

FINANCIAL STATEMENTS
LIBERTY MUTUAL GROUP

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C O N S O L I D A T E D B A L A N C E S H E E T S

L I B E R T Y M U T U A L H O L D I N G C O M P A N Y I N C .

(DOLLARS IN MILLIONS)

DECEMBER 31	2002	2001
ASSETS		
Investments		
Fixed maturities, available for sale, at fair value (amortized cost of \$25,287 and \$24,241)	\$26,968	\$24,993
Equity securities, available for sale, at fair value (cost of \$768 and \$1,012)	1,088	2,088
Trading securities, at fair value (cost of \$233 and \$154)	227	156
Other investments	675	761
Short-term investments	779	553
Total investments	29,737	28,551
Cash and cash equivalents	2,615	3,231
Premium and other receivables (net of allowance of \$102 and \$99)	4,525	4,070
Reinsurance recoverables (net of allowance of \$51 and \$38)	11,635	10,130
Deferred income taxes	614	667
Deferred policy acquisition costs	913	819
Goodwill and intangible assets	748	728
Prepaid reinsurance premiums	999	583
Other assets	2,204	2,088
Separate account assets	1,887	2,198
	<u>\$55,877</u>	<u>\$53,065</u>
LIABILITIES		
Unpaid claims and claim adjustment expenses and future policy benefits:		
Property and casualty	\$27,475	\$26,385
Life	2,367	1,985
Other policyholder funds and benefits payable	1,843	1,632
Unearned premiums	5,952	4,839
Funds held under reinsurance treaties	1,917	1,483
Short-term debt	143	290
Long-term debt	1,250	1,288
Deferred revenue	1,091	1,101
Other liabilities	5,505	5,979
Separate account liabilities	1,887	2,198
Total liabilities	49,430	47,180
POLICYHOLDERS' EQUITY		
Unassigned equity	5,343	4,835
Accumulated other comprehensive income	1,104	1,050
Total policyholders' equity	6,447	5,885
	<u>\$55,877</u>	<u>\$53,065</u>
SEE ACCOMPANYING NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS		

C O N S O L I D A T E D S T A T E M E N T S O F I N C O M E
L I B E R T Y M U T U A L H O L D I N G C O M P A N Y I N C .

(DOLLARS IN MILLIONS)

YEARS ENDED DECEMBER 31	2002	2001
REVENUES		
Premiums earned	\$12,118	\$10,737
Net investment income	1,618	1,577
Net realized investment gains	272	212
Fee and other revenues	535	509
Total revenues	14,543	13,035
CLAIMS, BENEFITS AND EXPENSES		
Benefits, claims and claim adjustment expenses	10,087	10,861
Insurance operating costs and expenses	1,908	1,993
Amortization of deferred policy acquisition costs	1,668	1,572
Dividends to policyholders	63	83
Other expenses	224	219
Total claims, benefits and expenses	13,950	14,728
Income (loss) from continuing operations before income tax expense, cumulative effect of change in accounting principle and discontinued operations	593	(1,693)
Federal and foreign income tax expense	78	285
Income (loss) from continuing operations before cumulative effect of change in accounting principle and discontinued operations	515	(1,978)
Cumulative effect of change in accounting principle	(7)	-
Income (loss) from continuing operations	508	(1,978)
Discontinued operations, net of tax	-	32
Net income (loss)	\$ 508	\$(1,946)
SEE ACCOMPANYING NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS		

C O N S O L I D A T E D S T A T E M E N T S O F C H A N G E S
I N P O L I C Y H O L D E R S ' E Q U I T Y
L I B E R T Y M U T U A L H O L D I N G C O M P A N Y I N C .
(DOLLARS IN MILLIONS)

	UNASSIGNED EQUITY	ACCUMULATED OTHER COMPREHENSIVE INCOME	TOTAL POLICYHOLDERS' EQUITY
BALANCE, JANUARY 1, 2001	\$ 6,781	\$1,107	\$ 7,888
Comprehensive income			
Net loss	(1,946)	–	(1,946)
Other comprehensive income (loss), net of taxes:			
Unrealized gains on securities	–	105	105
Less: reclassification adjustment for gains and losses included in net income	–	(137)	(137)
Foreign currency translation adjustments	–	(25)	(25)
Other comprehensive loss, net of taxes	–	(57)	(57)
Total comprehensive loss			(2,003)
BALANCE, DECEMBER 31, 2001	\$ 4,835	\$1,050	\$ 5,885
Comprehensive income			
Net income	508	–	508
Other comprehensive income (loss), net of taxes:			
Unrealized gains on securities	–	238	238
Less: reclassification adjustment for gains and losses included in net income	–	(177)	(177)
Minimum pension liability	–	(12)	(12)
Foreign currency translation adjustments	–	5	5
Other comprehensive income, net of taxes	–	54	54
Total comprehensive income			562
BALANCE, DECEMBER 31, 2002	\$ 5,343	\$1,104	\$ 6,447
SEE ACCOMPANYING NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS			

C O N S O L I D A T E D S T A T E M E N T S O F C A S H F L O W S

L I B E R T Y M U T U A L H O L D I N G C O M P A N Y I N C .

(DOLLARS IN MILLIONS)

YEARS ENDED DECEMBER 31	2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	\$ 508	\$(1,946)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Cumulative effect of change in accounting principle	7	-
Depreciation and amortization	154	187
Realized investment gains	(272)	(212)
Undistributed limited partnership loss	151	108
Premium and other receivables	(455)	(300)
Reinsurance recoverables and funds held under reinsurance treaties	(1,071)	(1,600)
Deferred policy acquisition costs	(94)	(59)
Liabilities for insurance reserves	2,796	2,667
Taxes payable, net of deferred	53	48
Other, net	(516)	1,035
Total adjustments	753	1,874
Net cash provided by (used in) operating activities	1,261	(72)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(15,392)	(10,802)
Sales and maturities of investments	13,912	11,188
Property and equipment purchased, net	(169)	(27)
Acquisition and disposal of businesses	(6)	(32)
Other investing activities	(30)	(113)
Net cash (used in) provided by investing activities	(1,685)	214
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net activity in policyholder accounts	103	169
Debt financing, net	(185)	(443)
Net securities lending activity	(48)	136
Other financing activities	(62)	(82)
Net cash used in financing activities	(192)	(220)
Net decrease in cash and cash equivalents	(616)	(78)
Cash and cash equivalents, beginning of year	3,231	3,309
Cash and cash equivalents, end of year	\$ 2,615	\$ 3,231
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Income taxes paid (recovered)	\$ 71	\$ (11)
SEE ACCOMPANYING NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS		

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**Basis of Presentation**

The accompanying consolidated financial statements of Liberty Mutual Holding Company Inc. ("LMHC" or the "Company") include the accounts of Liberty Mutual Insurance Company ("LMIC"), Employers Insurance Company of Wausau ("EICOW"), Liberty Mutual Fire Insurance Company ("Liberty Fire"), Montgomery Mutual Insurance Company ("Montgomery") and Merchants and Business Men's Mutual Insurance Company ("M&B") and their related subsidiaries.

In 2001, LMIC reorganized into a stock insurance company as part of an overall conversion to a mutual holding company structure. LMIC formed as its ultimate parent, LMHC, a Massachusetts mutual holding company. Additionally, as part of its reorganization, LMIC formed (i) LMHC Massachusetts Holdings Inc., a Massachusetts stock holding company ("LMHC MA") which is a direct, wholly-owned subsidiary of LMHC and (ii) Liberty Mutual Group Inc., a Massachusetts stock holding company ("LMGI") which is a direct wholly-owned subsidiary of LMHC MA and the direct parent of LMIC. In 2001, Employers Insurance of Wausau A Mutual Company ("EIOW") reorganized into a stock insurance company named Employers Insurance Company of Wausau ("EICOW") as part of an overall conversion to a mutual holding company structure. EICOW formed as its direct parent Employers Insurance of Wausau Mutual Holding Company, a Wisconsin mutual holding company ("EIOW MHC").

In March 2002, the final step in a series of reorganization transactions was completed in which (a) EIOW MHC merged with LMHC, with LMHC as the surviving entity, and EICOW became an indirect wholly-owned stock subsidiary of LMHC; and (b) Liberty Fire reorganized from a Massachusetts mutual insurance company to a Massachusetts stock insurance company and Liberty Fire became an indirect wholly-owned stock subsidiary of LMHC.

The accompanying consolidated financial statements have been prepared on the basis of accounting principles generally accepted in the United States ("GAAP"). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Certain reclassifications have been made to the 2001 consolidated financial statements to conform with the 2002 presentation. All material intercompany transactions and balances have been eliminated.

Nature of Operations

The Company's consolidated financial statements include:

Domestic Property and Casualty: The accounts of the primary property and casualty companies, LMIC, Liberty Fire, EICOW and their domestic property and casualty subsidiaries and affiliates comprise approximately 71% and 73% of total assets at December 31, 2002 and 2001, respectively, and 73% of total revenues for the years ended December 31, 2002 and 2001. Property and casualty revenues include most types of property-casualty insurance, fidelity and surety bonds and insurance related services for individuals, businesses, government units and associations.

International Operations: International operations are primarily comprised of Liberty International Holdings, Inc., a holding company for most international operations and Liberty Insurance Group, Compania de Seguros y Reaseguros, S.A. of Spain.

The assets and liabilities of the International subsidiaries are located principally in the countries where the insurance risks are written and/or investment and non-insurance related operations are located. In addition, certain domestic subsidiaries have branch and/or subsidiary operations and substantial assets and liabilities in foreign countries. Certain countries have restrictions on the conversions of funds which generally cause a delay in the outward remittance of such funds.

International operations comprised 13% and 11% of total assets at December 31, 2002 and 2001, respectively. International operations revenues comprised 17% and 16% of total revenues for the years ended December 31, 2002 and 2001, respectively, and are primarily derived from personal automobile insurance, commercial insurance, and life and health insurance.

Life Insurance and Financial Services: The Company's continuing domestic life insurance operations are marketed through Liberty Life Assurance Company of Boston ("Liberty Life"). As more fully discussed in Note 2, the Company disposed of its annuity and asset management businesses in 2001. Liberty Life comprised 13% of total assets at December 31, 2002 and 2001. Liberty Life revenues comprised 7% of total revenues for the years ended December 31, 2002 and 2001. Continuing life insurance operations provide life and annuity products to individuals, as well as structured settlements and corporate and bank owned life insurance products.

Adoption of New Accounting Standards

Effective January 1, 2001, the Company adopted Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("FAS 133"). FAS 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the consolidated balance sheet and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically identified as (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or unrecognized firm commitment, (b) a hedge of the exposure to variable cash flows of a recognized asset or liability or of a forecasted transaction, or (c) a hedge of the foreign currency exposure of a net investment in foreign operations, an unrecognized firm commitment, an available for sale security, or a foreign currency denominated forecasted transaction. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation.

As a result of adopting FAS 133, the Company recorded, after tax, net of related effects of deferred policy acquisition costs and minority interest, a charge of \$38 reflected as a cumulative effect of change in accounting principle in the consolidated statements of income. The charge was related to Liberty Financial Companies, Inc. ("LFC") and as such, has been included in discontinued operations in the consolidated statements of income.

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Effective in 2001, the Company adopted FASB Emerging Issues Task Force ("EITF") Issue 99-20, "*Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*" ("EITF 99-20"). EITF 99-20 provides new guidance on the recognition and measurement of interest income and impairment on certain investments (e.g., asset-backed securities). The implementation of EITF 99-20 did not have a material impact on the Company's results of operations, financial condition or liquidity.

In 2001, the FASB issued Statements of Financial Accounting Standards 141 ("FAS 141") and 142 ("FAS 142"). FAS 141, "*Business Combinations*", changes the accounting for business combinations by prohibiting the prospective use of pooling-of-interests accounting, eliminating the periodic amortization of goodwill and certain indefinite lived intangible assets, and requires allocation of purchased goodwill and intangible assets to reporting units. FAS 142, "*Goodwill and Other Intangible Assets*", requires companies to perform annual reviews for impairment of goodwill and indefinite lived intangible assets. Impairment exists when the carrying value of the goodwill or intangible assets exceeds the fair value, which is determined based on quoted market prices, discounted cash flows or appraised values. During 2002 and under the transition provisions of FAS 142, the Company recognized an impairment loss of \$7 as a cumulative effect of change in accounting principle in the consolidated statements of income.

In August 2001, the FASB issued Statement of Financial Accounting Standards No. 144, "*Accounting for the Impairment or Disposal of Long-lived Assets*" ("FAS 144"). FAS 144 establishes a single accounting model for long-lived assets to be disposed of by sale. A long-lived asset classified as held for sale is to be measured at the lower of its carrying amount or its fair value less cost to sell. Additionally, depreciation (amortization) ceases. Impairment is recognized only if the carrying amount of a long-lived asset is not recoverable from its undiscounted cash flows and is measured as the difference between the carrying amount and the fair value of the asset. Long-lived assets to be abandoned, exchanged for a similar productive asset, or distributed to owners in a spin-off are considered held and used until disposed of. Accordingly, discontinued operations are no longer to be measured on a net realizable basis, and future operating losses are no longer recognized before they occur. The Company adopted FAS 144 effective January 1, 2002. The Statement did not have a material impact on the Company's results of operations, financial condition or liquidity.

In April 2002, the FASB issued Statement of Financial Accounting Standards No. 145, "*Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections*" ("FAS 145"). FAS 145 rescinds FAS 4, "*Reporting Gains and Losses from Extinguishment of Debt, an Amendment of APB Opinion 30*", which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income taxes. As a result, the criteria in Opinion 30, "*Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*", will now be used to classify those gains and losses. FAS 145 also amends FAS 13, "*Accounting for Leases*", to require that certain lease modifications that have economic effects similar to sale-leaseback transactions be

accounted for in the same manner as sale-leaseback transactions. The Company adopted FAS 145 on May 15, 2002. The Statement did not have an impact on the Company's results of operations, financial condition or liquidity.

Future Adoption of New Accounting Standards

In June 2002, the FASB issued Statement of Financial Accounting Standards No. 146, "*Accounting for Costs Associated with Exit or Disposal Activities*" ("FAS 146"). FAS 146 nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, "*Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*." The principal difference between FAS 146 and EITF 94-3 relates to its requirements for recognition of a liability for a cost associated with an exit or disposal activity. Under FAS 146, a liability for a cost associated with an exit or disposal activity is recognized when the liability is incurred. Under EITF 94-3, a liability for an exit cost was recognized at the date of an entity's commitment to an exit plan. FAS 146 also establishes fair value as the basis for initial measurement of the liability. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. The Company will adopt FAS 146 effective January 1, 2003.

In November 2002, the FASB issued Interpretation No. 45, "*Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of the Indebtedness of Others*" ("FIN 45"). Along with new disclosure requirements, FIN 45 requires guarantors to recognize, at the inception of certain guarantees, a liability for the fair value of the obligation undertaken in issuing the guarantee. This differs from the current practice to record a liability only when a loss is probable and reasonably estimable. The recognition and measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. Management is currently evaluating the impact of the adoption of FIN 45 and believes it will not have a material impact on the Company's results of operations, financial condition or liquidity.

In January 2003, the FASB issued Interpretation No. 46, "*Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51*" ("FIN 46"). FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first annual period beginning after June 15, 2003. Management is currently evaluating the impact of the adoption of FIN 46 and believes it will not have a material impact on the Company's results of operations, financial condition or liquidity.

Investments

Available for sale: Fixed maturity securities classified as available for sale, are debt securities, that might have fixed or variable principal payment schedules, held for indefinite periods of time, and might be used as a part of the Company's asset/liability strategy or sold in response to changes in interest rates, anticipated prepayments, risk/reward characteristics, liquidity needs or similar economic factors. These securities are carried at market value with the corresponding unrealized appreciation or depreciation, net of deferred income taxes, reported in accumulated other comprehensive income.

Equity securities classified as available for sale, include common equities and non-redeemable preferred stocks and are reported at quoted market values. Changes in the market values of these securities, net of deferred income taxes, are reflected as unrealized appreciation or depreciation in accumulated other comprehensive income.

Trading Securities: Trading securities are securities bought principally for the purpose of sale in the near term and are reported at market value. Changes in market value are recognized in income in the current period.

Realized gains and losses on sales of investments are recognized in income using the specific identification method. Unrealized losses that are other-than-temporary are recognized in income. The Company's accounting policy for other-than-temporary impairment recognition requires other-than-temporary impairment charges to be recorded when it is determined that the Company is unlikely to recover its cost basis in an investment. Factors considered in evaluating whether a decline in value is other-than-temporary include: (a) the length of time and the extent to which the fair value has been below cost; (b) the financial condition and near-term prospects of the issuer; and (c) the intent and ability of the Company to retain the investment for a period of time sufficient to allow for any anticipated recovery. In addition, for securities expected to be sold, an other-than-temporary impairment charge is recognized if the Company does not expect the fair value of a security to recover to cost or amortized cost prior to the expected date of sale.

For mortgage-backed fixed maturity securities, the Company recognizes income using a constant effective yield based on anticipated prepayments over the economic life of the security. The mortgage-backed portfolio is accounted for under the retrospective method; prepayment assumptions are based on market expectations. When actual prepayments differ significantly from anticipated prepayments, the effective yield is recalculated to reflect actual payments to date and anticipated future payments and any resulting adjustment is included in investment income.

Cash equivalents are short-term, highly liquid investments that are both readily convertible into known amounts of cash and so near to maturity that they present insignificant risk of changes in value due to changing interest rates. The Company's cash and cash equivalents include debt securities purchased with maturities of three months or less at acquisition and are carried at amortized cost which approximates fair market value.

Short-term investments are debt securities with maturities at acquisition between three months and one year, are considered available for sale and are carried at amortized cost, which approximates fair market value.

Other investments, principally investments in private equities through limited partnerships, are accounted for using the equity method and reported as a component of net investment income unless the investment is so minor that the Company has no influence over partnership operating and financial policies. Investments in excess of three percent of limited partnerships equity are considered more than minor.

Derivatives

All derivatives are recognized on the balance sheet at fair value following the adoption of FAS 133. Effective upon the implementation of FAS 133 on January 1, 2001, on the date the contract is entered into, the Company designates the derivative as either (1) a hedge of a fair value of a recognized asset ("fair value hedge") or (2) an economic hedge ("non-designated derivative"). Changes in the fair value of a derivative that is highly effective and is designated and qualifies as a fair value hedge, along with the loss or gain on the hedged asset attributable to the hedged risk, are recorded in current period operations as a component of net investment income. Changes in the fair value of non-designated derivatives are reported in current period operations, as a component of net realized gains and losses and the derivative is included in other assets or liabilities. Prior to the sale of the LFC operations (see Note 2), LFC utilized interest rate swap agreements and designated the agreements as fair value hedges.

In 2002 and 2001, the Company was party to derivative contracts in the form of equity swap contracts. These contracts were terminated in 2002. The purpose of the contracts was to exchange rates of return of a specified set of common stocks for rates of return consistent with the broad equity markets as represented by the S&P 500 Index. The Company agreed with counter parties to exchange, at quarterly intervals, the net performance differential of the S&P 500 Index and notional portfolio of common stocks. Changes in the fair value were recognized in income from continuing operations.

The Company's foreign indirectly owned subsidiary, Liberty Insurance Group, Compania de Seguros y Reaseguros, S.A. uses various derivative instruments to hedge its exposure to interest rates and equity market returns guaranteed by certain life products. In addition, the Company owns call or put options embedded in certain bonds it has purchased. The fair value of these derivative instruments is based on broker quotations.

Securities Lending

The Company engages in securities lending whereby certain investment securities are loaned to other institutions for short periods of time. The Company generally receives cash or short-term investments collateral from the borrower, equal to or in excess of 102% of the market value of the loaned securities, and reinvests the cash collateral in short-term investments. The loaned securities remain a recorded asset of the Company, however, the Company records a liability for the amount of collateral held, representing its obligation to return the collateral related to the loaned securities.

Goodwill and Intangible Assets

Goodwill represents the excess of amounts paid for acquiring businesses over the fair value of the net assets acquired. For 2001 and prior, the Company amortized goodwill and intangible assets using a straight-line method over the period in which the expected benefits from an acquisition were expected to be realized, generally over 5 to 30 years. The Company adopted FAS 142 effective January 1, 2002 and reviews for impairment on an annual basis.

Deferred Policy Acquisition Costs

Costs that vary with and are primarily related to the acquisition of new and renewal insurance and investment contracts are deferred and amortized over the respective policy terms. Deferred policy acquisition costs are reviewed annually for recoverability. Investment income is considered in the recoverability assessment. For short-duration contracts, acquisition costs include commissions, underwriting expenses and premium taxes and assessments.

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For long duration insurance contracts, these costs include first year commissions in excess of annual renewal commissions and variable sales, underwriting and administrative expenses.

For short-duration contracts, acquisition costs are amortized in proportion to earned premiums. For traditional long-duration contracts, acquisition costs are amortized over the premium paying period of the related policies using assumptions consistent with those used in computing policy benefit reserves. For universal life insurance, annuity and investment products, acquisition costs are amortized in relation to expected gross profits.

Insurance Liabilities and Reserves

For short duration contracts, the Company provides reserves for unpaid insurance claims and claim adjustment expenses covering events that occurred in 2002 and prior years. These reserves reflect estimates of the total cost of claims reported but not yet paid and the cost of claims not yet reported, as well as the estimated expenses necessary to settle the claims. Reserve estimates are based on past loss experience modified for current claim trends, as well as prevailing social, economic and legal conditions. Final claim payments, however, may ultimately differ from the established reserves, since these payments might not occur for several years. Reserve estimates are continually reviewed and updated, and any resulting adjustments are reflected in current operating results. The Company does not discount reserves other than tabular discounting on the long-term indemnity portion of workers compensation claims and the long-term disability portion of group accident and health claims as permitted by insurance regulations in certain states. Reserves are reduced for estimated amounts of salvage and subrogation and deductibles recoverable from policyholders.

For long duration contracts, measurement of liabilities is based upon generally accepted actuarial techniques but requires assumptions about mortality, lapse rates and assumptions about future returns on related investments. Annuity and structured settlement contracts without significant mortality or morbidity risk are accounted for as investment contracts, whereby the premium received plus interest credited less policyholder withdrawals represents the investment contract liability. In 2002 and 2001, credited interest rates for structured settlement contracts in force were between 5.0% and 11.5% and credited rates for universal life contracts in force were between 4.0% and 8.5%. Liabilities for future policy benefits for traditional life policies have been computed using the net level premium method based upon estimated future investment yields (between 4.50% and 10.25% for all years of issue), mortality assumptions (based on the Company's experience relative to standard industry mortality tables) and withdrawal assumptions (based upon the Company's experience).

Revenue Recognition

For short duration insurance contracts, premiums are reported as earned income generally on a pro-rata basis over the terms of the related policies. For retrospectively rated policies and contracts, premium estimates are continually reviewed and updated and any resulting adjustments are reflected in current operating results.

For traditional long duration insurance contracts (including term and whole life contracts and annuities), premiums are earned when due.

For annuities and structured settlements without significant mortality or morbidity risk (investment contracts) and universal life contracts (long duration contracts with terms that are not fixed or guaranteed), revenues represent investment income earned on the related assets. Universal life and annuity contract revenues also include mortality, surrender and administrative fees charged to policyholders.

Reinsurance

All assets and liabilities related to reinsurance ceded contracts are reported on a gross basis in the consolidated balance sheets. The consolidated statements of income reflect premiums, benefits and settlement expenses net of reinsurance ceded.

Transactions that do not transfer risk are included in other assets or other liabilities. Transactions which transfer risk but are retroactive are included in reinsurance balances. The excess of estimated liabilities for claims and claim costs over the consideration received or paid with respect to retroactive property and casualty reinsurance contracts is established as a deferred charge or credit at inception. The deferred amounts are subsequently amortized using the interest method over the expected settlement periods of the claim liabilities assumed or ceded. The periodic amortization is reflected in the accompanying consolidated statements of income as benefits, claims and claim adjustment expenses.

Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liabilities associated with the reinsured business. The Company evaluates reinsurance collectibility and a provision for uncollectible reinsurance is recorded.

Separate Account Assets and Liabilities

Separate and variable accounts represent funds for which investment income and investment gains and losses accrue directly to the policyholders who predominantly bear the investment risk. Each account has specific investment objectives, and the assets are carried at fair value. The assets of each account are legally segregated and are not subject to claims which arise out of any other business of the Company. The assets of these accounts are equal to the account liabilities.

Translation of Foreign Currencies

The Company translates the financial statements of its foreign operations into U.S. dollars, from the functional currency designated for each foreign unit, generally the currency of the primary economic environment in which it operates. Assets and liabilities are translated into U.S. dollars at period-end exchange rates, while income and expenses are translated using average rates for the period. The resulting translation adjustments are recorded, net of tax, as a separate component of policyholders' equity.

The aggregate exchange gains included in pretax income for the years ending December 31, 2002 and 2001 were \$79 and \$31, respectively. Amounts are included in insurance operating costs and expenses in the accompanying consolidated statements of income.

Income Taxes

The income tax provision is calculated under the liability method. Deferred tax assets and liabilities are recorded based on the difference between the financial statement and tax bases of assets and liabilities at the enacted tax rates. The principal assets and liabilities giving rise to such differences are unrealized capital gains and losses on certain investments, insurance reserves, unearned premiums, deferred policy acquisition costs and employee benefits.

Service Revenues and Expenses

Service revenues consist primarily of fees generated from processing business for involuntary assigned risk pools and are earned on a pro rata basis over the term of the related policies and are included in fee and other revenues in the consolidated statements of income. Acquisition expenses are deferred and amortized over the period in which the related revenues are earned.

Real Estate and Other Fixed Assets

The costs of buildings and furniture and equipment are depreciated principally on a straight-line basis over their estimated useful lives (a maximum of 40 years for buildings and 10 years for furniture and equipment). Expenditures for maintenance and repairs are charged to income as incurred while expenditures for betterments are capitalized and depreciated.

Policyholder Dividends

Policyholder dividends are accrued using an estimate of the ultimate amount to be paid in relation to premiums earned based on the underlying contractual obligations.

For domestic property-casualty insurance, certain insurance contracts, primarily workers' compensation policies, are issued with the expectation that management will recommend that dividends be paid to policyholders, subject to approval by the insurer's board of directors. Such policies approximate 2% and 4% of domestic property-casualty insurance premiums written at December 31, 2002 and 2001, respectively.

For life insurance, dividends to participating policyholders are calculated as the sum of the difference between the assumed mortality, interest and loading, and the actual experience of the Company relating to participating policyholders. As a result of statutory regulations, the major portion of earnings from participating policies inures to the benefit of the participating policyholders. Participating policies approximate 19% and 21% of ordinary life insurance in force at December 31, 2002 and 2001, respectively.

Accumulated Other Comprehensive Income

Other comprehensive income (loss) consists of foreign currency translation adjustments, minimum pension liability and unrealized gains and losses on certain investments in debt and equity securities.

The components of accumulated other comprehensive income, net of related deferred acquisition costs and taxes, are as follows:

	2002	2001
Unrealized gains on securities	\$1,279	\$1,218
Foreign currency translation adjustments	(163)	(168)
Minimum pension liability	(12)	—
Accumulated other comprehensive income	<u>\$1,104</u>	<u>\$1,050</u>

(2) DISCONTINUED OPERATIONS

On October 31, 2001, LFC, a 70% indirectly owned subsidiary of LMIC, sold its annuity and bank marketing businesses for \$1,700 in cash. Additionally, on November 1, 2001, LFC sold its asset management business for \$900 in cash and the buyer assumed approximately \$110 in revolving debt. LFC recorded an after-tax gain of approximately \$100 on the transactions. Following the sales of LFC's operating subsidiaries, LFC completed a tender offer for approximately 96% of its \$450 senior debt outstanding and LMIC then acquired the outstanding minority shares. LFC's operating results and the gain on sale of its operating subsidiaries qualified as discontinued operations.

Operating results of discontinued operations, comprised primarily of LFC, for the period ended November 1, 2001 are as follows:

	2001
Revenues	<u>\$1,247</u>
Income before income taxes and minority interest	\$ 418
Federal and foreign income taxes	308
Income before minority interest	110
Cumulative effect of adoption of new accounting principles	(60)
Minority interest	(18)
Net income	<u>\$ 32</u>

(3) INVESTMENTS

Components of Net Investment Income

	2002	2001
Interest income	\$1,729	\$1,733
Dividends	72	40
Other investment losses	(130)	(144)
Gross investment income	1,671	1,629
Investment expenses	(53)	(52)
Net investment income	<u>\$1,618</u>	<u>\$1,577</u>

Components of Net Realized Investment Gains

	2002	2001
Fixed maturities	\$171	\$101
Equities	127	150
Other	(26)	(39)
Net realized investment gains	<u>\$272</u>	<u>\$212</u>

During the years ended December 31, 2002 and 2001, other-than-temporary unrealized losses recognized through earnings and included in net realized investment gains were \$165 and \$27, respectively.

During the years ended December 31, 2002 and 2001, proceeds from sales of fixed maturities available for sale were \$10,491 and \$10,315, respectively. The gross realized gains and (losses) on such sales totaled \$385 and \$(200) in 2002 and \$287 and \$(259) in 2001, respectively. Realized (losses) and gains on trading securities for the years ended December 31, 2002 and 2001 were \$(95) and \$2, respectively.

Components of Change in Net Unrealized Investment Gains

	2002	2001
Fixed maturities	\$ 929	\$ 260
Equities	(756)	(295)
Adjustments to deferred policy acquisition costs	(24)	(15)
Net change in unrealized investment gains (losses)	149	(50)
Deferred income taxes	(88)	18
Net change in unrealized investment gains (losses), net of tax	<u>\$ 61</u>	<u>\$ (32)</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

LIBERTY MUTUAL HOLDING COMPANY INC.

(CONTINUED)

Available for Sale Investments

The gross unrealized gains and losses and fair values of fixed maturities at December 31, 2002 and 2001 are as follows:

DECEMBER 31, 2002	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	FAIR VALUE
U.S. Treasury securities	\$ 1,509	\$ 200	\$ (1)	\$ 1,708
Mortgage and asset-backed securities of government and corporate agencies	9,525	628	(33)	10,120
State and municipal	688	72	(1)	759
Corporate and other	13,565	924	(108)	14,381
Total fixed maturities available for sale	<u>\$25,287</u>	<u>\$ 1,824</u>	<u>\$(143)</u>	<u>\$26,968</u>

DECEMBER 31, 2001	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	FAIR VALUE
U.S. Treasury securities	\$ 1,331	\$ 93	\$ (8)	\$ 1,416
Mortgage and asset-backed securities of government and corporate agencies	9,267	314	(48)	9,533
State and municipal	1,637	97	(3)	1,731
Corporate and other	12,006	465	(158)	12,313
Total fixed maturities available for sale	<u>\$24,241</u>	<u>\$ 969</u>	<u>\$(217)</u>	<u>\$24,993</u>

The gross unrealized gains and losses and fair values of equity securities at December 31, 2002 and 2001 are as follows:

DECEMBER 31, 2002	COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	FAIR VALUE
Equity securities available for sale	<u>\$ 768</u>	<u>\$ 391</u>	<u>\$ (71)</u>	<u>\$ 1,088</u>

DECEMBER 31, 2001	COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	FAIR VALUE
Equity securities available for sale	<u>\$ 1,012</u>	<u>\$ 1,128</u>	<u>\$ (52)</u>	<u>\$ 2,088</u>

At December 31, 2002 and 2001, fixed maturities carried at \$4,692 and \$4,617, respectively, were on deposit with regulatory authorities as required by law.

At December 31, 2002 and 2001, the fair values of fixed maturities loaned were approximately \$485 and \$505, respectively. Cash and short-term investments received as collateral in connection with the loaned securities were approximately \$312 and \$379 as of December 31, 2002 and 2001, respectively. Non-cash collateral received in connection with the loaned securities was approximately \$184 and \$139 as of December 31, 2002 and 2001, respectively.

The amortized cost and fair value of fixed maturities at December 31, 2002 by contractual maturity, are set forth as follows:

	AMORTIZED COST	FAIR VALUE
Due to Mature:		
One year or less	\$ 699	\$ 710
Over one year through five years	4,559	4,748
Over five years through ten years	6,514	6,967
Over ten years	3,990	4,423
Mortgage and asset-backed securities	9,525	10,120
	<u>\$25,287</u>	<u>\$26,968</u>

Expected maturities may differ from contractual maturities as borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Derivatives

As of December 31, 2001, equity swaps had notional amounts of \$362, and fair value of \$14. This program was terminated during 2002.

As of December 31, 2002 and 2001, the Company's indirectly owned foreign subsidiary, Liberty Insurance Group, Compania de Seguros y Reaseguros, S.A. held \$52 and \$50, respectively, of derivative instruments (all classified as fair value hedges) and are included as fixed maturities on the consolidated balance sheets.

(4) DEFERRED POLICY ACQUISITION COSTS

The following reflects the policy acquisition costs deferred for amortization against future income and related amortization charged to income:

YEARS ENDED DECEMBER 31,	2002	2001
Balance at beginning of year	\$ 819	\$ 701
Acquisition costs deferred	1,762	1,690
Amortization charged to income	<u>(1,668)</u>	<u>(1,572)</u>
Balance at end of year	<u>\$ 913</u>	<u>\$ 819</u>

For long duration contracts, to the extent unrealized gains or losses on fixed income securities carried at fair value would result in an adjustment of estimated gross profits had those gains or losses actually been realized, the related unamortized deferred policy acquisition costs are recorded net of tax as a reduction of the unrealized capital gains or losses and included in accumulated other comprehensive income.

(5) ACQUISITIONS

On November 26, 2001, LMIC purchased 99.99% of Royal & Sun Alliance, S.A. Compania Espanola de Seguros y Reaseguros (re-named Liberty Insurance Group, Compania de Seguros y Reaseguros, S.A.) in Spain. The purchase was effective July 1, 2001 and the price was approximately \$193. This transaction resulted in goodwill of \$78. In addition, the Company acquired various foreign companies in 2001 for aggregate consideration of \$111, resulting in goodwill of \$83.

(6) UNPAID CLAIMS AND CLAIM ADJUSTMENT EXPENSES

Property-casualty insurance unpaid claims and claim adjustment expenses represent the Company's best estimate of amounts necessary to settle all outstanding claims, including claims that are incurred but not reported as of the reporting date. The Company's reserve projections are based primarily on detailed analysis of the facts in each case, experience with similar cases and various historical development patterns. Consideration is given to such historical patterns as field reserving trends and claims settlement practices, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions and public attitudes. All of these factors can affect the estimation of reserves.

Establishing loss reserves, including loss reserves for catastrophic events that have occurred, is an estimation process. Many factors can ultimately affect the final settlement of a claim and, therefore, the necessary reserve. Changes in the law, results of litigation, medical costs, the costs of repair materials and labor rates can all affect ultimate claim costs. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a loss and the payment or settlement of the claim, the more variable the ultimate settlement can be. Accordingly, "short-tail" claims, such as property damage claims, tend to be easier to estimate than "long-tail" claims, such as workers' compensation or general liability claims.

As information develops that varies from past experience, provides additional data, or in some cases, augments data that previously was not considered sufficient for use in determining reserves, changes in the Company's estimate of ultimate liabilities may be required. The effects of these changes are reflected in current operating results.

Catastrophes are an inherent risk of the property-casualty insurance business and have contributed to material period-to-period fluctuations in the Company's results of operations and financial position. The level of catastrophe losses experienced in any period cannot be predicted and can be material to the results of operations and financial position of the Company.

The Company has material exposure to claims arising from the terrorist attack of September 11, 2001. The exposure arises

primarily from property, workers' compensation and reinsurance contracts. Although uncertainty about the final loss amount still exists, the claims are reasonably estimable and such estimate has been recorded. The cumulative pre-tax impact, net of reinsurance, is approximately \$646.

Activity in property and casualty unpaid claims and claim adjustment expenses of the Company is summarized as follows:

	2002	2001
Balance as of January 1	\$26,385	\$23,876
Less: unpaid reinsurance recoverables	<u>7,514</u>	<u>5,771</u>
Net balance as of January 1	18,871	18,105
Balance attributable to dispositions, acquisitions, and affiliations	—	272
Incurred attributable to:		
Current year	8,749	8,873
Prior years	<u>814</u>	<u>1,592</u>
Total incurred	9,563	10,465
Paid attributable to:		
Current year	4,075	4,265
Prior years	<u>5,568</u>	<u>5,677</u>
Total paid	9,643	9,942
Net adjustment due to foreign exchange	(64)	(29)
Add: unpaid reinsurance recoverables	<u>8,748</u>	<u>7,514</u>
Balance as of December 31	<u>\$27,475</u>	<u>\$26,385</u>

In 2002 and 2001, incurred claims and claim adjustment expenses attributable to prior years was primarily due to rising loss trends in commercial lines including workers' compensation and asbestos and environmental exposure.

The Company has not discounted unpaid property and casualty insurance claims and claim adjustment expenses other than tabular discounting on the long-term indemnity portion of workers' compensation claims and the Company's disability claims as permitted by insurance regulations in certain states.

The tabular discounting on these workers' compensation claims is based upon Unit Statistical Plan tables as approved by the respective states and generally approximates 4.0% for the years ended December 31, 2002 and 2001. Unpaid claims at December 31, 2002 and 2001 include liabilities of \$3,587 and \$3,620 at discounted values of \$2,299 and \$2,303, respectively. The tabular discounting on the disability claims is based on the 1987 Commissioners Group Disability Table (CGDT) at annual discount rates varying from 5.00% to 7.00% in 2002 (5.50% to 7.00% in 2001). Unpaid claims at December 31, 2002 and 2001 include liabilities of \$735 and \$675 carried at discounted values of \$511 and \$467, respectively.

Unpaid claims and claim adjustment expenses include \$1,292 and \$1,300 for asbestos and environmental related claims net of reinsurance at December 31, 2002 and 2001, respectively. The Company has exposure to asbestos and environmental claims which emanate principally from general liability policies written prior to the mid-1980's. In establishing asbestos and environmental reserves, the Company estimates case basis reserves for anticipated losses, and bulk reserves for loss adjustment expenses and incurred but not reported losses. The Company maintained casualty excess of loss reinsurance during the relevant periods. The reserves are reported net of expected recoveries from reinsurers and include any reserves reported by ceding reinsurers on assumed reinsurance contracts.

Upon their de-affiliation from the Nationwide Group and re-affiliation with LMIC, EICOW, Wausau Business Insurance Company, Wausau General Insurance Company, and Wausau Underwriters Insurance Company entered into reinsurance contracts whereby Nationwide Indemnity Company assumed full

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responsibility for obligations on certain policies with effective dates prior to January 1, 1986, including all asbestos and environmental exposures.

The process of establishing reserves for asbestos and environmental claims is subject to greater uncertainty than the establishment of reserves for liabilities relating to other types of insurance claims. A number of factors contribute to this greater uncertainty surrounding the establishment of asbestos and environmental reserves, including, without limitation: (i) the lack of available and reliable historical claims data as an indicator of future loss development; (ii) the long waiting periods between exposure and manifestation of any bodily injury or property damage; (iii) the difficulty in identifying the source of asbestos or environmental contamination; (iv) the difficulty in properly allocating liability for asbestos or environmental damage; (v) the uncertainty as to the number and identity of insureds with potential exposure; (vi) the cost to resolve claims; and (vii) the collectibility of reinsurance.

The uncertainties associated with establishing reserves for asbestos and environmental claims and claim adjustment expenses are compounded by the differing, and at times inconsistent, court rulings on environmental and asbestos coverage issues involving: (i) the differing interpretations of various insurance policy provisions and whether asbestos and environmental losses are, or were ever intended to be, covered; (ii) when the loss occurred and what policies provide coverage; (iii) whether there is an insured obligation to defend; (iv) whether a compensable loss or injury has occurred; (v) how policy limits are determined; (vi) how policy exclusions are applied and interpreted; (vii) the impact of entities seeking bankruptcy protection as a result of asbestos-related liabilities; (viii) whether clean-up costs are covered as insured property damage; and (ix) applicable coverage defenses or determinations, if any, including the determination as to whether or not an asbestos claim is a products or completed operation claim subject to an aggregate limit and the available coverage, if any, for that claim.

In recent years, the Company, as well as the industry generally, has witnessed a significant increase in the number of asbestos claims being filed, due to a number of variables, including more intensive advertising by lawyers seeking asbestos claimants, and the increasing focus by plaintiffs on new and previously peripheral defendants, attempts to broaden the interpretation of compensable loss, and courts expanding the scope of the coverage.

As a result of the significant uncertainty inherent in determining a company's asbestos and environmental liabilities, the amount of reserves required to adequately fund the Company's asbestos and environmental claims cannot be accurately estimated using conventional reserving methodologies based upon historical data and trends. As a result, the use of conventional reserving methodologies frequently has to be supplemented by subjective considerations including managerial judgment.

The methods of determining estimates for reported and unreported losses and establishing resulting reserves and related reinsurance recoverables are periodically reviewed and updated, and adjustments resulting from this review are reflected in income currently.

As a direct result of the significant uncertainties associated with estimating its asbestos and environmental exposures and

establishing appropriate levels of reserves, the ultimate liability of the Company for asbestos and environmental exposures may vary materially from the reserves currently recorded. The Company and other industry members have and will continue to litigate the broadening judicial interpretation of policy coverage and the liability issues. If the courts continue to expand the scope of the coverage provided, additional liabilities could emerge for amounts in excess of reserves held. This emergence, as well as the other uncertainties noted above, cannot be reasonably estimated, but could have a material impact on the Company's future operating results and financial condition.

The following tables summarize the activity for the Company's asbestos and environmental claims and claim adjustment expenses, a component of the Company's unpaid claims and claim adjustment expenses for the years ended December 31, 2002 and 2001:

	2002	2001
Gross Asbestos:		
January 1 reserves:	\$1,479	\$1,408
Incurred activity	485	288
Paid activity	281	217
Ending reserves	<u>\$1,683</u>	<u>\$1,479</u>
Net Asbestos:		
January 1 reserves:	\$ 854	\$ 790
Incurred activity	294	179
Paid activity	175	115
Ending reserves	<u>\$ 973</u>	<u>\$ 854</u>
Gross Environmental:		
January 1 reserves:	\$ 705	\$ 860
Incurred activity	52	(1)
Paid activity	176	154
Ending reserves	<u>\$ 581</u>	<u>\$ 705</u>
Net Environmental:		
January 1 reserves:	\$ 446	\$ 469
Incurred activity	(9)	95
Paid activity	118	118
Ending reserves	<u>\$ 319</u>	<u>\$ 446</u>

For certain commercial lines of insurance, the Company offers experience-rated insurance contracts whereby the ultimate premium is dependent upon the claims incurred. At December 31, 2002 and 2001, the Company held \$4,212 and \$4,229, respectively, of unpaid claims and claim adjustment expenses related to experience-rated contracts. Premiums receivable included accrued retrospective and unbilled audit premiums of \$718 and \$710 at December 31, 2002 and 2001, respectively.

Unpaid claims and claim adjustment expenses are recorded net of anticipated salvage and subrogation of \$431 and \$428 as of December 31, 2002 and 2001, respectively.

At December 31, 2002 and 2001, the reserve for unpaid claim reserves were reduced by \$1,844 and \$1,451, respectively, for large dollar deductibles. Large dollar deductibles billed and recoverable were \$216 and \$257 at December 31, 2002 and 2001, respectively.

(7) REINSURANCE

In the ordinary course of business, the Company assumes reinsurance and also cedes reinsurance to other insurers to reduce overall risk, including exposure to large losses and catastrophic events. The Company is also a member of various involuntary pools and associations and serves as a servicing carrier for residual market organizations.

A summary of reinsurance financial data reflected within the consolidated statements of income is presented below:

	2002		2001	
	WRITTEN	EARNED	WRITTEN	EARNED
Direct	\$15,096	\$14,131	\$12,734	\$12,230
Assumed	1,645	1,489	793	631
Ceded	3,946	3,502	2,468	2,124
Net premiums	<u>\$12,795</u>	<u>\$12,118</u>	<u>\$11,059</u>	<u>\$10,737</u>

The Company remains contingently liable in the event reinsurers are unable to meet their obligations for paid and unpaid reinsurance recoverables and unearned premiums ceded under reinsurance agreements.

Effective November 1, 2001, the Company acquired the renewal rights to the independent agency business of OneBeacon, excluding New York, New Jersey and New England. The business includes small commercial and personal lines and gross written premiums were \$979 for 2002. Under the terms of the agreement, the Company retains one third of the underwriting results in the first year, two thirds in the second year and one hundred percent thereafter. The transaction excludes insurance liabilities for policies incepting prior to the effective date. Under the terms of the transaction, the Company assumed the related infrastructure, employees and underwriting responsibility for the business.

The Company has an aggregate reinsurance recoverable from Nationwide Indemnity Company in the amount of \$1,058 and \$1,099 as of December 31, 2002 and 2001, respectively. The reinsurance recoverable is guaranteed by Nationwide Mutual Insurance Company. Additionally, the Company has significant reinsurance recoverable concentrations with National Indemnity Company (a Berkshire Hathaway, Inc. subsidiary), North American Specialty Insurance Company (a subsidiary of Swiss Reinsurance Company), and Federal Insurance Company (a Chubb subsidiary) totaling \$464, \$470, and \$282, respectively, as of December 31, 2002, net of offsetting liabilities under the contracts.

The Company serves as a servicing carrier for various residual market organizations. Unearned premiums and unpaid claims and claim adjustment expenses ceded to residual market organizations totaled \$2,229 and \$1,950 as of December 31, 2002 and 2001, respectively.

In 2002 and 2001, the Company entered into retroactive reinsurance treaties with unaffiliated entities. The Company transferred unpaid claims and claim adjustment expenses of \$124 and \$1,603 and recorded deferred gains of \$0 and \$800 in 2002 and 2001, respectively. Accrued contingent profit sharing commissions of \$195 and \$162 were recorded as of December 31, 2002 and 2001, respectively.

(8) DEBT OUTSTANDING

Debt outstanding at December 31, 2002 and 2001 includes the following:

Short-term debt:

	2002	2001
Commercial paper	\$ 50	\$175
Revolving credit facilities	18	31
Receivables financing	40	72
Current maturities of long-term debt	35	12
Total short-term debt	<u>\$143</u>	<u>\$290</u>

Long-term debt:

	2002	2001
8.20%, Surplus Notes, due 2007	\$ 250	\$ 250
6.75%, Notes, due 2008	18	20
8.50%, Surplus Notes, due 2025	150	150
7.87%, Surplus Notes, due 2026	250	250
7.63%, Notes, due 2028	3	3
7.70%, Surplus Notes, due 2097	500	500
6.76% - 8.10%, Medium Term Notes, with various maturities	88	124
	<u>1,259</u>	<u>1,297</u>
Unamortized discount	(9)	(9)
Total long-term debt excluding current maturities	<u>\$1,250</u>	<u>\$1,288</u>

Short-term Debt

The Company issues commercial paper to meet short-term operating needs. The total facility was \$600 at December 31, 2002 and 2001 and is backed up by a \$450 line of credit facility (\$300 in 2001). Commercial paper issued and outstanding at December 31, 2002 and 2001 was \$50 and \$175, respectively. Interest rates ranged from 1.40% to 3.10% in 2002 and 2.05% to 6.63% in 2001. Interest expense on the commercial paper was \$3 and \$13 during 2002 and 2001, respectively.

In 2002 and 2001, the Company entered into one-year financing transactions, whereby LMGI sold \$142 and \$85 of premiums receivable, with recourse, for \$121 and \$72, respectively. The interest rate on this financing is the lender's cost of commercial paper plus 75 basis points.

Long-term Debt

Payments of interest and principal of the surplus notes are expressly subordinate to all policyholder claims and other obligations of LMIC. Accordingly, interest and principal payments are contingent upon prior approval of the Commissioner of Insurance of the Commonwealth of Massachusetts.

At December 31, 2002, the principal maturity schedule of long-term borrowings is as follows:

2004	\$ -
2005	61
2006	27
2007	250
Thereafter	<u>912</u>
	<u>\$1,250</u>

In 2002 and 2001, the Company entered into an arrangement to sell and leaseback certain furniture and equipment. The initial lease term is 13 months with the Company having the option to renew the lease monthly for up to five years at which time the Company has a purchase option. The weighted average interest rate on the lease is LIBOR plus 145 basis points. The transactions are accounted for as capital leases. The capital lease obligations as of December 31, 2002 and 2001 were \$114 and \$126, respectively, and are included in other liabilities.

As of December 31, 2002, the Company's future minimum lease payments under the sale-leaseback agreement through maturity are approximately \$36 for 2003, \$36 for 2004, \$23 for 2005, \$22 for 2006, and \$2 for 2007.

Interest

The Company paid \$113 and \$121 of interest in 2002 and 2001, respectively, and incurred \$116 and \$124 of interest expense in 2002 and 2001, respectively.

(9) FEDERAL AND FOREIGN INCOME TAXES

LMHC, Montgomery, and M&B each file separate Federal income tax returns. Each company files a consolidated Federal income tax

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return with their respective eligible subsidiaries. Pursuant to intercompany Federal income tax allocation agreements that each of these companies have with their respective subsidiaries, the consolidated tax liabilities are allocated to each company based on its separate return tax liability. Tax benefits are allocated to each company for its portion of net operating losses and tax credit carry forwards in the year they are used by the respective consolidated groups. Intercompany tax balances are settled quarterly.

A provision is made, where applicable, for taxes on foreign operations.

The components of Federal and foreign income tax expense (benefit) related to continuing operations are:

YEARS ENDED DECEMBER 31,	2002	2001
Current tax expense (benefit):		
United States Federal	\$ 241	\$(129)
United States Federal benefit of net operating losses	(195)	—
Foreign	39	25
Total current tax expense (benefit)	85	(104)
Deferred tax expense (benefit):		
United States Federal	(27)	486
Foreign	20	(97)
Total deferred tax (benefit) expense	(7)	389
Total Federal and foreign income tax expense	\$ 78	\$ 285

A reconciliation of the income tax expense (benefit) attributable to continuing operations computed at U.S. Federal statutory tax rates to the income tax expense (benefit) as included in the consolidated statements of income follows:

YEARS ENDED DECEMBER 31,	2002	2001
Expected Federal income tax expense (benefit)	\$208	\$(593)
Tax effect of:		
Nontaxable investment income	(29)	(54)
Change in valuation allowance	(35)	975
Goodwill	(14)	(14)
Revisions to estimates	(64)	(80)
Other	12	51
Actual Federal and foreign income tax expense	\$ 78	\$ 285

The significant components of the deferred income tax assets and liabilities at December 31, are summarized as follows:

	2002	2001
Deferred tax assets:		
Unpaid claims	\$ 769	\$ 823
Unearned premium reserves	310	263
Net operating losses	377	542
Employee benefits	204	158
Retroactive reinsurance	379	388
Other	484	626
Less: valuation allowance	(1,016)	(1,051)
Total deferred tax assets	1,507	1,749
Deferred tax liabilities:		
Deferred acquisition costs	260	233
Investments	585	601
Other	48	248
Total deferred tax liabilities	893	1,082
Net deferred tax assets	\$ 614	\$ 667

Management believes it is more likely than not that the deferred tax assets, net of valuation allowance, will be realized based primarily on the assumption that certain levels of future income will be achieved.

The Company had net operating loss carry forwards of \$1,300, alternative minimum tax credit carry forwards of \$147, and foreign tax credit carry forwards of \$21 as of December 31, 2002. The net operating loss carry forwards and foreign tax credits will begin to expire, if not utilized, in 2003 and the alternative minimum tax credits do not expire.

The Company has not provided for deferred taxes on unremitted earnings of subsidiaries outside the United States where such earnings are permanently reinvested. At December 31, 2002, unremitted earnings of foreign subsidiaries were \$263. If these earnings were distributed in the form of dividends or otherwise, the Company would be subject to U.S. income taxes less an adjustment for applicable foreign tax credits.

During 2002, the Company reached a settlement with the Internal Revenue Service ("IRS") relating to its Federal income taxes for the 1985-1993 tax years. In addition, the IRS has completed its review of the Company's Federal income tax returns through the 1998 tax year and is currently reviewing income tax returns for the 1999 through 2001 tax years. Any adjustments that may result from the IRS examinations of these income tax returns are not expected to have a material impact on the financial position, liquidity or results of operations of the Company.

(10) BENEFIT PLANS

The Company sponsors noncontributory defined benefit pension plans ("the Plans") covering substantially all U.S. and Canadian employees. The benefits and eligibility are based on age, years of service and the employee's compensation, as more fully described in the Plans.

Assets of the Plans consist primarily of investments in life insurance company separate accounts and a collective investment trust fund, which invests primarily in fixed income and Standard and Poor's 500 Index of equity securities. At December 31, 2002 and 2001, assets of the Plans totaling \$1,720 and \$2,000, respectively, were held in separate accounts of the Company.

The Company sponsors a supplemental retirement plan ("SIRP") for certain executives to provide pension benefits above the levels provided by the pension plans without regard to the statutory earnings limitations of qualified defined benefit pension plans. The supplemental plans are unfunded.

The Company also provides certain health care and life insurance benefits ("Postretirement") for retired employees of certain subsidiaries. A significant portion of U.S. and Canadian employees may become eligible for these benefits. Alternatively, retirees may elect certain health care benefit plans. Life insurance benefits are based upon a participant's final compensation subject to the plan maximum.

The following table sets forth the assets, obligations and assumptions associated with the various pension and post-retirement benefits. The amounts are recognized in the accompanying consolidated balance sheets as of December 31, 2002 and 2001, and consolidated statements of income for the years then ended:

	PENSION BENEFITS		SIRP BENEFITS		POSTRETIREMENT BENEFITS	
	2002	2001	2002	2001	2002	2001
Change in benefit obligations:						
Benefit obligation at beginning of year	\$1,966	\$1,627	\$ 112	\$ 102	\$ 426	\$ 380
Eligibility costs	88	70	4	3	13	11
Interest cost	131	121	10	7	29	27
Amendments	—	58	—	2	(38)	(2)
Actuarial (gain) loss	(49)	147	27	(1)	34	19
Benefits paid	(97)	(86)	(6)	(3)	(24)	(26)
Other	(3)	29	13	2	(1)	17
Benefit obligations at end of year	\$2,036	\$1,966	\$ 160	\$ 112	\$ 439	\$ 426
Accumulated benefit obligations	\$1,760	\$1,761	\$ 132	\$ 87	\$ 439	\$ 426
Change in plan assets:						
Fair value of plan assets at beginning of year	\$2,174	\$2,434	\$ —	\$ —	\$ 22	\$ 25
Actual return on plan assets	(234)	(195)	—	—	—	(1)
Employer contribution	—	—	—	—	22	24
Benefits paid	(97)	(86)	—	—	(24)	(26)
Other	(12)	21	—	—	—	—
Fair value of plan assets at end of year	\$1,831	\$2,174	\$ —	\$ —	\$ 20	\$ 22
Reconciliation of funded status:						
Funded status of the plan	\$ (205)	\$ 208	\$ (160)	\$ (112)	\$ (419)	\$ (404)
Unrecognized net (gain)/loss	336	(87)	46	21	(32)	(68)
Unrecognized prior service cost	53	58	18	20	(47)	(10)
Unrecognized net transition (asset)/obligation	(57)	(64)	2	3	135	145
Net amount recognized	\$ 127	\$ 115	\$ (94)	\$ (68)	\$ (363)	\$ (337)
Components of net periodic benefit costs						
Eligibility costs	\$ 88	\$ 70	\$ 4	\$ 3	\$ 13	\$ 11
Interest cost	131	121	10	7	29	27
Expected return on plan assets	(215)	(212)	2	—	(2)	(2)
Amortization of unrecognized:						
Net (gain)/loss	(14)	(27)	1	1	(2)	(3)
Prior service cost	5	—	1	2	(1)	(1)
Net transition (assets)/obligation	(7)	(6)	1	—	10	10
Net periodic benefit costs	\$ (12)	\$ (54)	\$ 19	\$ 13	\$ 47	\$ 42
Amounts recognized in the consolidated balance sheets consist of:						
Prepaid benefit cost	\$ 127	\$ 115	\$ —	\$ —	\$ —	\$ —
Accrued benefit liability	—	—	(132)	(87)	(363)	(337)
Intangible asset	—	—	19	19	—	—
Accumulated other comprehensive income	—	—	19	—	—	—
Net amounts recognized at year end	\$ 127	\$ 115	\$ (94)	\$ (68)	\$ (363)	\$ (337)
Weighted average assumptions						
Discount rate	7.00%	7.00%	7.00%	7.00%	7.00%	7.25%
Expected return on plan assets	8.50%	9.00%	—	—	7.15%	7.15%
Rate of compensation increase	5.20%	5.20%	4.90%	4.90%	—	—

(CONTINUED)

The average health care cost trend rates were 10.00% in 2002 and 5.75% in 2001. The 2002 rate is graded to 5% over six years. Health care cost trend rate assumptions have a material impact on the postretirement benefit obligation. A one-percentage change in assumed health care cost trend rates would have the following effects:

	1% POINT INCREASE	1% POINT DECREASE
Effect on total service and interest costs	\$6	\$(5)
Effect on accumulated benefit obligation	\$46	\$(41)

The Company sponsors defined contribution savings plans (a 401(k) plan) for substantially all U.S. and Canadian employees who meet certain eligibility requirements. During 2002 and 2001, employees could contribute a percentage of their annual compensation on a before and after-tax basis, subject to Federal limitations. In 2002 and 2001, the Company made matching contributions of \$61 and \$57, respectively.

Some foreign subsidiaries sponsor non-contributory pension plans to employees which provide benefits based on final pay. The assets of the plans are held separately from the assets of the foreign subsidiaries. Pension costs charged to the foreign subsidiaries operations during 2002 and 2001 were \$5 and \$2, respectively. The market value of the plan assets as of December 31, 2002 and 2001 was \$16 and \$7, respectively. The accumulated benefit obligation under the plans as of December 31, 2002 and 2001 was \$15 and \$6, respectively.

The Company provides various performance based compensation plans to employees meeting the participation requirements of the respective plans. Related compensation is determined in accordance with plan formulas.

(11) FAIR VALUE OF FINANCIAL INSTRUMENTS

Statement of Financial Accounting Standards No. 107, "Disclosures about Fair Value of Financial Instruments" requires disclosure of fair value information about financial instruments, as defined therein, for which it is practicable to estimate such fair value. All financial instruments may not be recognized in the consolidated balance sheets. SFAS 107 excludes certain financial instruments, including those related to certain insurance contracts. In the measurement of the fair value of certain financial instruments, quoted market prices were not available and other valuation techniques were utilized. These derived fair value estimates are significantly affected by the assumptions used. The following methods and assumptions were used to estimate the fair value of the financial instruments presented:

Cash and cash equivalents and short-term investments: The carrying amounts reported in the consolidated balance sheets for these instruments approximate fair values.

Fixed maturities: Fair values for fixed maturities were generally based upon quoted market prices. For certain fixed maturities securities for which quoted market prices were not available, fair values were estimated using values obtained from independent pricing services, or in the case of private placements, were determined by discounting expected future cash flows using a current

market rate applicable to the yield, credit quality, and maturity of the securities.

Equity securities: Fair values for equity securities were based upon quoted market prices.

Other Investments: Fair values represent the Company's equity in the partnership's net assets as determined by the respective General Partner.

Future policy benefits: Fair values for deferred annuity contracts are equal to current net surrender value. Fair values of liabilities under investment-type insurance contracts, including individual and group annuities, are estimated using discounted cash flow calculations at current pricing rates.

Debt outstanding: Fair values of commercial paper and short-term borrowings approximate carrying value. Fair values of long-term debt were either based upon quoted market prices or estimated using discounted cash flow analyses based on the Company's incremental borrowing rate.

The fair values and carrying values of the Company's financial instruments at December 31, 2002 and 2001 are as follows:

	2002		2001	
	CARRYING VALUE	FAIR VALUE	CARRYING VALUE	FAIR VALUE
Fixed maturity securities	\$26,968	\$26,968	\$24,993	\$24,993
Equity securities	1,088	1,088	2,088	2,088
Trading securities	227	227	156	156
Other investments	675	675	761	761
Short-term investments	779	779	553	553
Cash and cash equivalents	2,615	2,615	3,231	3,231
Future policy benefits, other plan funds and benefits payable	4,210	4,210	3,617	3,617
Debt	1,393	1,170	1,578	1,443
Separate account assets	1,887	1,887	2,198	2,198
Separate account liabilities	1,887	1,887	2,198	2,198

(12) COMMITMENTS AND CONTINGENT LIABILITIES

Various lawsuits against the Company have arisen in the normal course of business. Contingent liabilities arising from litigation, income taxes and other matters are not considered material in relation to the financial position of the Company.

The Company leases certain office facilities and equipment under operating leases expiring in various years through 2009. Rental expense amounted to \$165 and \$178 for the years ended December 31, 2002 and 2001, respectively. Future minimum rental payments under non-cancelable leases with terms in excess of one year are estimated as follows:

2003	\$145
2004	122
2005	98
2006	68
2007	51
Thereafter	<u>270</u>
Total	<u>\$754</u>

It is expected that as leases expire they will be replaced.

At December 31, 2002, the Company had unfunded capital commitments to private equity investments of \$797.

At December 31, 2002, the Company had commitments to purchase various mortgage backed securities settling in 2003, at a cost of \$725 and a fair value of \$744 and are included as fixed maturities on the consolidated balance sheets.

The Company is subject to guaranty funds and other assessments. Guaranty fund assessments are accrued at the time an insolvency is known. Premium based assessments are accrued when the premiums are written and loss based assessments are accrued when the losses are incurred. Other assessments are accrued when assessed.

The Company has accrued a liability for guaranty funds and other assessments of \$210. This represents management's best estimate of the liability. The amount of guaranty fund assessments varies each year and will be paid for the foreseeable future.

During 2001, the Company received notification of the insolvency of the Reliance Insurance Group. It is expected the insolvency will result in a guaranty fund assessment of \$104.

(13) POLICYHOLDERS' EQUITY

Statutory Surplus

Statutory surplus of the Company's domestic insurance companies was \$5.2 billion and \$5.8 billion at December 31, 2002 and 2001, respectively. Effective January 1, 2001, the Company's domestic insurance subsidiaries began preparing the statutory basis financial statements in accordance with the revised Accounting Practices and Procedures Manual of the National Association of Insurance Commissioners (a process referred to as "codification"), subject to any deviations prescribed by the insurance commissioners of the various insurance companies' states of domicile. The impact of codification was a reduction in statutory surplus of \$181. The Company does not have any material permitted practices that deviate from codification.

Dividends

The Company's domestic insurance subsidiaries are subject to various regulatory restrictions that limit the maximum amount of dividends that can be paid without the prior approval of insurance regulatory authorities. The maximum amount of dividends to be paid is generally based on surplus and net income. Additionally, as a result of a Keep Well Agreement dated November 28, 2001 between LMHC MA, LMGI, the Company, and the Massachusetts Commissioner of Insurance, the maximum dividend payout is also based on the authorized control level risk-based capital of certain insurance subsidiaries. The maximum dividend payout in 2003 that may be made prior to regulatory approval is \$125.

The Board of Directors

Liberty Mutual Holding Company Inc.

The accompanying consolidated financial statements and related information contained in this annual report are the responsibility of management and have been prepared in conformity with generally accepted accounting principles. These consolidated financial statements include amounts that are based on management's estimates and judgments, particularly our reserves for losses and loss adjustment expenses. We believe that these consolidated financial statements present fairly the Company's financial position and results of operations and that other information contained in the annual report is consistent with the consolidated financial statements.

We maintain and rely on a system of internal accounting controls designed to provide reasonable assurance that assets are safeguarded and transactions are properly authorized and recorded. We continually monitor these internal accounting controls, modifying and improving them as business conditions and operations change. Additionally, our internal audit department independently reviews and evaluates these controls. We believe our systems of internal accounting controls provide reasonable assurance that errors or irregularities that would be material to the consolidated financial statements are prevented or detected in the normal course of business.

Our independent auditors, Ernst & Young LLP, have audited the consolidated financial statements and expressed their opinion on the fairness of these consolidated financial statements. Their audit provides an independent, objective review of our consolidated financial statements. They review our internal controls and procedures, perform tests of accounting records, and conduct other auditing procedures as they consider necessary to comply with auditing standards generally accepted in the United States.

The Audit Committee of the Board of Directors, comprised solely of outside directors, oversees management's discharge of its financial reporting responsibilities. The Audit Committee meets periodically with management, our internal auditors and representatives from Ernst & Young LLP to discuss auditing, financial reporting and internal control matters. Both our internal audit department and Ernst & Young LLP have access to the Audit Committee without management's presence.



Edmund F. Kelly
Chairman, President and Chief Executive Officer



J. Paul Condrin, III
Senior Vice President and Chief Financial Officer

The Board of Directors
Liberty Mutual Holding Company Inc.

We have audited the accompanying consolidated balance sheets of Liberty Mutual Holding Company Inc. and subsidiaries (the Company) as of December 31, 2002 and 2001, and the related consolidated statements of income, changes in policyholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Liberty Mutual Holding Company Inc. and subsidiaries at December 31, 2002 and 2001, and the consolidated results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

As discussed in Note 1 to the consolidated financial statements, in 2002, the Company adopted Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" and the remaining provisions of Financial Accounting Standards No. 141, "Business Combinations".

As discussed in Note 1 to the consolidated financial statements, in 2001, the Company adopted Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities".

Boston, Massachusetts
March 14, 2003

Ernst & Young LLP