. Previously, debt securities were generally reported at amortized cost for FSA purposes. Under the new accounting standard AFLAC Japan will be required to record debt securities in four categories: at fair value in an available-for-sale category, at amortized cost in a held-to-maturity category, at amortized cost in a special category for policy-reserve-matching bonds, or at fair value in a trading category. Under this new regulatory accounting standard, the unrealized gains and losses on debt securities available for sale will be reported in FSA capital and surplus and reflected in solvency margin calculations. This new accounting standard may result in significant fluctuations in FSA equity, in the AFLAC Japan solvency margin and in amounts available for annual profit repatriation. OTHER In July 2001, the board of directors declared the third quarter cash dividend of $.05 per share. The dividend is payable September 4, 2001 to shareholders of record at the close of business on August 16, 2001. Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK Our financial instruments are exposed to primarily three types of market risks. These are interest rate, equity price, and foreign currency exchange rate risk. INTEREST RATE RISK Our primary interest rate exposure is a result of the effect of changes in interest rates on the fair value of our investments in debt securities. We use modified duration analysis, which provides a measure of price percentage volatility, to estimate the amount of sensitivity to interest rate changes in our debt securities. We attempt to match the duration of our assets with the duration of our liabilities. For AFLAC Japan, the duration of policy benefit liabilities is longer than that of the related invested assets due to the unavailability of acceptable long-duration yen-denominated securities. Currently, when our debt securities mature, the proceeds are reinvested at a yield below that of the interest required for the accretion of policy benefit liabilities on policies issued in earlier years. However, the investment yield on new investments exceeds interest requirements on policies issued in recent years. Since 1994, premium rates on new business have been increased several times (the latest occurred in April 2001 for ordinary life and annuity contracts) to help offset the lower investment yields available. 35 At June 30, 2001, we had $3.7 billion of net unrealized gains on total debt securities. The hypothetical reduction in the fair value of our debt securities resulting from a 100 basis point increase in market interest rates is estimated to be $3.1 billion based on our portfolio as of June 30, 2001. The effect on yen-denominated debt securities is approximately $2.6 billion and the effect on dollar-denominated debt securities is approximately $444 million. We have interest rate swaps on our variable-interest-rate yen- denominated borrowings. As of June 30, 2001, we had outstanding interest rate swaps with a notional amount of 19.1 billion yen ($153 million). On July 15, 2001, 15.2 billion yen ($122 million) of the 19.1 billion yen outstanding at quarter end expired. These swaps reduce the impact of fluctuations in interest rates on borrowing costs and effectively change our interest rates from variable to fixed. Therefore, movements in market interest rates should have no material effect on earnings. At June 30, 2001, we also had yen-denominated bank borrowings in the amount of 19.6 billion yen ($158 million) with a blended variable interest rate of .30%. The effect on net earnings in the first six months of 2001 due to changes in market interest rates was immaterial. For further information on our notes payable, see Note 4 of the Notes to the Consolidated Financial Statements. EQUITY PRICE RISK Equity securities at June 30, 2001, totaled $230 million, or .7% of total investments and cash on a consolidated basis. We use beta analysis to measure the sensitivity of our equity securities portfolio to fluctuations in the broad market. The beta of our equity securities portfolio is 1.03. For example, if the overall stock market value changed by 10%, the value of AFLAC's equity securities would be expected to change by approximately 10.3%, or $24 million. CURRENCY RISK Most of AFLAC Japan's investments and cash are yen-denominated. When yen-denominated financial instruments mature or are sold, the proceeds are generally reinvested in yen-denominated securities and are held to fund yen- denominated policy obligations. In addition to the yen-denominated financial instruments held by AFLAC Japan, AFLAC Incorporated has yen-denominated notes payable that have been designated as a hedge of our investment in AFLAC Japan. The unrealized foreign currency translation gains and losses related to these borrowings are reported in accumulated other comprehensive income. AFLAC Incorporated entered into cross-currency swaps to convert the dollar-denominated principal and interest into yen-denominated obligations on its $450 million senior notes that were issued in 1999. The cross- currency swaps have a notional amount of $450 million (55.6 billion yen). These swaps have also been designated as a hedge of our investment in AFLAC Japan. The unrealized foreign currency translation gains and losses related to these swaps are reported in accumulated other comprehensive income. For information regarding new accounting requirements for derivative instruments as of January 1, 2001, see Notes 2 and 5 of the Notes to the Consolidated Financial Statements. 36 We attempt to match yen-denominated assets to yen-denominated liabilities on a consolidated basis in order to minimize the exposure of our shareholders' equity to foreign currency translation fluctuations. The table below compares the U.S. dollar values of our yen-denominated assets and liabilities at various exchange rates. Dollar Value of Yen-Denominated Assets and Liabilities At Selected Exchange Rates (June 30, 2001) 109.60 124.60* 139.60 (In millions) Yen Yen Yen -- Yen-denominated financial instruments: Assets: Securities available for sale: Fixed maturities $ 18,431 $ 16,212 $ 14,470 Perpetual debentures 2,800 2,463 2,198 Equity securities 98 86 77 Securities held to maturity: Fixed maturities 5,549 4,881 4,357 Perpetual debentures 3,579 3,148 2,810 Cash and cash equivalents 629 553 494 Other financial instruments 4 4 3 ------- ------- ------- Sub-total 31,090 27,347 24,409 ------- ------- ------- Liabilities: Notes payable, yen-denominated 1,031 907 810 Cross-currency swaps 507 446 398 ------- ------- ------- Sub-total 1,538 1,353 1,208 ------- ------- ------- Net yen-denominated financial instruments 29,552 25,994 23,201 Other yen-denominated assets 3,876 3,410 3,043 Other yen-denominated liabilities 32,437 28,533 25,466 ------- ------- ------- Consolidated yen-denominated net assets subject to foreign currency fluctuation $ 991 $ 871 $ 778 ======= ======= ======= *Actual June 30, 2001 exchange rate For information regarding the effect of foreign currency translation on operating earnings per share, see Foreign Currency Translation beginning on page 23. FORWARD-LOOKING INFORMATION The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" to encourage companies to provide prospective information, so long as those informational statements are identified as forward-looking and are accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those 37 discussed. We desire to take advantage of these provisions. This report contains cautionary statements identifying important factors that could cause actual results to differ materially from those projected in this discussion and analysis, and in any other statements made by company officials in oral discussions with the financial community and contained in documents filed with the Securities and Exchange Commission (SEC). Forward- looking statements are not based on historical information and relate to future operations, strategies, financial results or other developments. In particular, statements containing words such as "expect," "anticipate," "believe," "goal," "objective" or similar words as well as specific projections of future results, generally qualify as forward-looking. AFLAC undertakes no obligation to update such forward-looking statements. We caution readers that the following factors, in addition to other factors mentioned from time to time in our reports filed with the SEC, could cause actual results to differ materially: regulatory developments, assessments for insurance company insolvencies, competitive conditions, new products, ability to repatriate profits from Japan, general economic conditions in the United States and Japan, changes in U.S. and/or Japanese tax laws or accounting requirements, adequacy of reserves, credit and other risks associated with AFLAC's investment activities, significant changes in interest rates, and fluctuations in foreign currency exchange rates. 38 PART II. OTHER INFORMATION Item 1. LEGAL PROCEEDINGS We are a defendant in various litigation considered to be in the normal course of business. Some of this litigation is pending in Alabama, where large punitive damages bearing little relation to the actual damages sustained by plaintiffs have been awarded against other companies, including insurers, in recent years. Although the final results of any litigation cannot be predicted with certainty, we believe the outcome of pending litigation will not have a material adverse effect on our financial position, results of operations, or cash flows. 39 ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K (a) Exhibits: 4.0 - There are no long-term debt instruments in which the total amount of securities authorized exceeds 10% of the total assets of AFLAC Incorporated and its subsidiaries on a consolidated basis. We agree to furnish a copy of any long-term debt instruments to the Securities and Exchange Commission upon request. 12.0 - Statement regarding the computation of ratio of earnings to fixed charges. 15.0 - Letter from KPMG LLP regarding unaudited interim financial information. (b) Reports on Form 8-K: There were no reports on Form 8-K filed during the quarter ended June 30, 2001. Items other than those listed above are omitted because they are not required or are not applicable. 40 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. AFLAC INCORPORATED Date August 9, 2001 /s/ KRISS CLONINGER, III ------------------------ --------------------------- KRISS CLONINGER,III President; Treasurer and Chief Financial Officer Date August 9, 2001 /s/ RALPH A. ROGERS, JR. ------------------------ --------------------------- RALPH A. ROGERS, JR. Senior Vice President, Financial Services 41 EXHIBITS FILED WITH CURRENT FORM 10-Q: 12.0 - Statement regarding the computation of ratio of earnings to fixed charges. 15.0 - Letter from KPMG LLP regarding unaudited interim financial information. 42 39