

Consolidated Financial Statements of

**Imagine Group Holdings Limited**

December 31, 2004



# Imagine Group Holdings Limited

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## **AUDITORS' REPORT TO THE SHAREHOLDERS**

We have audited the accompanying consolidated balance sheet of Imagine Group Holdings Limited as of December 31, 2004 and the related consolidated statements of income, changes in shareholders' equity and cash flows for the year 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 audit.

We conducted our audit in accordance with International Standards on Auditing. 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 audit provides a reasonable basis for our opinion.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as of December 31, 2004 and the results of its operations and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Chartered Accountants  
Bridgetown, Barbados  
March 22, 2005

# IMAGINE GROUP HOLDINGS LIMITED

## Consolidated Balance Sheet

As at December 31, 2004 with comparative figures for 2003

(Expressed in United States Dollars)

	<u>Notes</u>	<u>2004</u>	<u>2003</u>
<b>Assets</b>			
Cash and investments			
Cash	4 & 14	\$ 426,055,627	\$ 66,985,800
Short-term investments, at amortized cost			
which approximates fair value	4	250,416,690	124,691,047
Fixed maturities – available for sale at fair value	5 & 14	736,992,446	540,860,229
Derivative financial instruments held for trading at fair value	6	900,000	-
Structured insurance assets	7	88,739,425	48,380,634
Equities - available for sale at fair value		<u>5,312,004</u>	<u>-</u>
<b>Total cash and investments</b>		<b><u>1,508,416,192</u></b>	<b><u>780,917,710</u></b>
Accrued investment income		7,748,155	6,146,589
Funds held by ceding companies		17,415,116	7,520,499
Premiums and other reinsurance balances receivable		110,992,836	184,583,772
Deferred policy acquisition costs		23,330,344	6,603,529
Prepaid reinsurance premiums		19,000,933	14,823,794
Reinsurance deposits		43,000,000	-
Corporation taxes recoverable		2,207,106	209,837
Deferred tax assets	18	1,073,585	726,818
Reinsurance losses recoverable	20	123,256,178	-
Other assets		<u>32,119,907</u>	<u>7,754,293</u>
<b>Total Assets</b>		<b><u>\$ 1,888,560,352</u></b>	<b><u>\$ 1,009,286,841</u></b>
<b>Liabilities and Shareholders' Equity</b>			
<b>Liabilities</b>			
Claims and claims adjustment expenses	8	\$ 871,364,868	\$ 324,198,596
Unearned premiums	9	105,967,018	134,921,003
Deposit liabilities		172,043,343	89,293,104
Reinsurance balances payable	14 & 20	55,155,257	38,149,359
Corporation taxes payable		2,464,470	1,977,619
Deferred tax liabilities	18	14,318,930	3,311,302
Loans payable	10	52,445,508	10,179,000
Accounts payable and other liabilities		<u>87,924,202</u>	<u>19,499,501</u>
<b>Total Liabilities</b>		<b><u>1,361,683,596</u></b>	<b><u>621,529,484</u></b>
Minority interest		<u>845,046</u>	<u>924,926</u>
<b>Shareholders' Equity</b>			
Share capital	11	478,415,031	331,038,991
Unrealized investment (losses) gains	5	(115,132)	10,764,044
Cumulative translation adjustment		1,285,229	1,066,934
Retained earnings		<u>46,446,582</u>	<u>43,962,462</u>
<b>Total Shareholders' Equity</b>		<b><u>526,031,710</u></b>	<b><u>386,832,431</u></b>
<b>Total Liabilities and Shareholders' Equity</b>		<b><u>\$ 1,888,560,352</u></b>	<b><u>\$ 1,009,286,841</u></b>

See accompanying notes to consolidated financial statements

Approved on behalf of the Board:

..... Director

..... Director

# IMAGINE GROUP HOLDINGS LIMITED

## Consolidated Statement of Income

For the year ended December 31, 2004 with comparative figures for 2003

*(Expressed in United States Dollars)*

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	<u>Notes</u>	<u>2004</u>	<u>2003</u>
<b>Revenues:</b>			
Gross written premiums		\$ 519,169,277	\$ 609,921,843
Ceded premiums		<u>(12,917,437)</u>	<u>(16,095,539)</u>
Net written premiums		506,251,840	593,826,304
Change in unearned premiums	9	<u>60,818,987</u>	<u>(119,619,478)</u>
Net earned premiums		<u>567,070,827</u>	<u>474,206,826</u>
Net investment income	5	37,013,159	49,899,101
Net realized investment gains		4,324,880	3,596,027
Negative goodwill	3	30,941,083	-
Other income		<u>18,151,988</u>	<u>10,386,849</u>
<b>Total revenues</b>		<u>657,501,937</u>	<u>538,088,803</u>
<b>Expenses:</b>			
Claims and claims adjustment expenses incurred	8	463,349,157	399,149,785
Policy acquisition costs		104,308,219	75,376,708
Operating expenses	13	<u>42,323,893</u>	<u>23,007,941</u>
<b>Total expenses</b>		<u>609,981,269</u>	<u>497,534,434</u>
Income before corporation taxes		47,520,668	40,554,369
Corporation tax recovery/(expense)	17	<u>2,339,492</u>	<u>(5,561,509)</u>
Net income for the year		\$ <u>49,860,160</u>	\$ <u>34,992,860</u>

*See accompanying notes to consolidated financial statements*

# IMAGINE GROUP HOLDINGS LIMITED

## Consolidated Statement of Changes in Shareholders' Equity

For the year ended December 31, 2004 with comparative figures for 2003

*(Expressed in United States Dollars)*

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	<u>2004</u>	<u>2003</u>
<b>Share Capital</b>		
Balance at beginning of the year	\$ 331,038,991	\$ 298,038,991
Conversion of preferred shares	(318,000,000)	-
Par value of common shares issued during the year	49,614,164	330,000
Share premium on common shares issued during the year	<u>415,761,876</u>	<u>32,670,000</u>
Balance at end of the year	\$ <u>478,415,031</u>	\$ <u>331,038,991</u>
<b>Unrealized Investment Gains/(Losses)</b>		
Balance at beginning of the year	\$ 10,764,044	\$ 10,422,425
Change in unrealized investment (losses)/gains	<u>(10,879,176)</u>	<u>341,619</u>
Balance at end of the year	\$ <u>(115,132)</u>	\$ <u>10,764,044</u>
<b>Cumulative Translation Adjustment</b>		
Balance at beginning of the year	\$ 1,066,934	\$ 463,960
Change in cumulative translation adjustment	<u>218,295</u>	<u>602,974</u>
Balance at end of the year	\$ <u>1,285,229</u>	\$ <u>1,066,934</u>
<b>Retained Earnings</b>		
Balance at beginning of the year	\$ 43,962,462	\$ 41,969,602
Net income for the year	49,860,160	34,992,860
Dividends on preference shares	<u>(47,376,040)</u>	<u>(33,000,000)</u>
Balance at end of the year	\$ <u>46,446,582</u>	\$ <u>43,962,462</u>
<b>Total Shareholders' Equity at the end of the year</b>	<b>\$ <u>526,031,710</u></b>	<b>\$ <u>386,832,431</u></b>

*See accompanying notes to consolidated financial statements*

# IMAGINE GROUP HOLDINGS LIMITED

## Consolidated Statement of Cash Flows

For the year ended December 31, 2004 with comparative figures for 2003

(Expressed in United States Dollars)

	2004	2003
<b>Cash flows from operating activities</b>		
Income before corporation taxes	\$ 47,520,668	\$ 40,554,369
Adjustments to reconcile net income to net cash provided by operating activities:		
Negative goodwill	(30,941,083)	-
Interest income	(33,897,596)	(36,951,927)
Net realized investment gains	(4,324,880)	(3,596,027)
Amortization of goodwill	-	54,293
Unrealized investment gain on embedded derivatives	(4,923,207)	(12,947,174)
Unrealized investment gain on derivative financial instruments	1,807,644	-
Funds held by ceding companies	(9,894,617)	6,564,143
Premiums and other reinsurance balances receivable	90,609,936	(134,594,876)
Deferred policy acquisition costs	(10,633,815)	(6,603,529)
Prepaid reinsurance premiums	4,829,861	(14,823,794)
Reinsurance deposits	(43,000,000)	4,000,000
Reinsurance losses recoverable	(22,791,393)	-
Other assets	(13,256,799)	661,388
Claims and claims adjustment expenses	242,959,022	115,618,810
Unearned premiums	(60,628,985)	120,718,836
Deposit liabilities	82,750,239	30,162,972
Reinsurance balances payable	16,986,700	(48,776,003)
Accounts payable and other liabilities	12,131,746	6,052,968
Minority interests	(1,132)	29,923
Corporation taxes paid	(2,095,901)	(2,312,432)
<b>Cash provided by operating activities</b>	<u>263,206,408</u>	<u>63,811,940</u>
<b>Cash flows from investing activities</b>		
Interest received	33,608,685	36,219,160
Acquisition of subsidiaries, net of cash acquired	267,923,634	3,016,552
Net purchase of structured insurance assets	(35,355,584)	(28,010,272)
Net purchase of derivative financial instruments	(353,914)	-
Purchase of equities	(5,000,000)	-
Purchase of fixed maturities and short-term investments	(2,777,294,724)	(1,985,742,166)
Proceeds on sale of fixed maturities and short-term investments	<u>2,638,057,023</u>	<u>1,867,448,126</u>
<b>Cash provided by (used in) investing activities</b>	<u>121,585,120</u>	<u>(107,068,600)</u>
<b>Cash flows from financing activities</b>		
Issuance of shares	465,376,040	33,000,000
Conversion of preferred shares	(318,000,000)	-
Dividends paid	(47,376,040)	(33,000,000)
Net proceeds from loan	<u>3,942</u>	<u>179,000</u>
<b>Cash provided by financing activities</b>	<u>100,003,942</u>	<u>179,000</u>
Net increase (decrease) in cash and cash equivalents	484,795,470	(43,077,660)
Cash and cash equivalents at beginning of the year	<u>191,676,847</u>	<u>234,754,507</u>
Cash and cash equivalents at end of the year	<u>\$ 676,472,317</u>	<u>\$ 191,676,847</u>
<b>Represented by:</b>		
Cash	\$ 426,055,627	\$ 66,985,800
Short-term investments	<u>250,416,690</u>	<u>124,691,047</u>
	<u>\$ 676,472,317</u>	<u>\$ 191,676,847</u>

See accompanying notes to consolidated financial statements

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

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## 1. General and Background

Imagine Group Holdings Limited (the "Company" or "IGHL") is a holding company formed under the laws of Bermuda. The Company was incorporated on December 10, 1998. At December 31, 2004, there were 128 employees (2003 – 77). The Consolidated Financial Statements were authorized for issue by the directors on March 22, 2005.

The Company provides structured insurance and reinsurance capital to the global insurance marketplace. The Company offers these services through its direct and indirect subsidiaries as follows:

<u>Company</u>	<u>% Interest</u>	<u>Domicile</u>
Danish Re (Bermuda) Limited	100%	Bermuda
Danish Re (U.K.) Group Limited	100%	U. K
Danish Re Capital Limited	100%	U. K.
Danish Re Syndicates Limited	100%	U .K.
Polder Limited	100%	U. K
Fenwall Limited	100%	U .K.
Danish Re Underwriting Agencies ApS	100%	Denmark
Danish Reinsurance Group Limited*	100%	Ireland
Danre 1400 Singapore Pte. Limited	100%	Singapore
Danish Re (Australia) Pty. Limited*	100%	Australia
First Property & Casualty Corporation	100%	Canada
IBNI Insurance Services Limited	100%	Canada
Imagine Re (Luxembourg) S.A.	100%	Luxembourg
Imagine Intermediary Holding Company Limited	100%	Barbados
Imagine Insurance Company Limited	100%	Barbados
Pillar Insurance Company (Bermuda) Limited	100%	Bermuda
Imagine International Reinsurance Limited	100%	Ireland
Imagine Insurance A/S	100%	Denmark
Imagine Reinsurance S. A.	100%	Luxembourg
Imagine U.S. Holdings Limited	100%	Delaware
Imagine Reinsurance SCC	100%	Barbados
Perspective Financial Products Limited*	100%	Bermuda
Perspective Capital Markets ApS*	100%	Denmark
Imagine Advisors, Inc.	100%	Connecticut
Imagine Advisors GmbH*	100%	Switzerland
Perspective Asset Management (2004) Limited	100%	Barbados
Imagine Reinsurance U.S. Limited	100%	Barbados
Affiliated Chemical Insurance Limited	100%	Bermuda
Pillar Insurance Company Limited	100%	Gibraltar
Imagine Group (Australia) Pty. Limited	100%	Australia
Imagine Corporate Capital Limited	96.7%	U. K
GMA Imagine Limited	66.67%	U. K.
Imagine Underwriting Limited	66.67%	U. K.
Imagine Management Services Limited	66.67%	U. K.
Risk Corp Inc.	49%	Canada

\*These companies are currently going through the process of being dissolved.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

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## 2. Significant accounting policies

The accompanying Consolidated Financial Statements are prepared in accordance with International Financial Reporting Standards (IFRS) adopted by the International Accounting Standards Board (IASB). They are prepared on the historical cost basis as modified by the accounting for investments and derivative financial instruments as detailed in Notes 2(b) and (c).

The accounting policies applied by the Company are consistent with those used in the previous year.

The preparation of Consolidated Financial Statements in accordance with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Significant accounting policies are as follows:

### a) *Principles of consolidation*

The Consolidated Financial Statements include IGHL and all of its subsidiaries that are controlled, directly or indirectly, by IGHL. A listing of the Company's significant subsidiaries is included in Note 1.

Companies acquired are consolidated from the date on which control over the net assets and operations of the acquiree is effectively transferred to the Company. The financial effects of the acquisitions on December 8 and 31, 2004, are described in Note 3. All intercompany balances and transactions including unrealized intercompany profits have been eliminated.

### b) *Investments and structured insurance assets*

The Company classified its investments in the following categories: trading, originated loans and available-for-sale. The classification is dependent on the purpose for which the investments were acquired. Management determines the classification of its investments at the time of the purchase and re-evaluates such designation on a regular basis.

#### i) *Fixed maturities, equities and short-term investments*

Investments in fixed maturities and equities are classified as available-for-sale. Available-for-sale investments are initially recorded at cost, including transaction costs and are subsequently recorded at fair value based on published market prices. Unrealized gains and losses arising from changes in fair value are included in shareholders' equity. Realized gains and losses arising from the sale of these investments, which are determined by specific identification, are included in net income and include adjustments for declines in value that are considered other than temporary.

Short-term investments, which have a maturity of one year or less at the date of acquisition, are carried at amortized cost, which approximates fair value.

All regular way purchases and sales of investment securities are recognized at the trade date, which is the date that the Company commits to purchase or sell the financial instrument.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

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## 2. Significant accounting policies (Continued)

### *ii) Structured insurance assets*

Structured insurance assets consist of alternative assets sourced from insurance or insurance related business and include both purchased insurance claims and commission arrangements.

In purchasing structured insurance assets, the Company does not act as an insurer and does not assume any obligation to pay claims or to cover their inherent litigation or arbitration exposures. The Company receives the assignment of the right to pursue recovery of the value of the remaining insurance claims or reinsurance recoveries. The Company does take on the credit risk of the insurance carriers who have the ultimate payment obligation for each asset type as well as the actuarial risks (mortality, morbidity, lapse, etc.) affecting the timing of those payments. The majority of these insurance carriers are investment grade and the assets have short repayment durations.

Purchased insurance claims are recorded at cost. Revenue is recognized by applying the effective interest method to the cash flows which are expected to be received over the term to maturity of the claims.

Contracts entitling the Company to the right to collect commissions are carried at amortized cost using the effective yield method. Where these arrangements entitle the Company to profit sharing, these rights which fluctuate based on the anticipation of the likely level and timing of future profits, are considered to be embedded derivatives and are split from the host contracts where their risks and characteristics are not closely related to those of the host contracts and the host contracts are not carried at fair value, with unrealized gains and losses reported in income. Embedded derivatives are accounted for as trading investments which are initially recognized at cost, including transaction costs, and subsequently re-measured at their fair value based on discounted cash flow models.

The commissions due to the Company under this arrangement have actuarial and credit risks. The Company takes on the credit risk of the insurance carriers who have the ultimate payment obligation for each asset type. The majority of these insurance carriers are single "A" investment grade and the assets have short repayment durations of between one and five years. In addition, the Company takes on actuarial risk in the form of the uncertain timing and future payment of the commissions; these can be interrupted or terminated if any of the following events occur: (i) the policy is cancelled by the insured or annual premiums are not paid ("lapse risk"); (ii) the insured becomes sick and makes a claim under the insurance policy ("morbidity risk"); or (iii) the insured dies and the policy expires ("mortality risk").

These actuarial risks are modeled using data drawn from current Society of Actuaries Long Term Care Studies, as well as data from other public and non-public sources, and are used to project the future commission payments the Company can expect to receive from a portfolio of long term care policies. The purchase price paid is based on discounting these cash flows using a U.S. Treasury yield curve on the purchase date adjusted for a credit margin reflecting the insurance carriers' credit risk of making these estimated commission payments over time.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

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## 2. Significant accounting policies (Continued)

### c) *Derivative financial instruments*

Derivative financial instruments, including interest rate swaps and credit default swaps, are originally recognized in the Consolidated Balance Sheet at cost (including transaction costs) and are subsequently re-measured at their fair value.

The fair value of interest rate swaps is the estimated amount that the Company would receive or pay to terminate the swap at the balance sheet date, taking into account current interest rates and current credit worthiness of the counterparties. The fair value of credit default swaps is their quoted market price at the balance sheet date.

All derivative financial instruments are categorized as held for trading. This includes certain instruments which, whilst providing effective economic hedges under the Company's risk management policies, do not qualify for hedge accounting under the specific rules in IAS 39. Changes in fair value of derivative financial instruments, along with realized gain and losses as well as contractual interest and premium payments, are recorded within net investment income.

### d) *Cash and cash equivalents*

In its presentation of the Consolidated Statement of Cash Flows, the Company considers all short-term investments with an original maturity of three months or less to be cash equivalents.

### e) *Claims and claims adjustment expenses*

The liability for claims and claims adjustment expenses represents the estimates of the ultimate cost of all claims incurred but not paid through to the balance sheet date. It is based on individual case estimates received from ceding companies and a provision is also included for claims and claims adjustment expenses related to incurred but not reported ("IBNR") claims, including expected development on reported claims. The IBNR provision is established by a qualified actuary. Inherent in the estimate of ultimate claims are expected trends in frequency, claim severity, timing of claim payments, interest yields and other factors that could vary significantly as claims are settled.

Accordingly, ultimate claims could differ, perhaps substantially, from the best estimate recorded in the Consolidated Financial Statements. These estimates are continually reviewed and, as adjustments become necessary, such adjustments are reflected in current operations. The liability for claims and claims adjustment expenses is shown on a discounted basis for seven (2003 – four) of the contracts which estimates the present value of funds required to pay claims at future dates assuming appropriate interest rates and payment profiles. These reserves are discounted at rates between 2.96% and 5.85% (2003 – 0.91% and 5.52%) based on estimated loss payout patterns. The reserves are discounted where management believes that the timing and amount of claims payments and the amount of the liability are reliably determinable and where anticipated future investment income is an integral variable when pricing a particular contract. However, such liability is necessarily based on estimates and the ultimate liability may exceed the Company's estimates.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

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## 2. Significant accounting policies (Continued)

### f) *Premiums and acquisition costs*

Premiums are recognized as revenue ratably over the period of the related insurance and reinsurance contracts. Unearned premium reserves are established to cover the remainder of the contract period. Acquisition costs are deferred and amortized over the period in which the related premiums are earned. Deferred policy acquisition costs are limited to their estimated realizable value based on the related unearned premiums, anticipated claims and claims expenses and anticipated investment income.

### g) *Deposit accounting*

Reinsurance contracts assumed are reported using deposit accounting if the contracts do not result in a reasonable possibility that the reinsurer may realize a significant loss from the insurance risk assumed and do not provide for the transfer of significant insurance risk to the Company. For these contracts, the Company originally records deposit liabilities for the amount of assets received. Thereafter, these liabilities are reviewed by a qualified actuary and adjusted accordingly. Underwriting income recognized on these contracts is included within other income in the Consolidated Statement of Income.

### h) *Corporation taxes*

Corporation tax on the profit or loss for the year comprises current and deferred tax. Corporation tax is recognized in the Consolidated Statement of Income except to the extent that it relates to items recognized directly to equity, in which case it is recognized in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

The following temporary differences are not provided for: goodwill not deductible for tax purposes, the initial recognition of assets or liabilities that affect neither accounting nor taxable profit, and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realization or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantially enacted at the balance sheet date.

A deferred tax asset is recognized only to the extent that it is probable that future taxable profits will be available against which the asset can be utilized. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

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## 2. Significant accounting policies (Continued)

### i) *Financial instruments*

Fair value disclosures with respect to certain financial instruments are separately included herein where appropriate.

The carrying values of other financial instruments, including cash, accrued investment income, funds held by ceding companies, premiums and other reinsurance balances receivable, other assets, reinsurance deposits, reinsurance losses recoverable, deposit liabilities, reinsurance balances payable and accounts payable and other liabilities approximate their fair value due to their short-term nature.

The estimates of fair values presented herein are subjective in nature and are not necessarily indicative of the amounts that the Company would actually realize in a current market exchange. Any differences would not be expected to be material. Certain items such as deferred policy acquisition costs, prepaid reinsurance premiums and deferred income taxes, the liability for claims and claims adjustment expenses and the liability for unearned premiums are excluded from fair value disclosure. Thus the total fair value amounts cannot be aggregated to determine the underlying fair value of the Company.

Credit risk is the risk that a counterparty will be unable to pay amounts in full when due. The maximum exposure to credit risk is represented by the carrying amount of each financial asset in the Consolidated Balance Sheet, including cash and investments, funds held by ceding companies, premiums and other reinsurance balances receivable, deposit assets and reinsurance losses recoverable. Management monitors the exposure to credit risk on an ongoing basis and credit evaluations are performed for all potential and existing cedants.

Cash and short-term investments are placed with high credit quality financial institutions and the credit risk associated with fixed maturities, derivative financial instruments and structured insurance assets are disclosed in Notes 5, 6 and 7. Premiums and other reinsurance balances receivable as well as reinsurance losses recoverable are reported net of any provision for impairment and funds held by ceding companies are carefully monitored with reference to the credit quality of the cedant.

Interest rate risk is the exposure to the effects of fluctuations in the prevailing levels of market interest rates on the Company's financial position and cash flows. The Company's exposure to interest rate risk is disclosed in Notes 5, 6, 7, 8, 10 and 14.

### j) *Employee benefits*

#### i) *Defined contribution pension plans*

Obligations for contributions to defined contribution pension plans are recognized as an expense in the Consolidated Statement of Income as incurred.

#### ii) *Long-Term Incentive Plan*

The Company has adopted a Long Term Incentive Plan (the "LTIP"), which is outlined in Note 13. The LTIP awards vest over a four-year period. The increase in the vested portion only of the LTIP will be included in operating expenses of the Company in the year incurred.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

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## 2. Significant accounting policies (Continued)

### j) *Employee benefits (Continued)*

#### iii) *Share Options*

The Company does not have a formal share option plan. Where share options are issued to key executives, however, no compensation cost or obligation is recognized at the date of the grant in situations where the exercise price equals the estimated market price of the underlying shares. Where options are exercised, equity is increased by the amount of the proceeds received.

### k) *Foreign currency*

#### i) *Foreign currency transactions*

In the individual subsidiary companies, transactions in foreign currencies are recorded at the exchange rate at the date of the transaction. Foreign currency monetary assets and liabilities are translated at the exchange rate in effect at the balance sheet date. Resulting exchange differences are recognized in the Consolidated Statement of Income for the year. Non-monetary assets and liabilities denominated in foreign currency are recorded at the exchange rate at the date of transaction.

#### ii) *Financial statements of foreign operations*

The Company's foreign operations are not considered an integral part of its operations. Accordingly, the assets and liabilities of foreign operations, including goodwill and fair value adjustment arising on consolidation, are translated at foreign exchange rates ruling at the balance sheet date. The revenues and expenses of foreign operations are translated at rates approximating the foreign exchange rates ruling at the dates of transactions. Foreign exchange differences arising on translation are recognized directly in shareholders' equity.

### l) *Goodwill and negative goodwill*

Positive goodwill represents the excess of the cost of acquisition over the fair value of the Company's share of the identifiable assets, liabilities and contingent liabilities of the acquired subsidiary at the date of acquisition. Such goodwill is tested for impairment annually in accordance with IAS 36 and carried at cost less accumulated impairment charges.

Negative goodwill arising on an acquisition represents the excess of the fair value of the identifiable assets, liabilities and contingent liabilities acquired over the cost of acquisition, after a reassessment of the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination. Such negative goodwill is recognized immediately in the Consolidated Statement of Income.

### m) *Impairment*

The carrying amounts of the Company's assets, other than deferred tax assets, are reviewed at each balance sheet date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated. For intangible assets that are not yet available for use, the recoverable amount is estimated at each balance sheet date. An impairment loss is recognized whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognized in the Consolidated Statement of Income.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

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## 2. Significant accounting policies (Continued)

### m) *Impairment (Continued)*

#### i) *Calculation of recoverable amount*

The recoverable amount of the Company's receivables is calculated as the present value of expected future cash flows, discounted at the original effective interest rate inherent in the asset. Receivables with a short duration are not discounted.

The recoverable amount of other assets is the greater of their net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

#### ii) *Reversals of impairment*

An impairment loss in respect of a receivable is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognized.

In respect of other assets, an impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount.

An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized.

### n) *Operating lease payments*

Payments made under operating leases are recognized in the Consolidated Statement of Income on a straight-line basis over the term of the lease.

### o) *Provisions*

A provision is recognized in the Consolidated Balance Sheet when the Company has a legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

### p) *Offsetting*

Reinsurance assets and related liabilities are offset and the net amount reported in the Consolidated Balance Sheet when there is a legally enforceable right to set off recognized amounts and there is an intention to settle on a net basis.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

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### 3. Acquisition of subsidiaries

#### *Danish Re (Bermuda) Ltd.*

Effective December 31, 2004, the Company acquired Danish Re (Bermuda) Limited ("Dan Re") and its subsidiaries for \$92,856,000 of which \$47,905,500 is to be satisfied in cash subsequent to December 31, 2004, when regulatory approvals are granted, and of which \$44,950,500 will be satisfied by the issuance of a contingent note payable. The portion to be satisfied in cash has been recorded within accounts payable and other liabilities at December 31, 2004. The contingent note payable has been recognized at December 31, 2004 at its discounted value of \$42,262,566 (see Note 10). Also included within the cost of the business combination is \$800,000 in legal and other costs directly attributable thereto. The excess of net identifiable fair value assets, liabilities and contingent liabilities over the cost of the business combination amounting to \$30,426,469 has been recognized immediately in the Consolidated Statement of Income after the careful reassessment of the identification and measurement of Dan Re's identifiable assets, liabilities and contingent liabilities.

Dan Re is an international reinsurance group that focuses on three niche areas of business – Accident and Health, Property and Financial Institutions. Dan Re was established in 1999 and operates through active offices in Bermuda, London, Copenhagen and a representative office in Tokyo. It also has significant reserves associated with certain discontinued operations. As part of its ongoing operations it manages and controls Syndicate 1400 and the affiliated corporate capital vehicles at Lloyd's of London.

#### *First Property and Casualty Corporation*

On December 31, 2004, the Company acquired First Property and Casualty Corporation ("First Property") and its subsidiaries for \$187,386, satisfied in cash. The excess of net identifiable fair value assets, liabilities and contingent liabilities over the purchase price amounting to \$514,614 has been recognized immediately in the Consolidated Statement of Income after the careful reassessment of the identification and measurement of First Property's identifiable assets, liabilities and contingent liabilities. First Property is a risk management group which includes an insurance brokerage and a claims management company.

#### *Imagine Re (Luxembourg) S.A., formerly Nordea Re S.A.*

On December 8, 2004, the Company acquired Nordea Re S.A. for \$30,745,508, satisfied in cash. Goodwill arising on this acquisition of \$5,659,900 has been recognized as an intangible asset within other assets. On December 21, 2004, this company's name changed to Imagine Re (Luxembourg) S.A. Imagine Re (Luxembourg) S.A is a captive insurance company domiciled in Luxembourg.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

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## 3. Acquisition of subsidiaries (Continued)

These acquisitions were accounted for using the purchase method of accounting. The acquisitions had the following effect on the Company's assets and liabilities:

	<u>2004</u>
Cash and cash equivalents	\$ 299,656,528
Fixed maturities	66,055,000
Accrued investment income	1,312,655
Premiums and other reinsurance balances receivable	17,019,000
Reinsurance losses recoverable (net)	100,464,785
Deferred policy acquisition costs	6,093,000
Prepaid reinsurance premiums	9,007,000
Deferred tax assets	384,000
Other assets	5,448,914
Claims and claims adjustment expenses	(304,207,250)
Unearned premiums	(31,675,000)
Reinsurance balances payable	(19,198)
Deferred tax liabilities	(11,997,836)
Corporation taxes payable	(1,972,000)
Accounts payable and other liabilities	<u>(8,387,455)</u>
Net identifiable fair value assets and liabilities	147,182,143
Negative goodwill	(30,941,083)
Positive goodwill	<u>5,659,900</u>
Cost of the business combination	121,900,960
Consideration payable	(47,905,500)
Consideration satisfied by issuance of a contingent note payable	<u>(42,262,566)</u>
Consideration satisfied in cash and including directly attributable costs	31,732,894
Cash and cash equivalents acquired	<u>299,656,528</u>
Net cash inflow per Consolidated Statement of Cash Flows	\$ <u>267,923,634</u>

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

## 4. Cash and cash equivalents

Cash and short-term investments amounting to \$518,375,726 (2003 - \$109,881,323) have been pledged under reinsurance trust arrangements and are therefore not readily available for use by the Company.

In addition to the above, cash and short-term investments amounting to \$101,011,351 (2003 - \$9,047,032) have been provided as security for letters of credit (see Note 12).

## 5. Investment in fixed maturities

The amortized cost and fair value of investments in fixed maturities available for sale are as follows:

<u>At December 31, 2004</u>	<u>Amortized Cost</u>	<u>Unrealized Gain</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>
U.S. Government Securities	\$ 394,522,675	\$ 1,151,934	\$ 1,359,932	\$ 394,314,677
Non-U.S. Government Securities	29,028,095	206,086	627,849	28,606,332
Corporate Securities	171,541,356	1,362,966	899,922	172,004,400
Mortgage Backed Securities	76,125,243	60,979	3,467,174	72,719,048
Asset Backed Securities	48,497,791	718,122	1,826,385	47,389,528
Collateralized Debt Obligations	<u>17,392,418</u>	<u>4,665,809</u>	<u>99,766</u>	<u>21,958,461</u>
	<u>\$ 737,107,578</u>	<u>\$ 8,165,896</u>	<u>\$ 8,281,028</u>	<u>\$ 736,992,446</u>

<u>At December 31, 2003</u>	<u>Amortized Cost</u>	<u>Unrealized Gain</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>
U.S. Government Securities	\$ 249,935,317	\$ 737,932	\$ 587,649	\$ 250,085,600
Non-U.S. Government Securities	4,679,336	2,172	-	4,681,508
Corporate Securities	141,122,166	4,115,216	235,142	145,002,240
Municipal Government	1,339,691	497	-	1,340,188
Mortgage Backed Securities	20,772,841	267,217	618,773	20,421,285
Asset Backed Securities	96,714,875	4,737,645	1,601,122	99,851,398
Collateralized Debt Obligations	15,245,560	4,263,912	319,726	19,189,746
Other	<u>286,399</u>	<u>1,865</u>	<u>-</u>	<u>288,264</u>
	<u>\$ 530,096,185</u>	<u>\$14,126,456</u>	<u>\$ 3,362,412</u>	<u>\$ 540,860,229</u>

Proceeds from the sale of investments in fixed maturities during the year amounted to \$2,638,057,023 (2003 - \$1,867,448,126). Gross realized gains of \$7,335,038 (2003 - \$6,791,497) and gross realized losses of \$5,443,886 (2003 - \$3,195,470) from these sales have been included in net realized investment gains in the Consolidated Statement of Income.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

## 5. Investment in fixed maturities (Continued)

The contractual maturities of investments in fixed maturities held at December 31, 2004 and December 31, 2003 are shown below. Actual maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without prepayment penalties.

	<u>2004</u>	<u>2003</u>
Less than 1 year	\$ 106,213,893	\$ 3,910,490
1 - 5 years	444,164,581	274,350,811
5 - 10 years	31,695,235	148,440,151
Greater than 10 years	12,851,700	4,453,677
Mortgage and Asset Backed Securities	120,108,576	90,515,354
Collateralized Debt Obligations	<u>21,958,461</u>	<u>19,189,746</u>
	<u>\$ 736,992,446</u>	<u>\$ 540,860,229</u>

The following table summarizes the composition of the fair value of available for sale fixed maturities by rating (primary rating source: Moody's Investors Service).

	<u>2004</u>		<u>2003</u>	
	Fair Value	%	Fair Value	%
Aaa, Treasury	\$ 512,295,494	69.5	\$ 341,073,219	63.1
Aa	106,449,509	14.4	28,355,035	5.2
A	71,441,674	9.7	47,694,899	8.8
Baa	8,391,295	1.2	52,388,910	9.7
Below Baa	5,171,978	0.7	51,352,582	9.5
Not rated	<u>33,242,496</u>	<u>4.5</u>	<u>19,995,584</u>	<u>3.7</u>
	<u>\$ 736,992,446</u>	<u>100.0</u>	<u>\$ 540,860,229</u>	<u>100.0</u>

In the normal course of reinsurance operations, the Company must secure its obligations under certain reinsurance contracts by collateralizing them with letters of credit or trust arrangements. These trusts and letters of credit may, in turn, be secured by the Company's investments. At December 31, 2004, the Company pledged \$433,780,112 (2003 - \$299,580,617) of its fixed maturities for reinsurance trust arrangements.

Net investment income is comprised of the following:

	<u>2004</u>	<u>2003</u>
Net investment income	\$ 19,181,889	\$ 12,292,821
Investment income on purchased insurance claims (Note 7)	1,367,913	3,794,712
Investment income on funds held by ceding companies	13,347,794	20,864,394
Unrealized investment loss on derivative financial instruments	(1,807,644)	-
Unrealized investment gain on embedded derivatives (Note 7)	<u>4,923,207</u>	<u>12,947,174</u>
	<u>\$ 37,013,159</u>	<u>\$ 49,899,101</u>

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

## 6. Derivative financial instruments

Derivative financial instruments at December 31, 2004 are comprised of the following:

	Notional Amounts		Fair values	
		Assets	Liabilities	Total
Interest rate swaps	200,000,000	\$ 893,056	(78,915)	814,141
Credit default swaps – single name	31,000,000	2,053,102	(601,364)	1,451,738
Credit default swaps – index	100,000,000	-	(1,365,879)	(1,365,879)
		\$ <u>2,946,158</u>	<u>(2,046,158)</u>	<u>900,000</u>

All of the above derivative financial instruments are with counterparties of Aaa credit quality and have a duration of less than one year.

## 7. Structured insurance assets

At December 31, the structured insurance assets were as follows:

		2004	2003
Purchased insurance claims	(i)	\$ 8,455,959	\$ 10,283,401
Commissions purchased	(ii)	61,413,085	25,150,059
Originated loans		1,000,000	-
Embedded derivatives	(ii)	<u>17,870,381</u>	<u>12,947,174</u>
		\$ <u>88,739,425</u>	\$ <u>48,380,634</u>

### i) Purchased Insurance Claims:

The amount of \$8,455,959 (2003 - \$10,283,401) represents the cost of outstanding rights purchased by the Company to collect insurance claims against certain insolvent and impaired insurance companies operating under Schemes of Arrangement ("Scheme") in the London insurance market.

Each Scheme's initial dividend rate is published and known to the Company at the time of purchasing the claim. In determining the purchase price paid for a claim, the Company estimates the expected future dividend payments for each Scheme and discounts these cash flows using a U.S. Treasury yield curve on the purchase date adjusted for a credit margin reflecting the Scheme's credit risk of making these estimated dividend payments over time. The Company is also entitled to receive subsequent annual dividends through and including the final dividend paid out upon the closing of a given Scheme and liquidation of all that Scheme's assets. The total period of recovery can range from two to seven years or more depending on the age of the respective Scheme.

During the year, the Company invested \$795,195 (2003 – \$8,080,399) in new claims and received \$3,990,550 (2003 – \$9,014,898) in Scheme dividends.

Investment income of \$1,367,913 (2003 – \$3,794,712) has been recognized on these claims by applying an effective interest rate to the cash flows received during the year and those expected to be received over time.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

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## 7. Structured insurance assets (Continued)

### ii) *Commissions Purchased:*

During the year the Company purchased two additional assignments of the right to collect commissions from different portfolios of long term care insurance policies issued by several investment grade insurance carriers for a total consideration of \$45,472,891 (2003 - \$28,500,000). Under these arrangements, the commissions are paid into separate trusts, which pay amounts due to the Company on a pre-agreed formula based on the amount of commissions collected by the trusts and the expenses of the trusts. These investments earn commission income at a fixed percentage over U.S. Treasury yield per annum. At December 31, 2004, the outstanding balance amounted to \$61,413,085 (2003 - \$25,150,059). The commission income earned of \$1,355,287 (2003 - \$512,876) has been recorded within net investment income.

In two of these arrangements, the Company has also been granted an effective right to share in the profits of one of the trusts above an agreed amount set at \$15,750,000 (2003 - \$15,000,000) at inception, but growing at a margin over the U.S. Treasury yield, thereafter. This right is effectively an embedded derivative with the value of the right fluctuating based on the anticipation of the likely level and timing of future profits. At December 31, 2004, this derivative was bifurcated, categorized as a trading asset and fair valued, resulting in an unrealized gain of \$4,923,207 (2003 - \$12,947,174), which has been recognized in the Consolidated Statement of Income.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

## 8. Claims and claims adjustment expenses

The liability for claims and claims adjustment expenses for seven (2003 – four) contracts are shown on a discounted basis. Rates of interest used in discounting range from 2.96% to 5.85% (2003 – 0.91% to 5.52%). The effect of discounting is to decrease the liability for claims and claim adjustment expenses at December 31, 2004 by approximately \$117,395,398 (2003 - \$76,012,051).

	<u>2004</u>	<u>2003</u>
Claims and claims adjustment expenses		
- beginning of year	\$ 324,198,596	\$ 211,656,727
Add: reserves offset against funds withheld	<u>303,339,544</u>	<u>203,110,044</u>
Claims and claims adjustment expenses		
- beginning of year before offsetting	<u>627,538,140</u>	<u>414,766,771</u>
<b>Add:</b>		
<i>Incurred losses:</i>		
Current year	443,875,417	379,487,236
Prior years	<u>19,473,740</u>	<u>19,662,549</u>
Total incurred losses	<u>463,349,157</u>	<u>399,149,785</u>
<b>Deduct:</b>		
<i>Losses and loss expenses paid related to:</i>		
Current year	(105,926,284)	(84,540,446)
Prior years	<u>(230,558,639)</u>	<u>(86,758,020)</u>
Total paid losses	<u>(336,484,923)</u>	<u>(171,298,466)</u>
<b>Add/(Deduct):</b>		
Net claims reserves acquired during the year	193,089,250	79,058
Claims reserves reclassified from (to) deposit liabilities	3,498,103	(15,690,598)
Foreign exchange differences	<u>5,831,638</u>	<u>531,590</u>
Net claims and claims adjustment expenses - end of year	956,821,365	627,538,140
Less: reserves offset against funds withheld	(229,688,571)	(303,339,544)
Add: gross reinsurance losses recoverable (Note 20)	<u>144,232,074</u>	<u>-</u>
Claims and claims adjustment expenses – end of year	\$ <u>871,364,868</u>	\$ <u>324,198,596</u>

Of the prior years' development, \$6,426,921 (2003 - \$7,780,612) relates to the unwinding of the discount on contracts where the Company held discounted reserves.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

## 9. Unearned premiums

	<u>2004</u>	<u>2003</u>
Unearned premiums		
- beginning of year	\$ 134,921,003	\$ 14,202,167
Change in unearned premiums	(60,818,987)	119,619,478
Unearned premiums acquired during the year	31,675,000	-
Foreign exchange differences	<u>190,002</u>	<u>1,099,358</u>
Unearned premiums – end of year	\$ <u>105,967,018</u>	\$ <u>134,921,003</u>

## 10. Loans payable

In connection with acquisition of Danish Re (Bermuda) Limited, the Company has issued a contingent note in the initial principal amount of \$44,950,500, which bears interest at a rate equal to 6-month LIBOR plus 100 basis points per annum, compounded on a semi-annual basis in arrears. Interest accruing on this note is due and payable in full on the maturity date of January 31, 2008 or upon completion of the December 31, 2007 audited consolidated financial statements of Dan Re.

On the earlier of June 30, 2005 or the date that the audited financial statements of Dan Re are delivered, the initial principal amount of the note, \$44,950,500, will be reset to an amount equal to the excess of the consolidated book value of Dan Re at December 31, 2004 over \$62,905,000.

The principal amount of the note shall be subject to upward or downward adjustment for any positive or adverse development on any reinsurance related balances occurring between the December 31, 2004 and December 31, 2007 audited consolidated financial statements of Dan Re. In the case of a positive reserve variance, the upward adjustment amount shall equal to 50% of the positive reserve variance. In the case of a negative reserve variance, the adjustment amount shall equal to 100% on the first \$10,000,000 and to the extent that the variance exceeds this amount, 90% on the excess portion. The principal amount of the note may also be adjusted to satisfy any claims relating to representations and warranties given by the vendor in connection with the acquisition. In the case of an event of default, principal and interest on the note would become payable immediately.

The contingent note has been recognized in the Consolidated Financial Statements at its discounted value of \$42,262,566 using a discount rate of 6-month LIBOR plus 300 basis points, which management believes to be the appropriate market rate for a similar instrument of an issuer with a similar credit rating.

Also included within loans payable is an amount of \$10,000,000 (2003 - \$10,000,000), which matures in June 2007 and can be prepaid at the Company's option with no penalty. Fixed maturity investments of \$10,500,000 serve to collateralize the loan. Interest on the loan is equal to the US dollar three-month LIBOR plus 0.50%.

The remaining amount of \$182,942 (2003 – \$179,000) is unsecured, interest free and repayable immediately on the closure of the open years of account of Syndicates 947, 923, 2947, and 2923.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 11. Share capital

At December 31, 2004, the Company had an authorized share capital of 200,000,000 (2003 – 200,000,000) shares consisting of:

- a) 49,764,164 common shares (2003 – 250,000, 60% called and paid) with a par value of \$1 each and an issue price of \$10.24 per share,
- b) 150,235,836 (2003 – 195,870,000) undesignated shares with a par value of \$1 each.

At December 31, the issued share capital is as follows:

	<u>2004</u>	<u>2003</u>
<i>Common shares at a par value of \$1 per share:</i>		
49,764,164 common shares – 100% called and paid	\$ <u>49,764,164</u>	\$ <u>150,000</u>
<i>Preference shares at a par value of \$1 per share:</i>		
1,750,000 Class A preference shares – 60% called and paid	-	1,050,000
800,000 Class A preference shares, Series 2 – 100% called and paid	-	800,000
1,000,000 Class A preference shares, Series 3 – 100% called and paid	-	1,000,000
330,000 Class A preference shares, Series 4 – 100% called and paid	<u>-</u>	<u>330,000</u>
Total par value of shares issued	49,764,164	3,330,000
Additional paid up capital/share premium	<u>428,650,867</u>	<u>327,708,991</u>
Total share capital	\$ <u>478,415,031</u>	\$ <u>331,038,991</u>

On August 30, 2004 the following events occurred:

- a) A dividend amounting to \$47,376,040 was paid to the Class A preferred shareholders with respect to the four series of preference shares and these funds were utilized by the preferred shareholders to subscribe for 267,448 common shares in the Company at an issue price of \$177.14 per share;
- b) 37,687,372 of the 195,870,000 undesignated shares of the Company were designated as Common Shares of par value US\$1.00 each;
- c) The four series of Class A preference shares were consolidated and sub-divided into 1,795,181 common shares through a consolidation and subdivision process at an issue price of \$177.14 per share; and
- d) A further reorganization of the Company's share capital occurred whereby a bonus issue of common shares was made by capitalizing the share premium account resulting in a total number of common shares in issue of 40,000,000 at an issue price of \$10.24 per share.

On August 31, 2004, a further 9,764,164 common shares were issued with a par value of \$1 each at an issue price of \$10.24 per share, all of which were fully paid in cash.

The holders of the common shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share at meetings of the Company.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

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## 12. Letters of credit

Effective October 1, 2004, the Company entered into a credit agreement with five financial institutions, including ING Bank, N.V. London Branch (as administrative agent) and Barclays Bank PLC, New York Branch (as lead issuing bank) to establish a letter of credit facility (the "Facility") under which the issuing banks have agreed to provide letters of credit on an unsecured basis with a total capacity of \$242,500,000. Letters of credit under the Facility mature 364 days from the date of issue on an evergreen basis, meaning that they automatically renew each year unless utilized by the letter of credit beneficiary. As at December 31, 2004, five letters of credit totaling \$93,425,303 have been issued under the Facility. Under the Facility, the Company and/or certain of its subsidiaries must maintain certain covenants, including a minimum adjusted tangible net worth covenant and a maximum leverage covenant. A breach of any of these covenants, or certain other events set out in the credit agreement, would result in an event of default, upon which the Company may be required to provide appropriate collateral under the Facility. At December 31, 2004, the Company was in compliance with all of the covenants of the Facility.

Prior to October 1, 2004, the Company obtained several unsecured letters of credit under the facility of its ultimate parent company, Brascan Corporation. The Company is currently in the process of transferring these letters of credit to the Facility. As at December 31, 2004, two letters of credit totaling \$10,825,000 (2003 - \$174,922,644) still remained under the parent company's facility.

In addition, the Company has also obtained five letters of credit outside the Facility in the aggregate amount of \$102,835,932 (2003 - \$9,047,032), which have been collateralized with cash and short term investments amounting to \$101,011,351 (2003 - \$9,047,032).

## 13. Employee benefit and Long-Term Incentive Plan

The Company has adopted a Long Term Incentive Plan (the "LTIP"), which is intended to provide an incentive to certain officers and key employees of the Company. The LTIP is based on the Adjusted Consolidated Net Income (the "ACNI") of the Company. A principal component of the ACNI is the net present value of all reinsurance and capital transactions entered into by the Company. The LTIP awards vest over a four-year period. As of December 31, 2004 the vested portions of LTIP awards granted that have been included in the operating expenses of the Company amounted to \$7,380,795 (2003 - \$2,770,348).

The Company also sponsors various defined contribution retirement plans, which allow eligible participants to make voluntary contributions pursuant to their respective jurisdictions. All employees of the Company are eligible to participate in the plans and contribute a percentage of their eligible earnings. The Company makes a contribution in cash to each participating employee which vests fully from one to five years. During the year, the Company incurred approximately \$794,425 (2003 - \$535,594) of expenses with respect to these plans.

During the year, the Company granted 1,550,000 stock options. Each stock option entitles the holder to acquire one share of the Company at an exercise price of \$10.15 subject to downward adjustment to reflect any dividends paid by the Company after the date of issuance. When the options are exercised, equity is increased by the amount of the proceeds received. These options vest immediately upon issuance and expire on September 24, 2014. No options were exercised during the year.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2004

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## 14. Related party balances and transactions

Included in cash are amounts totaling \$7,295,224 (2003 - \$16,527,875) on deposit with Trilon International Inc., a shareholder of IGHL. These amounts earn interest at rates ranging from 0.59% to 1.79% (2003 - 0.60% to 0.88%) per annum.

Included within fixed maturities is an investment of \$nil (2003 - \$86,631,343) in a portfolio of high yield and high-grade corporate bonds managed by Trilon International Inc. These bonds earned interest of \$2,002,535 at rates ranging from 1.6% to 15.0% for the period January 1, 2004 to September 30, 2004 (2003 - 5.5% to 8.5% for the period November 13, 2003 to December 31, 2003). On October 1, 2004, this portfolio was transferred to a third party. Included in net investment income is a net realized gain of \$1,786,504 on the sale of the investments in the Trilon High Yield portfolio formerly managed by Trilon International Inc.

Included in reinsurance balances payable are funds withheld payable of \$28,613,249 (2003 - \$13,673,417) due to Century Property & Casualty Insurance Corporation with respect to a reinsurance contract. The net underwriting income on this contract recorded during the year was \$292,065 (2003 - \$148,000).

During the year, the Company incurred investment asset management fees of \$2,500,000 (2003 - \$nil) to Brascan Strategic Asset Management LLC, a related party.

## 15. Commitments

The Company leases office space under operating leases expiring in various years through 2012 (2003 - 2009). The future minimum rental payments related to these commitments are as follows:

	<u>2004</u>	<u>2003</u>
Less than one year	\$ 1,633,135	\$ 1,611,962
Between one and five years	5,321,402	3,590,046
More than five years	<u>918,102</u>	<u>601,763</u>
	<u>\$ 7,872,639</u>	<u>\$ 5,803,771</u>

In addition, a subsidiary of the Company has entered into a sublease arrangement from April 22, 2002 to December 31, 2005 on its premises in New York. This sublease arrangement reimburses the Company \$67,624 monthly amounting to \$2,998,008 over the term of the arrangement.

## 16. Statutory requirements

Imagine Insurance Company Limited, Imagine Reinsurance SCC, Imagine Insurance A/S, Imagine Reinsurance S.A., Imagine Re (Luxembourg) S.A., Pillar Insurance Company (Bermuda) Limited, Affiliated Chemical Insurance Limited, Imagine Reinsurance U.S. Limited, Imagine International Reinsurance Limited, Imagine Corporate Capital Limited, Imagine Underwriting Limited, Danish Re (Bermuda) Limited, Danish Re Syndicates Limited and Pillar Insurance Company Limited are required to maintain certain measures of solvency and liquidity as prescribed by regulations of Barbados, Bermuda, Denmark, Luxembourg, Ireland, Gibraltar and the United Kingdom. The Company's ability to pay dividends is therefore subject to the regulatory restrictions on the payment of dividends by its licensed insurance subsidiaries.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 16. Statutory requirements (Continued)

Actual and minimum statutory capital and surplus as of December 31, 2004 and December 31, 2003 of each company referred to above are as follows:

<u>Company</u>	<u>Actual</u> <u>2004</u>	<u>Minimum</u> <u>2004</u>	<u>Actual</u> <u>2003</u>	<u>Minimum</u> <u>2003</u>
Imagine Insurance Company Limited	482,433,206	23,432,140	368,604,802	11,561,681
Imagine Reinsurance SCC	3,799,489	125,000	4,236,699	125,000
Imagine Insurance A/S	14,103,878	6,292,331	13,799,762	3,229,321
Imagine Reinsurance S.A.*	481,306	1,670,986	4,440,490	1,599,762
Imagine Re (Luxembourg) S.A.*	1,841,495	1,670,986	-	-
Pillar Insurance Company (Bermuda) Limited	1,559,842	1,000,000	2,089,914	1,000,000
Affiliated Chemical Insurance Limited	388,032	250,000	385,340	250,000
Imagine Reinsurance U.S. Limited	159,958	125,000	158,553	125,000
Imagine International Reinsurance Limited	41,746,571	866,025	42,604,215	797,370
Imagine Corporate Capital Limited	30,492,752	30,492,752	27,969,425	27,969,425
Pillar Insurance Company Limited	4,271,422	4,092,211	3,750,000	3,750,000
Imagine Underwriting Limited	1,248,552	770,640	-	-
Danish Re Syndicates Limited	1,140,547	770,640	-	-
Danish Re (Bermuda) Limited	81,364,575	27,936,624	-	-

\*Subsequent to December 31, 2004, these two companies were amalgamated resulting in actual statutory capital in excess of the minimum statutory capital required.

## 17. Taxation

Imagine Insurance Company Limited, Imagine Reinsurance SCC and Imagine Reinsurance U. S. Limited are all registered as Qualifying Insurance Companies (QICs) under the Insurance Act 1996-32 of Barbados (the "Act"). Under the Act, the Companies are, as QICs, liable for tax on their taxable income at a rate of 33% (2003 - 36%). However, as their income is exclusively earned from foreign insurance business, the Companies would be eligible for a tax credit of 93%, the maximum allowance under Section 12H of the Barbados Income Tax Act, Cap 73. This has resulted in a net effective tax rate of 2.31% (2003 - 2.52%).

In addition to the above, Imagine Reinsurance U.S. Limited also made an irrevocable election under Section 953(d) of the U.S. Internal Revenue Code to be treated as a U.S. domestic insurance company. The current statutory tax rate in the United States is 34% (2003 - 34%).

Under current Bermuda law, the Company and its subsidiaries domiciled in Bermuda, Pillar Insurance Company (Bermuda) Limited, Danish Re (Bermuda) Limited, Perspective Financial Products Limited and Affiliated Chemical Insurance Limited, are not required to pay any taxes in Bermuda on either income or capital gains. In the event of any such taxes being imposed, the Company has received undertakings from the Minister of Finance in Bermuda that they will be exempted from taxation until 2016.

Imagine U.S. Holdings Limited files a consolidated U.S. income tax return with its includable subsidiaries, Imagine Reinsurance U.S. Limited and Imagine Advisors, Inc. The current statutory tax rate in the United States is 34% (2003 - 34%).

# IMAGINE GROUP HOLDINGS LIMITED

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## 17. Taxation (Continued)

Imagine Insurance A/S, Imagine Reinsurance S.A and Imagine Re (Luxembourg) S.A. are subject to a corporate tax rate of 30% (2003 – 30%) in Denmark and Luxembourg. Imagine International Reinsurance Limited was subject to a tax rate of 12.5% (2003 – 12.5%) in Ireland.

Imagine Corporate Capital Limited, GMA Imagine Limited, Imagine Underwriting Limited and Imagine Management Services Limited are subject to a corporate tax rate of 30% (2003 – 30%) in the United Kingdom.

Income taxes reflected in the Consolidated Statement of Income relate primarily to Barbados, U.S., United Kingdom and Danish taxation.

Corporation tax (recovery)/expense comprise:

	<u>2004</u>	<u>2003</u>
<i>Current tax expense</i>		
Current year	\$ (1,048,332)	\$ 2,907,981
(Over) under provided in prior years	<u>(638,612)</u>	<u>554,325</u>
	<u>(1,686,944)</u>	<u>3,462,306</u>
<i>Deferred tax expense</i>		
Decelerated tax depreciation	7,722	-
Other temporary differences	680,471	1,618,397
Benefits of tax losses recognized	(1,463,405)	-
Under provided prior years	126,214	-
Write-off of deferred tax asset	-	480,806
Foreign exchange differences	<u>(3,550)</u>	<u>-</u>
	<u>(652,548)</u>	<u>2,099,203</u>
Corporation tax (recovery)/expense	\$ <u>(2,339,492)</u>	\$ <u>5,561,509</u>
Reconciliation of taxes calculated at the applicable tax rate with corporation tax (recovery)/expense		
Income before corporation taxes	\$ <u>47,520,668</u>	\$ <u>40,554,369</u>
Tax calculated at a tax rate of 0% (2003 – 0%)	-	-
Effect of different tax rates in other countries	7,597,774	11,211,413
Tax effect of rate at which deferred liability is computed	439,227	-
Income not subject to tax	(111,332)	-
Expenses not deductible for tax purposes	94,714	10,419
Utilization of previously unrecognized tax losses	(276,057)	(223,128)
(Over) under provided in prior years current tax	(638,612)	554,325
Prior year taxes incurred on conversion to a QIC	-	915,011
Under provided in prior years deferred tax	126,214	-
Tax credit for net foreign currency earnings of QIC's	(8,665,951)	(7,387,337)
Write-off of deferred tax asset	-	480,806
Release of deferred tax charge	(1,463,405)	-
Under provided in current year's tax	<u>557,936</u>	<u>-</u>
Corporation tax (recovery)/expense	\$ <u>(2,339,492)</u>	\$ <u>5,561,509</u>

# IMAGINE GROUP HOLDINGS LIMITED

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## 18. Deferred taxes

The movement on the net deferred tax account is as follows:

	<u>2004</u>	<u>2003</u>
At beginning of year	\$ 2,584,484	\$ 1,158,957
Exchange differences	306,042	-
Acquisition of subsidiaries	11,613,836	-
Income statement (credit) charge (Note 17)	(652,548)	2,099,203
Other	<u>(606,469)</u>	<u>(673,676)</u>
At end of year	\$ <u>13,245,345</u>	\$ <u>2,584,484</u>

The net deferred tax account is comprised as follows:

Deferred tax assets	\$ (1,073,585)	\$ (726,818)
Deferred tax liabilities	<u>14,318,930</u>	<u>3,311,302</u>
Net deferred tax account	\$ <u>13,245,345</u>	\$ <u>2,584,484</u>

Deferred tax assets and liabilities are attributable to the following items:

	<u>2004</u>	<u>2003</u>
<b>Deferred tax liabilities:</b>		
Accelerated tax depreciation	\$ 1,722	\$ -
Accrued interest	91,431	-
Fair value gains	2,298,868	3,081,802
Reserves	11,926,909	-
Other	<u>-</u>	<u>229,500</u>
	\$ <u>14,318,930</u>	\$ <u>3,311,302</u>

	<u>2004</u>	<u>2003</u>
<b>Deferred tax assets:</b>		
Decelerated tax depreciation	\$ 140,242	\$ 177,475
Tax losses	<u>933,343</u>	<u>549,343</u>
	\$ <u>1,073,585</u>	\$ <u>726,818</u>

# IMAGINE GROUP HOLDINGS LIMITED

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## 19. Contingencies

From time to time, in connection with its operations, the Company and its subsidiaries are named as defendants in actions for damages and costs allegedly sustained by the plaintiffs. While it is not possible to estimate the outcome of the various proceedings at this time, such actions have generally been resolved with minimal damages or expense in excess of amounts provided for in the Consolidated Financial Statements and the Company does not believe that it will incur any significant additional loss or expense in connection with such actions.

The insurance industry has been the subject of recent regulatory scrutiny, including reviews of transactions considered to involve non-traditional or finite reinsurance products. The Company, like many companies in our industry, received a subpoena in late 2004 from the U.S. Securities and Exchange Commission ("SEC") related to non-traditional products. The office of the Attorney General of the State of New York is working with the SEC in this review. The Company is cooperating fully with these agencies and has submitted information in compliance with the subpoena.

## 20. Reinsurance

Reinsurance contracts do not relieve the Company from its obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to the Company. Consequently, allowances are established for amounts deemed uncollectible. The Company evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of its reinsurers to minimize the exposure to significant losses from reinsurer insolvencies. The Company's policy is to cede reinsurance only to companies rated by Standard & Poor's or A.M. Best as minimum A-.

Ceded premiums payable of \$1,190,713 (2003 - \$nil) included within reinsurance balances payable was with respect to one reinsurer. As at December 31, 2004, \$123,256,178 (2003 - \$nil) was recoverable from retrocessionaires, net of allowances for doubtful accounts amounting to \$20,975,896 (2003 - \$ nil).

## 21. Comparative figures

Certain comparative amounts for 2003 have been reclassified to conform to the current year's presentation.