

Consolidated Financial Statements of

**Imagine Group Holdings Limited**

December 31, 2005



# Imagine Group Holdings Limited

## Table of Contents

	Page
Auditors' Report to the Shareholders	1
Consolidated Balance Sheet	2
Consolidated Statement of Income	3
Consolidated Statement of Changes in Equity	4
Consolidated Statement of Cash Flows	5
Notes to Consolidated Financial Statements	6 – 54

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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, 2005 and the related consolidated statements of income, changes in 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, 2005 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  
May 9, 2006

# IMAGINE GROUP HOLDINGS LIMITED

## Consolidated Balance Sheet

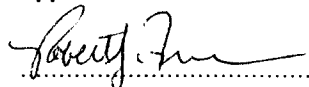
As at December 31, 2005 with comparative figures for 2004

(Expressed in Thousands of United States Dollars)

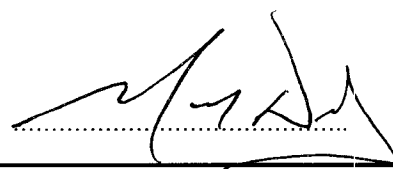
	<u>Notes</u>	<u>2005</u>	<u>2004</u>
<b>Assets</b>			
Cash and investments			
Cash and cash equivalents	7 & 20	\$ 382,150	\$ 426,056
Short-term investments	7	242,121	250,417
Fixed maturities	8	957,429	736,992
Derivative financial instruments	9	28	2,946
Structured insurance assets	10	76,211	88,739
Equities		<u>24,567</u>	<u>5,312</u>
<b>Total cash and investments</b>		1,682,506	1,510,462
Accrued investment income		11,501	7,748
Funds held by ceding companies		15,220	17,415
Premiums and other reinsurance balances receivable		177,692	110,993
Deferred policy acquisition costs	11	36,502	23,330
Prepaid reinsurance premiums		19,267	19,001
Investment contract assets	20	40,430	43,000
Reinsurance losses recoverable	13	203,283	123,256
Assets classified as held for sale	6	65,877	-
Goodwill	12	4,411	5,804
Tax assets and recoveries	24	18,872	3,281
Other assets		<u>42,264</u>	<u>26,317</u>
<b>Total assets</b>		\$ <u>2,317,825</u>	\$ <u>1,890,607</u>
<b>Liabilities and Shareholders' Equity</b>			
<b>Liabilities</b>			
Claims and claims adjustment expenses	13	\$ 1,171,676	\$ 871,365
Unearned premiums	14	164,635	105,967
Reinsurance balances payable	20	105,885	55,155
Tax liabilities	24	12,425	16,783
Investment contract liabilities		142,590	172,043
Loans payable	15	87,219	52,446
Derivative financial instruments	9	1,496	2,046
Liabilities classified as held for sale	6	55,816	-
Accounts payable and other liabilities		<u>48,474</u>	<u>87,925</u>
<b>Total liabilities</b>		<u>1,790,216</u>	<u>1,363,730</u>
<b>Shareholders' Equity</b>			
Share capital	16	478,415	478,415
Unrealized investment gains (losses)		1,713	(115)
Cumulative translation adjustment		(2,380)	1,285
Retained earnings		<u>48,840</u>	<u>46,447</u>
<b>Total shareholders' equity</b>		526,588	526,032
Minority interest		<u>1,021</u>	<u>845</u>
<b>Minority interest and shareholders' equity</b>		<u>527,609</u>	<u>526,877</u>
<b>Total liabilities and shareholders' equity</b>		\$ <u>2,317,825</u>	\$ <u>1,890,607</u>

See accompanying notes to consolidated financial statements

Approved on behalf of the Board:

  
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Director

  
.....

Director

# IMAGINE GROUP HOLDINGS LIMITED

## Consolidated Statement of Income

For the year ended December 31, 2005 with comparative figures for 2004

(Expressed in Thousands of United States Dollars)

	<u>Notes</u>	<u>2005</u>	<u>2004</u>
<b>Revenues:</b>			
Gross written premiums		\$ 594,451	\$ 519,169
Ceded premiums		<u>(78,026)</u>	<u>(12,917)</u>
Net written premiums		516,425	506,252
Change in unearned premiums	14	<u>(27,763)</u>	<u>60,819</u>
Net earned premiums		<u>488,662</u>	<u>567,071</u>
Net investment income	18 & 20	57,410	35,953
Net realized investment gains		259	4,325
Negative goodwill		-	30,941
Net foreign exchange gains		3,182	2,554
Other income		<u>26,609</u>	<u>18,152</u>
<b>Total revenues</b>		<u>576,122</u>	<u>658,996</u>
<b>Expenses:</b>			
Claims and claims adjustment expenses incurred	13	453,447	463,349
Policy acquisition costs	11	66,457	105,528
Operating expenses	12, 19, 20 & 21	63,447	42,398
Impairment loss on disposal group held for sale	6	<u>5,000</u>	<u>-</u>
<b>Total expenses</b>		<u>588,351</u>	<u>611,275</u>
<b>Operating (loss) income before financing costs</b>		(12,229)	47,721
Finance costs	20	<u>3,765</u>	<u>199</u>
<b>(Loss) income before corporation taxes</b>		(15,994)	47,522
Corporation tax recoveries	23	<u>18,564</u>	<u>2,339</u>
<b>Net income for the year</b>		<u>\$ 2,570</u>	<u>\$ 49,861</u>
<b>Attributable to:</b>			
Equity holders of the parent		\$ 2,393	\$ 49,860
Minority interest		<u>177</u>	<u>1</u>
Net Income for the year		<u>\$ 2,570</u>	<u>\$ 49,861</u>
Basic earnings per share	26	<u>\$ 0.05</u>	<u>\$ 2.67</u>
Diluted earnings per share	26	<u>\$ 0.05</u>	<u>\$ 2.66</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, 2005 with comparative figures for 2004

(Expressed in Thousands of United States Dollars)

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	<u>2005</u>	<u>2004</u>
<b>Share Capital</b>		
Balance at beginning of the year	\$ 478,415	\$ 331,039
Conversion of preferred shares	-	(318,000)
Par value of common shares issued during the year	-	49,614
Share premium on common shares issued during the year	<u>-</u>	<u>415,762</u>
Balance at end of the year	\$ <u>478,415</u>	\$ <u>478,415</u>
<b>Unrealized Investment Gains (Losses)</b>		
Balance at beginning of the year	\$ (115)	\$ 10,764
Change in unrealized investment gains (losses)	<u>1,828</u>	<u>(10,879)</u>
Balance at end of the year	\$ <u>1,713</u>	\$ <u>(115)</u>
<b>Cumulative Translation Adjustment</b>		
Balance at beginning of the year	\$ 1,285	\$ 1,067
Change in cumulative translation adjustment	<u>(3,665)</u>	<u>218</u>
Balance at end of the year	\$ <u>(2,380)</u>	\$ <u>1,285</u>
<b>Retained Earnings</b>		
Balance at beginning of the year	\$ 46,447	\$ 43,963
Net income attributable to equity holders of the parent	2,393	49,860
Dividends on preference shares	<u>-</u>	<u>(47,376)</u>
Balance at end of the year	\$ <u>48,840</u>	\$ <u>46,447</u>
<b>Minority Interest</b>		
Balance at beginning of the year	\$ 845	\$ 925
Net income attributable to minority interest	177	1
Other	<u>(1)</u>	<u>(81)</u>
Balance at end of the year	<u>1,021</u>	<u>845</u>
<b>Total Minority Interest and Shareholders' Equity at the end of the year</b>	<b>\$ <u>527,609</u></b>	<b>\$ <u>526,877</u></b>

See accompanying notes to consolidated financial statements

# IMAGINE GROUP HOLDINGS LIMITED

## Consolidated Statement of Cash Flows

For the year ended December 31, 2005 with comparative figures for 2004

(Expressed in Thousands of United States Dollars)

	<u>2005</u>	<u>2004</u>
<b>Cash Flows from Operating Activities</b>		
(Loss) income before corporation taxes	\$ (15,994)	\$ 47,522
Adjustments to reconcile (loss) income before corporation taxes to net cash provided by operating activities:		
Goodwill impairment (negative goodwill)	1,144	(30,941)
Impairment of subsidiary classified as held for sale	5,000	-
Impairment loss on fixed maturities	2,954	-
Investment income	(64,512)	(33,897)
Net realized investment gains	(259)	(4,325)
Unrealized investment gain on embedded derivatives	(1,530)	(4,923)
Unrealized investment loss on derivative financial instruments	1,468	1,808
Finance costs	3,765	199
Funds held by ceding companies	2,195	(9,895)
Premiums and other reinsurance balances receivable	(33,983)	90,610
Deferred policy acquisition costs	(5,364)	(10,634)
Prepaid reinsurance premiums	10,572	4,830
Investment contract assets	2,570	(43,000)
Reinsurance losses recoverable	(57,990)	(22,791)
Other assets	(8,936)	(13,257)
Claims and claims adjustment expenses	213,584	242,959
Unearned premiums	21,120	(60,629)
Reinsurance balances payable	39,819	16,987
Investment contract liabilities	17,578	82,750
Accounts payable and other liabilities	(52,823)	11,933
Net corporation taxes paid	(1,456)	(2,099)
<b>Net cash provided by operating activities</b>	<u>78,922</u>	<u>263,207</u>
<b>Cash Flows from Investing Activities</b>		
Interest received	60,550	33,609
Net cash acquired on acquisition of subsidiaries	23,953	267,924
Net movement of structured insurance assets	14,058	(35,356)
Net movement of derivative financial instruments	5,440	(354)
Net purchase of equities	(19,816)	(5,000)
Purchase of fixed maturities	(1,482,969)	(2,777,295)
Proceeds on sale of fixed maturities	<u>1,254,152</u>	<u>2,638,057</u>
<b>Net cash (used in) provided by investing activities</b>	<u>(144,632)</u>	<u>121,585</u>
<b>Cash Flows from Financing Activities</b>		
Issuance of common shares	-	465,376
Conversion of preferred shares	-	(318,000)
Dividends paid	-	(47,376)
Net proceeds on loans payable	<u>50,000</u>	<u>4</u>
<b>Net cash provided by financing activities</b>	<u>50,000</u>	<u>100,004</u>
Net (decrease) increase in cash and cash equivalents	(15,710)	484,796
Cash and cash equivalents at beginning of the year	<u>676,473</u>	<u>191,677</u>
Cash and cash equivalents at end of the year	\$ <u><u>660,763</u></u>	\$ <u><u>676,473</u></u>
<b>Represented by:</b>		
Cash and cash equivalents	\$ 382,150	\$ 426,056
Short-term investments	242,121	250,417
Cash and short-term investments classified as held for sale (Note 6)	<u>36,492</u>	<u>-</u>
	\$ <u><u>660,763</u></u>	\$ <u><u>676,473</u></u>

See accompanying notes to consolidated financial statements

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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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, with its registered office located at 7 Reid Street, Hamilton, Bermuda. The Company was incorporated on December 10, 1998 and its ultimate majority shareholder is Brookfield Asset Management Inc. (NYSE: BAM)

The Company provides traditional and structured insurance and reinsurance capital to the global insurance marketplace through its direct and indirect subsidiaries.

The Consolidated Financial Statements were authorized for issue by the directors on May 9, 2006.

## 2. Significant accounting policies

The accompanying Consolidated Financial Statements are presented in United States dollars, rounded to the nearest thousand. They 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, structured insurance assets and derivative financial instruments as detailed in Notes 2(f) and (g).

The accounting policies applied by the Company are consistent with those used in the previous year and 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. 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 June 30, November 16 and December 19, 2005, are described in Note 5. All intercompany balances and transactions including unrealized intercompany profits have been eliminated.

Non-current assets or disposal groups designated as held for sale are stated at the lower of the carrying amount and fair value less estimated costs to sell.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## 2. Significant accounting policies (Continued)

### b) *Classification of insurance and investment contracts*

Contracts under which the Company accepts significant insurance risk from another party (the policyholder or ceding company) by agreeing to compensate the policyholder or ceding company if a specified uncertain future event (the insured event) adversely affects the policyholder or ceding company are classified as insurance contracts. Insurance risk is risk other than financial risk. Financial risk is the risk of a possible future change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. Insurance contracts may also transfer financial risk.

Insurance risk is significant if, and only if, an insured event could cause the Company to pay significant additional benefits. Once a contract is classified as an insurance contract it remains classified as an insurance contract until all rights and obligations are extinguished or expire.

Contracts under which the transfer of insurance risk to the Company from the policyholder or ceding company is not significant are classified as investment contracts, as described in Note 2(d).

### c) *Insurance contracts*

#### *(i) Premiums and acquisition costs*

Gross written premiums reflect business written during the year and are recognized as earned premium ratably over the exposure period of the related insurance and reinsurance contracts. Unearned premium reserves are established to cover the remainder of the contract period. Policy 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 adjustment expenses and anticipated net investment income.

#### *(ii) 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 by 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 claims ("IBNR"), 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.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## 2. Significant accounting policies (Continued)

### c) *Insurance contracts (continued)*

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 net income for the year. The liability for claims and claims adjustment expenses is shown on a discounted basis for nine (2004 – seven) 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 2.40% and 5.70% (2004 – 2.96% and 5.85%) 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.

#### *(iii) Liability adequacy tests*

At each balance sheet date, liability adequacy tests are performed to determine if the insurance contract provisions, less deferred acquisition costs and any related intangible assets are adequate. Current best estimates of all future contractual cash flows and related expenses as well as investment income from the assets supporting the insurance contract provisions are used in performing these tests. If a shortfall is identified, the related deferred acquisition costs and related intangible assets are written down and if necessary, an additional provision is established. The deficiency is recognized in net income for the current year.

### d) *Investment contracts*

Contracts under which the transfer of insurance risk to the Company from the policyholder or ceding company is not significant are classified as investment contracts. Investment contracts are recognized as financial liabilities in the Consolidated Balance Sheet when the Company becomes a party to their contractual provisions and are reviewed thereafter by a qualified actuary and adjusted accordingly. Contributions received from policyholders or ceding companies are not recognized in the Consolidated Statement of Income as net earned premiums and are instead accounted for as investment contract liabilities. Where there is a recovery or an amount receivable under these types of contracts the amount is reported as an investment contract asset on the Consolidated Balance Sheet. Income recognized from these contracts is reflected within other income on the Consolidated Statement of Income.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## 2. Significant accounting policies (Continued)

### e) Revenue

The Company's revenue comprises the following:

#### (i) *Net earned premiums from insurance contracts*

The accounting policies for the recognition of revenue from insurance contracts are disclosed in Note 2(c).

#### (ii) *Fee income and margin from investment contracts*

The accounting policies for the recognition of revenue from investment contracts are disclosed in Note 2(d).

#### (iii) *Net investment income*

Investment income from financial assets comprises interest and dividend income, unrealized gains and losses on financial instruments designated as trading, as well as realized gains and losses on financial instruments classified as trading and/or available-for-sale. Interest income on available-for-sale fixed maturities is recognized using the effective interest method. Dividend income for available-for-sale equities is recognized when the right to receive payment is established (i.e. the ex dividend date). Investment income is reported net of investment management fees and other investment related expenses.

### f) *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 designations 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 within net realized investment gains 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, 2005

(Expressed in Thousands of United States Dollars)

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## 2. Significant accounting policies (Continued)

### f) Investments and structured insurance assets (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 purchased commission rights.

##### *Purchased insurance claims:*

In purchasing insurance claims, 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 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.

##### *Purchased commission rights:*

In purchasing commission rights, 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 receive commission for the remaining duration of the underlying insurance policies. These contracts are carried at amortized cost using the effective interest rate 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 net investment income. Embedded derivatives are accounted for as trading investments which are initially recognized at cost, including transaction costs, and subsequently remeasured at their fair value based on discounted cash flow models.

The commissions due to the Company under these arrangements have credit and actuarial 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, 2005

(Expressed in Thousands of United States Dollars)

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## 2. Significant accounting policies (Continued)

### g) *Derivative financial instruments*

Derivative financial instruments, including interest rate swaps and credit default swaps, are initially recorded at cost, including transaction costs, and are subsequently remeasured 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.

### h) *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.

### i) *Corporation taxes*

Corporation tax on income before taxes comprises both 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 or 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, 2005

(Expressed in Thousands of United States Dollars)

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## 2. Significant accounting policies (Continued)

### j) *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 and cash equivalents, accrued investment income, funds held by ceding companies, premiums and other reinsurance balances receivable, other assets, reinsurance losses recoverable, 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 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, investment contract 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 ceding companies.

Cash and short-term investments are placed with financial institutions of a high credit quality and the credit risk associated with fixed maturities, derivative financial instruments and structured insurance assets are disclosed in Notes 8, 9 and 10. Premiums and other reinsurance balances receivable, investment contract assets and 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 ceding company.

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 8, 10, 13, 15 and 20.

### k) *Employee benefits*

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

Obligations for contributions to defined contribution pension plans are recognized within operating expenses in the Consolidated Statement of Income as incurred.

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

The Company has in place a Long-Term Incentive Plan (the "LTIP"), which is described in Note 19. The LTIP awards vest over a four-year period. The increase in the vested portion only of the LTIP is included within the operating expenses of the Company in the year incurred.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 2. Significant accounting policies (Continued)

### k) *Employee benefits (Continued)*

#### iii) *Share options*

The Company does not currently have a formal share option plan. Where share options have been 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.

### l) *Foreign currency*

#### i) *Functional and presentation currency*

The functional currency of the Company is the currency of the primary economic environment in which it operates. The Consolidated Financial Statements are presented in United States dollars which is the Company's presentation currency. A subsidiary whose functional currency is not the United States dollar is considered to be a foreign operation.

#### ii) *Foreign currency transactions*

Foreign currency transactions are transactions undertaken by the Company or one of its subsidiaries in a currency other than its functional currency. Foreign currency transactions are translated into the functional currency at the foreign exchange rate in effect at the date of the transactions.

Foreign currency monetary assets and liabilities are translated into functional currency at the exchange rate in effect at the balance sheet date. Foreign exchange differences arising on translation are recognized in the Consolidated Statement of Income. Foreign currency non-monetary assets and liabilities which are measured at historical cost are recorded at the exchange rate in effect at the date of transaction. Foreign currency non-monetary assets and liabilities which are measured at fair value are recorded at the exchange rate in effect at the date that fair value was determined.

Foreign exchange differences arising on the translation of equities classified as available-for-sale are recognized in the unrealized investment gains (losses) in shareholders' equity.

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

The results and financial position of a subsidiary whose functional currency is different from the Company's presentation currency are translated into United States dollars as follows:

- assets and liabilities are translated at the foreign exchange rates in effect at the balance sheet date; and
- income and expenses are translated at average rates approximating the foreign exchange rates in effect at the dates of the transactions.

Foreign exchange differences arising from the translation to United States dollars are recognized directly in shareholders' equity within the cumulative translation adjustment reserve.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 2. Significant accounting policies (Continued)

### m) Goodwill and negative goodwill

All business combinations are accounted for by applying the purchase method of accounting. Goodwill represents the excess of the cost of acquisition over the fair value of the Company's share of the net identifiable assets 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 net identifiable assets 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.

### n) Impairment

The carrying amounts of the Company's assets, other than deferred tax assets, are assessed 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 and the carrying value is reduced to the estimated recoverable amount by means of an impairment charge to the Consolidated Statement of Income. In the case of goodwill the recoverable amount is estimated at each balance sheet date even if there is no indication of impairment.

When a decline in the fair value of an available-for-sale security has been recognized directly in shareholders' equity and there is objective evidence that the asset is impaired, the cumulative loss that had been recognized directly in shareholders' equity is recognized in the Consolidated Statement of Income even though the financial assets have not been derecognized. The cumulative loss that is recognized in the Consolidated Statement of Income is the difference between the acquisition cost and the current fair value less any impairment loss previously recognized in the Consolidated Statement of Income. A significant decline in fair value below cost or a decline that persists for a significant period of time is considered evidence of impairment.

### i) Calculation of recoverable amount

The recoverable amount of the Company's originated loans and receivables is calculated as the present value of estimated future cash flows, discounted at the original effective interest rate inherent in the asset. Originated loans and 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.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 2. Significant accounting policies (Continued)

### n) *Impairment (Continued)*

#### ii) *Reversals of impairment*

An impairment loss in respect of an originated loan or 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.

An impairment loss with respect to equity instruments classified as available-for-sale is not reversed through the Consolidated Statement of Income. If the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognized, the impairment loss is reversed with the amount of the reversal recognized within the Consolidated Statement of Income. An impairment loss in respect of goodwill is not reversed through the Consolidated Statement of Income. In respect of all other assets, an impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount.

### o) *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 respective lease.

### p) *Loans payable and related finance costs*

Interest bearing loans are recognized initially at fair value less attributable transaction costs. Subsequent to initial recognition, interest bearing loans are stated at their amortized cost with any difference between cost and redemption value being recognized in the Consolidated Statement of Income over the term of the loan using the effective interest rate method.

### q) *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.

### r) *Offsetting*

Insurance and reinsurance assets and the related insurance and reinsurance liabilities are offset and the net amount reported in the Consolidated Balance Sheet only where 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, 2005

*(Expressed in Thousands of United States Dollars)*

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### **3. Critical accounting estimates and judgments in applying accounting policies**

The preparation of these Consolidated Financial Statements in accordance with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as well as 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. The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the year in which the estimate is revised if the revisions affect only that year or in the year of revision and future years if the revision affects both current and future years.

The Company's critical accounting policies and estimates and the application of these policies and estimates are considered by its Audit Committee and are outlined below:

*i) Key sources of estimation uncertainty*

Notes 2(c) and 13 contain information about the assumptions and estimates and uncertainties relating to the liability for claims and claims adjustment expenses and Note 4 discloses the risk factors associated with its insurance and reinsurance contracts. Notes 2(f) and 10 contain information about the assumptions and uncertainty related to the structured insurance assets.

*ii) Critical accounting judgments in applying the Company's accounting policies*

*Insurance contract classification*

Contracts are classified as insurance contracts where they transfer significant insurance risk from the holder of the contract to the Company (See Note 2(b)). There are a number of contracts issued where the Company exercises judgment with regards to the level of insurance risk transferred. Typically these are contracts which contain a significant financial component. The level of insurance risk is assessed by considering whether there are any scenarios with commercial substance in which the Company is required to pay significant additional benefits. These benefits are those which exceed the amounts payable if no insured or reinsured event were to occur.

### **4. Insurance and financial risk management**

#### **Underwriting strategy**

The Company underwrites property, casualty, life and accident & health reinsurance, and where licensed, insurance, in many countries around the world. The Company also invests capital in selective insurance industry participants and insurance related assets where its underwriting and investment expertise, and its network of broker and client relationships, translate into future opportunities. Business is written on either a traditional basis, primarily through syndicates which the Company manages at Lloyd's of London ("Lloyd's"), or through specialist underwriting teams which develop structured transactions for individual insurers, reinsurers, 'corporates', captives, risk retention groups and other industry associations.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## 4. Insurance and financial risk management (Continued)

### Underwriting strategy (Continued)

As a result, the two operating divisions of the Company are its operations at Lloyd's of London ("Lloyd's") and its business written outside of Lloyd's of London ("Non-Lloyd's"). The Company's assets, liabilities, revenues, expenses, and employees are managed independently within each division.

Within Lloyd's, experienced management and specialist underwriters are employed to write property, financial institutions, and accident & health reinsurance, as well as non-U.S. employers liability, professional liability, medical malpractice, and workers compensation. The Company underwrites at Lloyd's supported by its own capital as well as by the capital of third-party institutions and individual "Names" which is provided on an annual basis. Outside of Lloyd's, specialist underwriters create customized reinsurance and insurance programs covering property, professional, employers and general liability, workers compensation, trucking and non-standard auto and other primarily long-tail classes. In addition, specialized investments are made in support of reinsurance clients in need of capacity, proven niche underwriters with unique market opportunities, distressed or run-off portfolios or companies and insurance related assets such as insolvent claims, insurance commissions receivable and life related annuities.

Critical to the Company's strategy is managing its insurance and financial risks.

The Company's objective is to deliver an appropriate risk and return balance. Specific underwriting objectives are established for each account written at Lloyd's, or for each individual transaction in the case of Non-Lloyd's business.

While these objectives may differ in detail with respect to business written through Lloyd's and business written outside of Lloyd's many of the same principles of underwriting control are applied through:

- experienced underwriters, with appropriate actuarial support, which are the most important part of the Company's business process;
- restrictions on the size of transactions either individually or as a part of a portfolio or both;
- the requirement of an acceptable trade-off between potential return and downside exposure, whether on an individual transaction or portfolio basis;
- aggregate limits based on a balance of industry and internally developed models as well as management and underwriting judgment;
- peer reviews on an individual transaction basis, as well as periodically on a portfolio basis;
- dedicated risk management and reserving independent of the underwriting teams; and
- identification of specific individual, team, or committee authorization to bind business, appropriate to the size and nature of the transactions and the markets in which they are written.

The Company uses several methods to assess and monitor its insurance risk exposures both for individual types of risks insured and reinsured and the overall portfolio including concentrations by line, geographic region etc. These methods include internal risk measurement models, sensitivity analyses, scenario analyses and stress testing.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## 4. Insurance and financial risk management (Continued)

### Underwriting strategy (Continued)

#### Lloyd's Business

For the Lloyd's business, the Company's underwriting strategy seeks diversity to ensure a balanced portfolio and is based on underwriting a large portfolio of similar risks over a number of years in order to produce reduced variability of the outcome. The underwriting strategy is set out in the annual business plans submitted to Lloyd's for each account written that establishes the classes of business to be written, the territories in which business is to be written and the industry sectors in which the Company is prepared to underwrite. This strategy is communicated to individual underwriters through detailed underwriting authorities that set out the limits that any one underwriter can write by line size, class of business, territory and industry in order to ensure appropriate risk selection within the broader portfolio. All general insurance and reinsurance contracts are annual in nature and the underwriters have the right to refuse renewal or to change the terms and conditions of the contract at its renewal. Specifically, the Company endeavors to manage its exposure to volatility on its Lloyd's business by:

- employing experienced underwriters with strong track records;
- writing diversified risks by geography, client and class of business;
- conducting peer underwriting reviews of each risk written, along with periodic internal and independent reviews of each account;
- stochastic modeling of the catastrophe portfolio; and
- purchasing reinsurance designed to protect each account against significant aggregations or event-based risk.

#### Non-Lloyd's Business

Since its inception, the Company's business model has focused on identifying niche market segments in which there is significant demand for structured insurance and reinsurance products whose needs may not be met efficiently through traditional products. These structured products provide an alignment of risk and reward requirements between buyers and the Company, as well as a more limited potential downside. The classes of business written by the structured product underwriters are generally consistent with classes covered by traditional products.

Structured contracts may be written as capped quota shares, multi-year excess of loss, aggregate stop losses, loss portfolio transfers, adverse development covers, or a combination thereof. Business is written on both a prospective basis, in that coverage is for future events, and retrospective basis, where losses have already been incurred at the time of the contract but may still pose risk in terms of development, numbers of claims, loss amounts, loss adjustment expenses or other uncertainties.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## 4. Insurance and financial risk management (Continued)

### Underwriting strategy (Continued)

For the Non-Lloyd's business, the underwriting strategy is established through underwriting guidelines which limit the downside risk in return for limited underwriting profitability. These guidelines are specific with regards to leverage characteristics, negative potential outcomes, minimum return requirements, internal underwriting procedures and business risk monitoring and control. The guidelines stipulate a controlled underwriting process that the Company applies in order to manage its exposure to volatility for contracts which requires:

- pricing risks using proprietary stochastic models for each risk underwritten to enable the underwriters to properly evaluate all possible outcomes of the transaction under review;
- including structural protections such as sub-limits and aggregate limits of liability;
- conducting an actuarial peer review, along with accounting, credit, tax and legal reviews for each transaction; and
- the senior management team and the Imagine Underwriting Committee approval of each transaction (including renewals) prior to binding.

### Reinsurance purchasing strategy

The Company reinsures a portion of the risks which it underwrites, where appropriate and cost effective, to control its exposures to losses and protect capital resources. Generally, this reinsurance relates to its Lloyd's business where the reinsurance purchased is designed to protect against significant aggregations or event-based risk. The reinsurance program for each line of business is approved by the Imagine Underwriting Committee as part of the business plan review and approval process. On the Non-Lloyd's business, reinsurance is generally not purchased as such transactions, on a gross basis, are already within the Company's risk tolerance.

The Company purchases a combination of proportional and non-proportional reinsurance treaties. In addition, facultative reinsurance may be purchased in certain specified circumstances. All purchases of facultative reinsurance are subject to pre-approval by management.

The purchase of any reinsurance protection contains counterparty credit risk. The Company has a Broker Vetting and Reinsurance Security Committee ("BVRSC") that is responsible for setting the minimum security criteria for acceptable reinsurance and for monitoring the purchase of reinsurance against those criteria. The BVRSC also monitors erosion of the reinsurance program and its ongoing adequacy, as well as works with the Company's finance and risk management areas to establish provisions for potential and actual bad debts due from reinsurers.

The reinsurance bad debt provisions which consider both the inability and unwillingness to pay are calculated on a reinsurer by reinsurer basis, based largely on the credit rating of the reinsurer. The Company monitors the financial condition of its reinsurers on an ongoing basis as part of this reinsurance bad debt calculation process. (See also Note 13)

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## 4. Insurance and financial risk management (Continued)

### Asset/liability matching

The Company actively manages its financial position using an approach that balances principal protection, quality, diversification, liquidity, foreign exchange and investment return. The goal of the investment process is to optimize the risk-adjusted investment income and risk-adjusted total return net of taxes, whilst ensuring that the assets and liabilities are managed on a cash flow and duration basis. The Imagine Investment Committee reviews and approves target portfolios on a periodic basis, establishing investment guidelines and limits, and providing oversight of the asset/liability management process.

The Company establishes target asset portfolios for certain major transactions or blocks of business, which represents the investment strategies used to profitably fund its liabilities within acceptable levels of risk. These strategies include objectives for effective duration, yield curve sensitivity, liquidity, asset sector concentration and credit quality. The estimates used in determining the approximate amounts and timing of payments to or on behalf of policyholders and ceding companies for insurance and reinsurance liabilities are regularly re-evaluated. Many of these estimates are inherently subjective and could impact the Company's ability to achieve its asset/liability management goals and objectives. Please refer to the Key Assumptions and Sensitivities in Note 13 for more comprehensive details with respect to the acceleration of claims payout risk.

### Terms and conditions

In addition to providing insurance and reinsurance contracts on a traditional basis, the Company provides contractually capped coverages that use one or more structural elements to limit the net loss that the Company could incur. In exchange for this limit of losses, the Company often accepts a cap on the potential return that can be achieved by returning the profits in excess of a level specified in the contract. Some of the structural elements used to effect these limitations on the Company include sub-limits and loss corridors, annual and term aggregate limits, swing-rated or sliding scale commissions and contractual provisions to reduce exposure or early terminate contracts if loss triggers are exceeded or to require premium rate increases in underlying business. While many of these structural elements also appear in traditional contracts, the primary focus in providing these coverages on a structured basis is to provide a lower cost product that transfers a lower level of risk than traditional contracts while enabling financial participation by the client.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## 4. Insurance and financial risk management (Continued)

### Lines of Business

#### i) Casualty

##### a) *Product features*

The Company writes casualty insurance and reinsurance on a worldwide basis. The coverages provided include general liability, professional indemnity including physician liability, contractors' liability, employers' liability, public liability, financial institution liability, workers compensation, and the liability portion of non-standard auto and trucking coverage. Under these contracts and the primary contracts underlying the reinsurance coverages which the Company provides, compensation is paid for injury suffered primarily by parties other than the insured as a result of the acts or negligence of the insured.

A common characteristic of casualty business is the length of time it can take for claims to emerge and reach their ultimate claims cost which in turn adds uncertainty to the loss estimation process. The timing of claim reporting and settlement is a function of a number of factors, including the nature of the coverage, the policy provisions, the jurisdiction in which the contract is written, and whether the Company is providing insurance or reinsurance coverage. Typically, general, professional and contractors' liability claims have a longer tail than bodily injury claims.

The majority of bodily injury claims have a relatively short tail, with most of the claims for a given accident year settled in full within four years.

General liability claims may have a considerable lag in the reporting and payment of claims. For some emerging claims, the reporting lag (that is, the time between the occurrence of the insured event and its reporting) may be in excess of ten years. In these cases, there is scope for the Company to earn investment income due to the time delay between the receipt of premiums and the payment of claims.

These uncertainties include the reporting lag, the number of parties involved in the claim, whether the insured event is over multiple time periods and the potential amounts of the claim. The loss provisioning process is detailed in Note 13.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## 4. Insurance and financial risk management (Continued)

### i) Casualty (Continued)

#### *b) Management of risks*

Risks arising from casualty insurance and reinsurance contracts are managed primarily through appropriate pricing, product design, risk selection, investment strategy, rating and the purchase of reinsurance protection. The Company monitors and reacts to changes in the general economic and commercial environment in which it operates to ensure that the liability risks written satisfy the Company's criteria for profitability.

For bodily injury liability contracts, the key risk is the trend for courts in the United Kingdom and the United States of America to award higher levels of compensation. In pricing contracts, the Company makes assumptions that costs will increase in line with the latest available research.

The key risks associated with these contracts are underwriting risk, competitive risk, claims experience risk and the potential for policyholders to exaggerate or fabricate losses.

### ii) Property

#### *a) Product features*

The Company writes property insurance and reinsurance programs on a worldwide basis. Classes written include catastrophe, per risk excess of loss and pro rata reinsurance. Property insurance and reinsurance indemnifies, subject to any limits or excesses, the insured or reinsured against the loss or damage to their own material property and business interruption arising from this damage. The return to shareholders under these contracts arises from the total premiums charged to policyholders less the amounts paid to cover claims and the expenses incurred by the Company.

The event giving rise to a claim for damage to buildings or contents usually occurs suddenly (fire, flood, hurricane or earthquake) and the cause is, for the most part, easily determinable. The claim will thus be notified promptly and can be settled, usually, without delay. Property business is therefore classified as 'short-tail', meaning that expense deterioration and investment return will be of less importance than is the case with 'long-tail' business. In certain events, the approximate cause or causes of catastrophic loss, the nature and extent of the damage, the amount of the insured loss arising from the event or its after effects, and the timeliness of reporting may prove to be challenging. While not necessarily long-tail in nature, the ability to estimate losses from catastrophic events in a timely fashion is not always assured.

#### *b) Management of risks*

The key risks associated with these contracts are underwriting risk, competitive risk and claims experience risk (including the variable incidence of natural disasters).

Underwriting risk for property exposures is the risk that the Company does not charge and collect premiums that are appropriate for the different properties it insures or reinsures. The risk on any underlying policy will vary according to many factors such as location, safety measures in place and the age of property. For domestic property insurance or reinsurance it is expected that there will be large numbers of properties with similar risk profiles. However, for commercial business this will not be the case. Many commercial property proposals comprise a unique combination of location, type of business, and safety measures in place. Calculating a premium commensurate with the risk for these policies will ordinarily require more judgement.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## 4. Insurance and financial risk management (Continued)

### ii) Property (Continued)

These risks are managed primarily through the underwriting and pricing process. The Company adheres to strict underwriting criteria to ensure that the risk of losses is acceptable to the Company. The Company also monitors the underwriting process of its ceding companies through the conduct of periodic underwriting audits.

In addition, catastrophe reinsurance is purchased and catastrophe event sub-limits within contracts are used to protect the Company against an accumulation of losses from a single event.

### iii) Long-term insurance contracts - annuities

#### a) Product features

The Company participates in the annuity market through the provision of quota share reinsurance. The majority of annuities being reinsured are purchased with a single premium at the outset, and are paid to the underlying policyholder for the remainder of their lifetime.

#### b) Management of risks

Profits or losses arise when longevity and investment experience vary from that initially expected. Longevity risks arise as the annuities are paid for the lifetime of the insured lives, and this risk is managed through the initial pricing of the annuity. The pricing assumption is based on both historic information of the ceding company and externally generated information on mortality experience, including allowances for future mortality improvements. Investment risk depends on the extent to which the annuity payments under the contracts have been matched by suitable invested assets. The Company seeks to minimize this risk through investing in assets with matching returns and duration.

### iv) Specialty investments/structured insurance assets

#### a) Product features

The Company invests in specialized opportunities that merge its insurance and reinsurance with its investment expertise. These include the:

- purchase of undervalued balance sheet assets such as long-term care commissions and insolvent claims purchased at a deep discount; and
- advance of modest loans (less than \$5,000) to assist clients establish risk pooling vehicles thereby fostering long-term relationships for future reinsurance opportunities.

The Company purchases assignments of the right to collect commissions from different portfolios of long-term care insurance policies issued by several investment grade insurance carriers. 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. (See Note 10)

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## 4. Insurance and financial risk management (Continued)

### iv) Specialty investments/structured insurance assets (Continued)

The Company also purchases the right to collect insurance claims against certain insolvent and impaired insurance companies operating under Schemes of Arrangement (“Schemes”) in the London insurance market. The Company estimates the value of the claim and the ability of the Schemes to pay the claim over time. The claims purchased to date are already agreed with the participating, solvent insurers and are due and payable by the insolvent Schemes, albeit at a reduced level reflecting the Scheme’s degree of financial impairment. (See Note 10)

The Company makes loans of between \$1,000 to \$5,000 for select clients who are establishing risk retention groups, managing general agencies, or small insurance companies. These clients have demonstrated strong track records and an in-depth knowledge of and experience with a niche market opportunity. The loans are structured for early repayment and pay an attractive interest rate. Through these efforts, the Company develops a longer term reinsurance relationship with niche oriented insurance and reinsurance underwriting teams.

#### *b) Management of risks*

The Company is exposed to credit risk on these specialty investments. The credit exposure is minimized through credit reviews performed as part of the underwriting process and the requirement for collateral to be provided on the amounts due to the Company wherever possible. The Company deals with investment grade counterparties on the long-term care commission business and prices the insolvent claims purchases to take account of the increased credit risk in dealing with lower grade counterparties.

The long-term care commission business is also subject to the risk that the underlying long-term care policies lapse resulting in the commission flows ceasing. Lapse of the underlying policies occurs when the policyholder dies (“mortality risk”) or simply discontinues payment of premiums (“lapse risk”). Due to premium waivers in the event of illness, morbidity also impacts continued commission flows. These risks are managed in the pricing of the assignments by use of actuarial mortality and morbidity tables and historic data regarding the lapse rates in long-term care insurance portfolios.

### **Concentrations and aggregations of insurance risk**

A key aspect of the insurance risk faced by the Company arises from the concentration of insurance risk which may exist where a particular event or series of events could impact significantly upon the Company’s liability for claims and claims adjustment expenses. Such concentrations may arise from a single insurance or reinsurance contract or through the accumulation of risk under a number of contracts exposed to similar events.

Concentrations of risk can arise from both high-severity, low-frequency events, such as natural disasters and from situations where the underwriting of risk is biased towards a particular area of risk, such as a particular type of business or a particular geographic region.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

## 4. Insurance and financial risk management (Continued)

### High-severity, low-frequency events

By their nature, the timing of high-severity, low-frequency events, which trigger significant losses due to concentration/aggregation of exposures, are uncertain and their occurrence is expected to be rare. However, these types of events represent a risk to the Company because, although unlikely in any given financial year, should they occur they have the potential to result in a significant adverse financial impact on the Company ranging from a strain on its cash flow to a reduction in its profitability and, in the most serious of such events or combinations of events, capital adequacy implications. These financial consequences should be considered in the light of their likely occurrence, and therefore, the table below provides an indication of the gross and net expected losses based on exposures and reinsurance protections as at December 31, 2005 and the estimated frequency of the indicated events, which is based on the most recent research available to the Company.

	Expected gross Losses before <u>reinsurance</u>	Expected net losses after <u>reinsurance</u>	Frequency <u>(in years)</u>
Japanese Earthquake including Personal Accident	\$ 122,323	\$ 23,524	1 in 250
Florida Windstorm	117,400	48,994	1 in 250
California Earthquake	108,312	37,567	1 in 250
European Windstorm	94,078	26,610	1 in 250

The Company's key methods in managing these risks include:

(i) Underwriting controls

The risk is managed through appropriate underwriting controls. For the Non-Lloyd's business, underwriting guidelines place specific limitations on leverage characteristics and negative potential outcomes, both at the specific individual transaction level and at the entire portfolio level.

For the Lloyd's business, key downside and concentration aggregation controls include maximum line sizes for individual transactions and pre-determined portfolio aggregate limits set by geographic zone or territory.

(ii) Reinsurance purchased

These risks are also managed by the use of reinsurance, particularly with respect to the Company's Lloyd's business. The reinsurance purchased is designed to protect each account against significant aggregations or event-based risk. Key elements of the property catastrophe reinsurance program of Danish Re (Bermuda) Limited ("Dan Re") for the year ended December 31, 2005 include:

- the first \$6,000 loss is retained by the Company with 25% of the \$2,500 in excess of the \$6,000 layer also retained;
- the reinsurance program then provides coverage for 75% of the \$2,500 excess of \$6,000 layer; and
- 100% of \$60,500 in excess of \$8,500 thus providing protection for gross losses of up to \$69,000 from a single event.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## 4. Insurance and financial risk management (Continued)

### Monitoring concentrations and aggregate exposures

The Company monitors these concentrations and aggregate exposures at the time of underwriting an individual risk and on a regular basis thereafter by reviewing reports which show the key concentrations and aggregations to which the Company is exposed. The Company uses a number of modeling tools to monitor aggregations and to simulate catastrophe losses in order to measure the effectiveness of its reinsurance programs and the net exposure to the Company. A number of additional stress and scenario tests were run using these models during the year.

### Claims development

Claims development information is disclosed in order to illustrate the insurance risk inherent in the Company. The tables below compare the claims paid on an accident year basis with the provisions established for these claims. The top part of the table provides a review of ultimate claim cost estimates and demonstrates how these estimates have changed at subsequent reporting or accident year-end dates. The estimates are increased or decreased as losses are paid and more information becomes available with respect to the likely frequency and severity of unpaid claims. Data in the table related to acquired businesses are included from the acquisition date onwards. The lower part of the table provides a reconciliation of the total provision for claims and claims adjustment expenses included in the Consolidated Balance Sheet as at December 31, 2005 and the estimate of cumulative claims.

While the information in the table provides a historical perspective on the adequacy of unpaid claims estimates established in previous years, readers of these Consolidated Financial Statements are cautioned against extrapolating redundancies or deficiencies of the past on current unpaid loss balances. The Company believes that the estimate of total claims and claims adjustment expenses outstanding as at December 31, 2005 is adequate. However, due to the inherent uncertainties in the provisioning process, it cannot be assumed that such balances will ultimately prove to be adequate. See Note 13 for details on the reserving process.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

## 4. Insurance and financial risk management (Continued)

### Claims development (Continued)

Analysis of claims development – net of reinsurance

<u>Accident Year</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>Total</u>
Estimate of cumulative claims:					
At the end of accident year	\$ 579,634	\$ 230,942	\$ 559,578	\$ 372,210	
One year later	613,661	259,927	567,289	-	
Two years later	611,811	253,412	-	-	
Three years later	611,862	-	-	-	
Estimate of cumulative claims	611,862	253,412	567,289	372,210	
Cumulative payments	<u>(383,910)</u>	<u>(182,547)</u>	<u>(236,560)</u>	<u>(68,313)</u>	
	227,952	70,865	330,729	303,897	933,443
Effect of discounting	<u>(62,207)</u>	<u>(1,709)</u>	<u>(31,088)</u>	<u>(8,762)</u>	<u>(103,766)</u>
Net liability for claims and claims adjustment expenses	165,745	69,156	299,641	295,135	829,677
Add: net discounted reserves on annuity contracts					181,202
Add: reinsurance losses recoverable					203,283
Less: reserves offset against funds held by ceding companies					<u>(42,486)</u>
Claims and claims adjustment expenses					\$ <u>1,171,676</u>

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## 5. Acquisition and disposal of subsidiaries

### Acquisitions:

#### *(i) Greenfield Underwriting Limited*

On June 30, 2005, the Company acquired Greenfield Underwriting Limited ("GUL") for a nominal amount. There was no goodwill arising from this acquisition. The principal activity of GUL is the conduct of underwriting as a corporate member at Lloyd's. For the period from the acquisition date to December 31, 2005, GUL contributed a net loss of \$483 to consolidated net income. If GUL had been acquired from the start of the year the gross written premiums of the Company would have increased by \$nil and the consolidated net income for the year would have increased by \$28.

#### *(ii) Abacus Syndicates Limited and Abacus Underwriting Agencies Limited*

On November 16, 2005, the Company acquired Abacus Syndicates Limited and Abacus Underwriting Agencies Limited (collectively "Abacus") for \$352, including directly attributable costs, satisfied in cash. Goodwill arising from this acquisition amounting to \$351 has been recognized within goodwill on the Consolidated Balance Sheet. The principal activity of Abacus is the conduct of activities as an underwriting agent at Lloyd's. For the period from the acquisition date to December 31, 2005, Abacus contributed \$28 to consolidated net income. If Abacus had been acquired from the start of the year, the other income of the Company would have increased by \$4,519 and the consolidated net income for the year would have increased by \$575.

#### *(iii) SOC Corporate Member No. 6 Limited*

On December 19, 2005, the Company acquired SOC Corporate Member No. 6 Limited ("SOCM6") for \$76, including directly attributable costs, satisfied in cash. Goodwill arising from this acquisition amounting to \$100 has been recognized within goodwill on the Consolidated Balance Sheet. The principal activity of SOCM6 is the conduct of underwriting as a corporate member at Lloyd's. For the period from the acquisition date to December 31, 2005, SOCM6 contributed a net loss of \$24,690 to consolidated net income. If the corporate member had been acquired from the start of the year, the gross written premiums of the Company would have increased by \$65,790 and the consolidated net income for the year would have decreased by \$24,690.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 5. Acquisition and disposal of subsidiaries (Continued)

### Acquisitions: (continued)

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

Cash and cash equivalents	\$	24,381
Fixed maturities		26,714
Premiums and other reinsurance balances receivable		32,716
Deferred policy acquisition costs		7,808
Prepaid reinsurance premiums		12,287
Reinsurance losses recoverable		41,912
Tax assets and recoveries		299
Other assets		7,087
Claims and claims adjustment expenses		(87,775)
Unearned premiums		(39,581)
Reinsurance balances payable		(11,055)
Accounts payable and other liabilities		<u>(14,816)</u>
Net identifiable fair value assets and liabilities		(23)
Goodwill on acquisition (Note 12)		<u>451</u>
Consideration paid, which includes directly attributable costs, satisfied in cash		428
Cash and cash equivalents acquired		<u>24,381</u>
Net cash inflow per Consolidated Statement of Cash Flows	\$	<u><u>23,953</u></u>

### Disposals:

Effective January 1, 2005, the Company disposed of First Property and Casualty Corporation and its subsidiaries Risk Corp Inc. and IBNI Insurance Services Limited to a related party for \$187, satisfied in cash. The Company recognized a loss on disposal of \$515 which is reflected within operating expenses.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 6. Assets and Liabilities classified as held for sale

A subsidiary of the Company has been presented in these Consolidated Financial Statements as 'held for sale' following the decision of the Company's management on July 11, 2005 to sell this 'disposal group' in order to reallocate capital resources to other market segments. The sale is expected to occur on or before September 30, 2006. As at December 31, 2005, the 'disposal group' comprised assets of \$65,877 less liabilities of \$50,816 before impairment losses.

The Company has determined that an impairment charge of \$5,000 is appropriate arising from the measurement of the 'disposal group' at fair value less the appropriate estimated costs to sell. This impairment charge has been recognized and is reported separately on the Consolidated Statement of Income. The carrying value of the 'disposal group' as at December 31, 2005, net of impairment, is \$10,061.

Net assets held for sale prior to impairment charge	\$	15,061
Less: impairment charge		<u>(5,000)</u>
Net assets held for sale after impairment charge	\$	<u>10,061</u>

### Assets classified as held for sale

Cash and cash equivalents	\$	11,950
Short-term investments		24,542
Fixed maturities		27,280
Accrued investment income		211
Prepaid reinsurance premiums		1,449
Tax assets and recoveries		370
Other assets		<u>75</u>
	\$	<u>65,877</u>

### Liabilities classified as held for sale

Claims and claims adjustment expenses	\$	1,048
Unearned premiums		2,033
Reinsurance balances payable		144
Investment contract liabilities		52,031
Accounts payable and other liabilities		<u>560</u>
	\$	<u>55,816</u>

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

## 7. Cash, cash equivalents and short term investments

Cash and short-term investments amounting to \$371,409 (2004 – \$518,376) have been pledged under insurance and reinsurance trust arrangements and are therefore not readily available for use by the Company.

Cash and short-term investments amounting to \$7,362 (2004 – \$101,011) have been provided as security for letters of credit (see Note 17).

Cash and short-term investments amounting to \$1,936 (2004 – \$2,000) have been pledged in support of derivative financial instruments (see Note 9).

Cash and short-term investments amounting to \$10,500 (2004 – \$10,500) have been pledged to collateralize a loan payable (see Note 15).

## 8. Investment in fixed maturities

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

<u>At December 31, 2005</u>	<u>Amortized Cost</u>	<u>Unrealized Gain</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>
U.S. Government and agency securities	\$ 357,425	\$ 1,169	\$ 1,686	\$ 356,908
Non-U.S. Government securities	97,115	2,410	14	99,511
Corporate securities	211,727	473	1,750	210,450
Non-U.S. corporate securities	106,233	1,895	275	107,853
Mortgage backed securities	117,134	259	1,327	116,066
Asset backed securities	45,464	211	1,969	43,706
Collateralized debt obligations	14,979	2,050	-	17,029
Other	<u>5,960</u>	<u>-</u>	<u>54</u>	<u>5,906</u>
	<u>\$ 956,037</u>	<u>\$ 8,467</u>	<u>\$ 7,075</u>	<u>\$ 957,429</u>
<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 and agency securities	\$ 394,523	\$ 1,152	\$ 1,360	\$ 394,315
Non-U.S. Government securities	29,028	206	628	28,606
Corporate securities	171,541	1,363	900	172,004
Mortgage backed securities	76,125	61	3,467	72,719
Asset backed securities	48,498	718	1,826	47,390
Collateralized debt obligations	<u>17,392</u>	<u>4,666</u>	<u>100</u>	<u>21,958</u>
	<u>\$ 737,107</u>	<u>\$ 8,166</u>	<u>\$ 8,281</u>	<u>\$ 736,992</u>

Proceeds from the sale of investments in fixed maturities during the year amounted to \$1,254,152 (2004 – \$2,638,057). Gross realized gains of \$5,360 (2004 – \$7,335) and gross realized losses of \$9,513 (2004 – \$5,444) from these sales have been included within net realized investment gains in the Consolidated Statement of Income.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

## 8. Investment in fixed maturities (Continued)

The contractual maturities of investments in fixed maturities held at December 31, 2005 and December 31, 2004 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>2005</u>	<u>2004</u>
Less than 1 year	\$ 200,223	\$ 106,215
1 - 5 years	415,691	444,164
5 - 10 years	129,153	31,695
Greater than 10 years	35,561	12,852
Mortgage and asset backed securities	159,772	120,108
Collateralized debt obligations	<u>17,029</u>	<u>21,958</u>
	<u>\$ 957,429</u>	<u>\$ 736,992</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>2005</u>		<u>2004</u>	
	Fair Value	%	Fair Value	%
Aaa, Treasury	\$ 665,517	69.5	\$ 512,295	69.5
Aa	75,110	7.8	106,450	14.4
A	153,941	16.1	71,442	9.7
Baa	10,058	1.1	8,391	1.2
Below Baa	-	0.0	5,172	0.7
Not rated	<u>52,803</u>	<u>5.5</u>	<u>33,242</u>	<u>4.5</u>
	<u>\$ 957,429</u>	<u>100.0</u>	<u>\$ 736,992</u>	<u>100.0</u>

In the normal course of insurance and reinsurance operations, the Company must secure its obligations under certain insurance and 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 fixed maturities. At December 31, 2005, the Company pledged \$719,651 (2004 – \$433,780) of its fixed maturities for insurance and reinsurance trust arrangements.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

## 8. Investment in fixed maturities (Continued)

The following table summarizes the effective interest rates of the available-for-sale fixed maturities held at December 31, 2005 and December 31, 2004:

	<u>2005</u> %	<u>2004</u> %
U.S. Government and agency securities	3.9	3.3
Non-U.S. Government securities	4.6	3.0
Corporate securities	5.0	4.6
Non-U.S. corporate securities	4.9	0.0
Mortgage backed securities	5.0	6.1
Asset backed securities	4.7	5.2
Collateralized debt obligations	11.5	7.9
Other	7.8	0.0

## 9. Derivative financial instruments

Derivative financial instruments at December 31, 2005 and 2004 comprise the following:

<u>At December 31, 2005</u>	<u>Notional</u> <u>Amounts</u>	<u>Fair Value</u>		
		<u>Assets</u>	<u>Liabilities</u>	<u>Total</u>
Interest rate swaps	25,000	\$ 28	\$ -	\$ 28
Credit default swaps – single name	8,000	-	(1,496)	(1,496)
		\$ <u>28</u>	\$ <u>(1,496)</u>	\$ <u>(1,468)</u>
<u>At December 31, 2004</u>	<u>Notional</u> <u>Amounts</u>	<u>Fair Value</u>		
		<u>Assets</u>	<u>Liabilities</u>	<u>Total</u>
Interest rate swaps	200,000	\$ 893	\$ (79)	\$ 814
Credit default swaps – single name	31,000	2,053	(601)	1,452
Credit default swaps – index	100,000	-	(1,366)	(1,366)
		\$ <u>2,946</u>	\$ <u>(2,046)</u>	\$ <u>900</u>

Cash and short-term investments amounting to \$1,936 (2004 - \$2,000) have been pledged in support of these derivative instruments. These instruments are with counterparties of Aaa credit quality.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

## 10. Structured insurance assets

Structured insurance assets at December 31, 2005 and 2004 comprise the following:

	<u>2005</u>	<u>2004</u>
Purchased insurance claims (i)	\$ 5,509	\$ 8,456
Commissions purchased (ii)	42,997	61,413
Embedded derivatives (ii)	19,400	17,870
Originated loans (iii)	<u>8,305</u>	<u>1,000</u>
	<u>\$ 76,211</u>	<u>\$ 88,739</u>

i) *Purchased insurance claims:*

The amount of \$5,509 (2004 – \$8,456) above 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 (“Schemes”) 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 \$nil (2004 – \$795) in new claims and received \$5,866 (2004 – \$3,991) in Scheme dividends.

Investment income of \$2,919 (2004 – \$1,368) 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.

ii) *Commissions purchased and embedded derivatives:*

In previous years, the Company purchased various assignments of the right to collect commissions from different portfolios of long-term care insurance policies issued by several investment grade insurance carriers. 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 varying rates of interest per annum. At December 31, 2005, the outstanding balance amounted to \$42,997 (2004 – \$61,413). The commission income earned of \$7,794 (2004 – \$1,355) has been recorded within net investment income.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

## 10. Structured insurance assets (Continued)

### ii) Commissions purchased and embedded derivatives: (Continued)

In two of these arrangements, the Company has also been granted an effective right to share in the profits of the trusts above an agreed amount established at inception ranging from \$15,000 to \$15,750, 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, 2005, the net unrealized gain arising from the revaluation of the embedded derivative amounted to \$1,530 (2004 – \$4,923), which has been recorded within net investment income, with a corresponding increase in the amount of the embedded derivative asset.

### iii) Originated loans

From time to time, the Company makes loans to existing or potential clients who are in need of financing. The effective interest rates on the originated loans range between 4.1% and 20.0% (2004 – 20.0%). The latest maturity with respect to these loans is September 30, 2006.

## 11. Deferred policy acquisition costs

	<u>2005</u>	<u>2004</u>
Balance at the beginning of year	\$ 23,330	\$ 6,003
Deferred policy acquisition costs incurred during the year	73,233	116,715
Policy acquisition costs, charged to income	(66,457)	(105,528)
Deferred policy acquisition costs acquired during the year (Note 5)	7,808	6,093
Deferred policy acquisition costs novated during the year	(170)	-
Foreign exchange differences	<u>(1,242)</u>	<u>47</u>
Balance at the end of year	\$ <u><u>36,502</u></u>	\$ <u><u>23,330</u></u>

## 12. Goodwill

	<u>2005</u>	<u>2004</u>
<u>Cost</u>		
Balance at the beginning of the year	\$ 5,804	\$ -
Arising from business combinations (Note 5)	451	5,103
Foreign exchange differences	<u>(700)</u>	<u>701</u>
Balance at the end of the year	\$ <u><u>5,555</u></u>	\$ <u><u>5,804</u></u>
<u>Accumulated impairment losses</u>		
Balance at the beginning of the year	\$ -	\$ -
Impairment charge recorded during the year	<u>1,144</u>	<u>-</u>
Balance at the end of the year	\$ <u><u>1,144</u></u>	\$ <u><u>-</u></u>
Net carrying amount	\$ <u><u>4,411</u></u>	\$ <u><u>5,804</u></u>

The impairment charge recorded during the year of \$1,144 (2004 - \$nil) has been recognized within operating expenses in the Consolidated Statement of Income.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

## 13. Claims and claims adjustment expenses and reinsurance losses recoverable

(i) The movement in claims and claims adjustment expenses is as follows:

	<u>2005</u>	<u>2004</u>
Net claims and claims adjustment expenses at the beginning of year	\$ 871,365	\$ 324,199
Less: reinsurance losses recoverable	(135,133)	-
Add: reserves offset against funds held by ceding companies	<u>111,229</u>	<u>184,879</u>
Gross claims and claims adjustment expenses at the beginning of the year	<u>847,461</u>	<u>509,078</u>
<b>Add (Deduct):</b>		
<i>Incurring losses:</i>		
Current year	457,695	443,875
Prior years	<u>(4,248)</u>	<u>19,474</u>
Total incurred losses	<u>453,447</u>	<u>463,349</u>
<b>Deduct:</b>		
<i>Losses and loss expenses paid related to:</i>		
Current year	(97,743)	(105,926)
Prior years	<u>(219,815)</u>	<u>(230,559)</u>
Total paid losses	<u>(317,558)</u>	<u>(336,485)</u>
<b>Add (Deduct):</b>		
Net claims reserves acquired during the year (Note 5)	45,863	202,189
Foreign exchange differences	(37,161)	5,832
Amounts reclassified from investment contracts	-	3,498
Recovery against the contingent note payable (Note 15)	19,875	-
Transferred to liabilities held for sale (Note 6)	<u>(1,048)</u>	<u>-</u>
Net claims and claims adjustment expenses at the end of year	1,010,879	847,461
Less: reserves offset against funds held by ceding companies	(42,486)	(111,229)
Add: reinsurance losses recoverable	<u>203,283</u>	<u>135,133</u>
Claims and claims adjustment expenses at the end of year	\$ <u>1,171,676</u>	\$ <u>871,365</u>

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 13. Claims and claims adjustment expenses and reinsurance losses recoverable (Continued)

- (ii) The process used to determine the assumptions for measuring claims and claims adjustment expenses and reinsurance losses recoverable is as follows:

### **Overview**

The assumptions employed by the Company in the estimation of its insurance and reinsurance related assets and liabilities are intended to result in provisions which are sufficient to cover any liabilities arising out of all of its insurance and reinsurance contracts, including both contracts under which the Company accepts significant insurance risk ("insurance contracts") and those which do not contain significant insurance risk but may contain financial risk ("investment contracts"). In establishing reserves, the Company utilizes the same integrated, multi-disciplinary approach that it uses to establish its reinsurance prices. After initial analysis by the reserving actuaries, focusing on the structure of the contracts, the development of the contracts since inception and latest available information, preliminary results are shared with the appropriate personnel of the Company to ensure that the most comprehensive set of information possible is incorporated into the reserving process. These personnel may include the underwriters, pricing actuaries, claims and finance professionals, external professional advisors and, as appropriate, the senior management team. Following this comprehensive process, the Chief Risk Officer recommends the appropriate level of reserves for claims and claims adjustment expenses to the Board of Directors for adoption.

Setting appropriate reserves for claims and claims adjustment expenses is an inherently uncertain process. Claims reserves represent the estimate, at a given point in time, of the ultimate settlement and adjustment costs of losses incurred. Inherent in the estimate of ultimate claims are such factors as expected trends in frequency, claim severity, the occurrence of catastrophic events, the timing of claim payments and interest yields that could vary significantly as claims develop and are settled. The uncertainty in loss estimation is particularly pronounced for long-tail lines where information typically emerges over time. In the overall reserve setting process, provisions for economic inflation and changes in the social and legal environment are considered. The uncertainty inherent in the reserving process tends to be even greater for the reinsurance companies compared to primary insurance companies. This is because of, but not limited to, the time lag in reporting information from the insurer to the reinsurer and differing reserving practices among ceding companies. As a result, actual claims and claims adjustment expenses may deviate, perhaps materially, from the ultimate costs reflected in the Company's current reserves for claims and claims adjustment expenses.

### **Overall Reserving Basis**

Provision is made as at the balance sheet date for the expected ultimate cost of settlement of all claims incurred in respect of events up to that date, whether reported or not, together with related allocated claims handling expenses, less amounts already paid. These reserve amounts are calculated in accordance with IFRS adopted by the IASB under which the Company's Consolidated Financial Statements are prepared.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 13. Claims and claims adjustment expenses and reinsurance losses recoverable (Continued)

### Data

The sources of data used as inputs for the assumptions surrounding claims reserving includes data sources internal to the Company, data received, per contractual agreements, from counterparties that the Company reinsures, data provided by various professional advisors engaged by the Company and publicly available industry and market observable data. The assumptions are verified to ensure that they are consistent with observable market information or other published information where possible. For some transactions where sufficient claims or premium data is not available with which to make a reliable estimate of claims development, such as in the case where the insured or reinsured party is a new start-up entity, prudent assumptions that are in line with the assumptions used in the underlying pricing of the insurance or reinsurance contract are typically utilized.

### Reserves for Claims and Claims Adjustment Expenses

Claims reserves fall into two categories: reserves for reported claims and claims adjustment expenses ("case reserves") and reserves for incurred but not reported claims and claims adjustment expenses ("IBNR").

#### *Case Reserves*

Upon receipt of a notice of claim from an insured or reinsured party, the Company establishes case reserves for the estimated amount of the ultimate settlement. These case reserves are usually determined by the amount of reserves reported by the insured or reinsured party and may be subsequently amended, as deemed necessary, following the internal review processes.

For the Company's Lloyd's business, each notified claim is assessed on a separate case-by-case basis with due regard to the circumstances of the claim, information available from loss adjusters and historical evidence with respect to the size of similar claims. This is performed by the Company's Lloyd's based claims department. For Non-Lloyd's business case estimates may be based on reviews undertaken by third party administrators ("TPAs") and/or by reviews carried out by external professional advisors engaged by the Company. Case estimates are reviewed regularly and are updated as and when new information arises.

#### *IBNR*

The estimation of claims incurred but not reported is generally subject to a greater degree of uncertainty than the estimates of claims already notified, where more information is available. IBNR claims may often not be apparent to the Company until many years after the occurrence of the underlying event giving rise to the claim.

These IBNR reserves include estimated legal and other claims adjustment expenses where appropriate. The Company calculates its IBNR reserves by using generally accepted actuarial techniques and in doing so utilizes actuarial tools and techniques that rely on historical client-specific and industry loss data, pricing information and statistical models, as well as our pricing analyses. The reserve analysis typically relies upon the basic assumption that past experience, adjusted for the effect of current developments and likely trends, is an appropriate basis to estimate the current liability for claims and claims adjustment expenses.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 13. Claims and claims adjustment expenses and reinsurance losses recoverable (Continued)

The key statistical methodologies used, which remain unchanged from prior years, are as follows:

- Chain ladder and Bornhuetter Ferguson methods, which use historical data to estimate the paid and incurred to date proportions of the ultimate claim cost;
- Expected loss ratio methods, which use the Company's expectation of the loss ratio for a class of business;
- Benchmarking methods, which use the experience of comparable, more mature, classes and industry benchmarks to estimate the cost of claims;
- Stochastic methods which use probability distributions of losses to estimate the expected losses ceded to the Company; and
- Life annuity reserving methodologies.

The actual method or blend of methodologies used varies by the accident year (or underwriting year) being considered, the class of insurance and/or reinsurance contracts and observed historical claims development.

To the extent that these methods use historical claims development information, they assume that the historical claims development pattern will occur again in the future. There are reasons why this may not be the case, which, insofar as they can be identified, have been allowed for by modifying the methodologies described. Such reasons include:

- Economic, legal, political and social trends (for example, a difference in the expected level of inflation);
- Changes in the mix of insurance and/or reinsurance contracts incepted;
- Changes in the reporting time lag between the insured and the reinsured and the insurer and the reinsurer;
- Changes in the reserving processes and/or practices of the insured and/or reinsured; and
- The impact of large losses and catastrophes. Large claims are generally assessed separately and are measured on a case by case basis or projected separately in order to allow for the possible distorting effects on development and incidence of these large claims.

### Uncertainty

The provision estimation difficulties differ by class of business and/or type of transaction for a number of reasons, including differences in the:

- Terms and conditions of the underlying contracts (See Note 4);
- Complexity of claims;
- Severity of individual claims; and
- Period between the occurrence and subsequent reporting of claims.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 13. Claims and claims adjustment expenses and reinsurance losses recoverable (Continued)

As the estimation of the reserves for claims and claims adjustment expenses is an inherently uncertain process, quantitative techniques frequently have to be supplemented by professional and managerial judgment. In addition, trends that have affected the development of reserves in the past may not necessarily occur or continue to affect reserve development to the same degree in the future.

### Discounting of Claims and Claims Adjustment Reserves

In line with the IFRS framework and the practice of many reinsurance companies reporting under this framework, the Company typically discounts its claims and claims adjustment reserves for retrospective transactions, life contracts and for prospective transactions involving long tailed liabilities.

The liability for claims and claims adjustment expenses for nine (2004 – seven) contracts are shown on a discounted basis. Rates of interest used in discounting range from 2.40% to 5.70% (2004 – 2.96% to 5.85%). The effect of discounting these claims reserves is to decrease the liability for claims and claim adjustment expenses at December 31, 2005 by approximately \$153,800 (2004 – \$117,395). Included within the prior years' development in claims incurred is an amount of \$12,171 (2004 – \$6,427) which relates to the unwinding of the discount on those contracts where the company carries discounted reserves.

### Reinsurance Losses Recoverable

The Company purchases a range of excess of loss, quota share and other reinsurance or retrocessional contracts principally for its Lloyd's business. IBNR provisions and provisions for outstanding claims and claims adjustment expenses are initially estimated at a gross level and a separate calculation is carried out to estimate the size of the related reinsurance losses recoverable. The methodologies use historical data, gross IBNR estimates and take into account directly the terms and conditions of the insurance and reinsurance contracts to estimate the carrying value of the reinsurance losses recoverable.

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

As at December 31, 2005, \$203,283 (2004 – \$123,256) was recoverable from reinsurers and retrocessionaires, net of allowances for doubtful accounts amounting to \$16,428 (2004 – \$20,976).

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 13. Claims and claims adjustment expenses and reinsurance losses recoverable (Continued)

### Key Assumptions and Sensitivities

The reserving for each transaction will incorporate a number of assumptions which may well differ from transaction to transaction and/or may differ by line or type of business. The assumptions that have the greatest effect on the measurement of the Company's claims and claims adjustment reserves and its reinsurance losses recoverable are as follows:

#### European experience account exposures

To the extent that the contractual terms of any particular transaction limiting the Company's liability thereunder to an experience account balance ("EAB") prove ineffective (which proposition has not been tested, and which management of the Company does not currently believe to be the case), management believes that the Company would be required to post additional reserves with respect to the relevant transaction. Management of the Company is not currently in a position to precisely determine the amount of required additional reserves, if any, but has preliminarily estimated an aggregate figure of \$19,000 for all such transactions.

#### Acceleration of claims payout for discounted deals

The Company discounts a number of transactions for the time value of money. This will necessarily involve certain assumptions about the expected payout of claims and the duration of these liabilities. Should claims payout faster than anticipated, the ultimate liability may exceed the Company's estimates. By way of illustration, the sensitivity of the reserves to a one year advancement (retardation) of all payments relative to the base case payout pattern is an increase (decrease) in the reserves for claims and claims adjustment expenses of approximately \$30,000.

#### Property catastrophe exposure

The Company was significantly impacted, at a gross level before reinsurance, by hurricane and flood activity during the year ended December 31, 2005, principally arising from Storm Erwin, the European Floods and Hurricanes Katrina, Rita and Wilma in the United States. Significant work has gone into establishing the appropriate reserve levels, both gross and net of reinsurance losses recoverable, for these events as at December 31, 2005. The main subsidiary involved in underwriting the majority of these exposures, has demonstrated a solid track record in establishing robust claims and claims adjustment reserves within approximately three months of the occurrence of such events. Unlike many of its competitors, the subsidiary's gross losses remained within its reinsurance program and its conservative estimates of losses continue to be adequate. These facts, coupled with remaining reinsurance protection provides comfort against material adverse reserve movement with respect to claims and claims adjustment expenses carried for events subsequent to December 31, 2005.

The 2005 Year of Account of Syndicate 2121 was also significantly impacted by hurricane activity during the year ended December 31, 2005, particularly Hurricanes Katrina, Rita and Wilma. The Company established reserves as at December 31, 2005 based on a review of the latest information available.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 13. Claims and claims adjustment expenses and reinsurance losses recoverable (Continued)

### Dan Re run-off business exposure

The Company has exposure to the run-off of various discontinued lines of business underwritten by one of its subsidiaries, Dan Re, during the period from 2000 to 2002 and in particular these exposures relate to two lines of business, namely the liability excess of loss and the motor excess of loss lines. In establishing the reserves for these lines of business, assumptions regarding the future development of claims and claims adjustment expenses are necessary. The calculation of reserves is complicated by the long-tailed nature of these liabilities, the volatility of recent claims development and the fact that the original underwriters responsible for this business are no longer employed by the Company.

However, under the terms of the purchase of Dan Re approximately 50% of the purchase consideration was deferred in the form of a contingent note payable under which the Company is indemnified for deterioration in the technical reserves as reported in the audited consolidated financial statements of Dan Re for the year ended December 31, 2004. (See Note 15 for more detail with respect to the contingent note payable). This deterioration was anticipated at the time of acquisition based on third party reserve reviews conducted as part of the Company's due diligence. The contingent note provides substantial protection against deterioration on these reserves. As at December 31, 2005, the Company has established a recovery against the note in the amount of \$19,875 as a result of the deterioration estimated at that date. Based on current estimates of the final principal amount of the note at its maturity, inclusive of accrued interest, the unutilized protection remaining under this note is approximately \$31,000 as at December 31, 2005.

### Impaired lives annuities

The Company has significant exposure to the impaired lives annuity market in the United Kingdom. The key assumptions in setting reserves relate to mortality (longevity) risk and investment return on the underlying invested assets. The estimation of mortality for impaired lives is a highly specialized area. The mortality assumptions used in setting the reserves have been derived by the ceding company. They are based on this company's ten years of experience in the impaired lives annuity market in the United Kingdom and are derived from standard mortality tables adjusted for the effects of impaired lives, various diseases and industry experts' views on improvements to mortality. The Company has engaged an external actuarial consultancy firm to review the methodology and assumptions used by the ceding company to determine mortality rates. The overall conclusion reached by the consulting actuaries was that the approach to determining impaired mortality was reasonable. With regard to investment risk, the Company adopts a matched asset/liability profile for the liabilities which should make it largely neutral to movements in the yield curve.

### Excess long tailed liability contracts

The Company has exposure to a number of excess long-tail liability type transactions with underlying exposures covering general and public liability, workers compensation and medical malpractice. These exposures typically have low frequency and high severity characteristics coupled with significant time lags for the emergence of actual claims activity. The reserving approach typically adopted for these transactions, particularly at the early stages of development, is to use the pricing model and assumptions. Deviations in actual experience from these assumptions are reflected in the quarterly reserving reviews carried out by Company.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 14. Unearned premiums

	<u>2005</u>	<u>2004</u>
Unearned premiums at the beginning of year	\$ 105,967	\$ 134,921
Change in unearned premiums	27,763	(60,819)
Unearned premiums acquired during the year (Note 5)	39,581	31,675
Unearned premiums transferred on novation	(1,594)	-
Unearned premiums transferred to liabilities held for sale (Note 6)	(2,033)	-
Foreign exchange differences	<u>(5,049)</u>	<u>190</u>
Unearned premiums at the end of year	\$ <u><u>164,635</u></u>	\$ <u><u>105,967</u></u>

## 15. Loans payable

Loans payable at December 31, 2005 and 2004 comprise the following:

	<u>2005</u>	<u>2004</u>
Senior loan - net of recovery (i)	\$ 27,046	\$ 42,262
Investment related loan (ii)	10,000	10,000
Subordinated loan (iii)	50,000	-
Other loan (iv)	<u>173</u>	<u>184</u>
	\$ <u><u>87,219</u></u>	\$ <u><u>52,446</u></u>

- (i) In connection with the acquisition of Dan Re on December 31, 2004, the Company issued a contingent note in the initial principal amount of \$44,951, which bears interest at a rate equal to six-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.

Upon the finalization of the audited consolidated financial statements of Dan Re for the year ended December 31, 2004, the initial principal amount of the note, \$44,951, was reset to \$46,603 being the amount equal to the excess of the audited consolidated book value of Dan Re at December 31, 2004.

The terms of this loan state that the principal amount of the note shall be subject to upward or downward adjustment for any positive or adverse development on any insurance or 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 be equal to 50% of the positive reserve variance. In the case of a negative reserve variance, the adjustment amount shall be equal to 100% on the first \$10,000 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.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

## 15. Loans payable (Continued)

The contingent note has been recognized in the Consolidated Financial Statements at its discounted value of \$46,921 (2004 – \$42,262) inclusive of accrued interest, less an amount recoverable of \$19,875 (2004 – \$nil) against the contingent note based on the results of a provisional determination of the adverse development on the reinsurance related balances of Dan Re as at December 31, 2005. The contingent note is discounted using a discount rate of six-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. Given that the Company has the legally enforceable right and intends to settle the outstanding contingent note payable net of the recovery against this note, the right of offset has been applied, reducing the discounted value to \$27,046 as at December 31, 2005.

- (ii) Also included within loans payable is an amount of \$10,000 (2004 – \$10,000) borrowed as part of an investment transaction entered into during 2001. This loan matures in June 2007 and can be prepaid at the Company's option with no penalty before this date. Interest on the loan is equal to the U.S. three-month LIBOR plus 50 basis points. The loan is collateralized with cash and short-term investments amounting to \$10,500 (2004 – \$10,500)
- (iii) On December 13, 2005, the Company borrowed \$50,000 on an unsecured basis maturing in ten years from Trilon International Inc, one of the Company's shareholders. This loan is subordinated to the letter of credit obligations under both of the letter of credit facilities described in Note 17. The amount outstanding under this loan shall initially bear interest at a rate equal to U.S. one-month LIBOR plus 400 basis points and be reset on the first day of each month thereafter. The interest rate at December 31, 2005 was 8.31% (2004 – nil%).
- (iv) The remaining amount of \$173 (2004 – \$184) is unsecured, interest free and repayable immediately on the closure of the open years of account of Syndicates 947, 923, 2947 and 2923. As at December 31, 2005, these open years of account have been closed and the Company is currently in the process of settling this amount.

## 16. Share capital

At December 31, 2005, the Company had an authorized share capital of 200,000,000 (2004 – 200,000,000) shares consisting of:

- a) 49,331,755 common shares (2004 – 49,764,164) with a par value of \$1 each and an issue price of \$10.24 per share,
- b) 150,236,000 (2004 – 150,236,000) undesignated shares with a par value of \$1 each.

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

	<u>2005</u>	<u>2004</u>
<i>Common shares at a par value of \$1 per share:</i>		
49,331,755 (2004 – 49,764,164) common shares	\$ 49,332	\$ 49,764
Additional paid up capital/share premium	<u>429,083</u>	<u>428,651</u>
Total share capital	\$ <u>478,415</u>	\$ <u>478,415</u>

During the year, 432,409 common shares were purchased from a shareholder for \$nil consideration and subsequently cancelled.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 17. Liquidity resources

### (i) Letters of Credit

#### Non-Lloyd's Facility

Effective November 18, 2005, the Company renewed and expanded its letter of credit agreement (the "Non-Lloyd's Facility") with five (2004 – four) financial institutions, including ING Bank, N.V. London Branch (as administrative agent) and Barclays Bank PLC, New York Branch (as lead issuing bank). Under the Non-Lloyd's Facility, the banks have agreed to provide letters of credit on an unsecured basis with a total capacity of \$290,000 (2004 – \$242,500).

Letters of credit under the Non-Lloyd's Facility mature 364 days from the date of issuance on an evergreen basis, meaning that they automatically renew each year unless utilized by the letter of credit beneficiary. Under the Non-Lloyd's 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 the appropriate collateral under the Non-Lloyd's Facility. As at December 31, 2005, thirteen (2004 – five) letters of credit totaling \$152,008 (2004 – \$93,425) have been issued and the Company is in compliance with all of the covenants under the Non-Lloyd's Facility.

#### Lloyd's Facility

Effective December 5, 2005, the Company entered into a credit agreement with three financial institutions, including ING Bank, N.V. London Branch (as administrative agent and lead issuing bank) to establish a letter of credit facility (the "Lloyd's Facility") under which the issuing banks have agreed to provide letters of credit with a total capacity of £115,000 (US\$197,915) of which £80,000 (US\$137,680) is on an unsecured basis and £35,000 (US\$60,235) is on a secured basis. At December 31, 2005, two letters of credit totaling £76,839 (US\$132,240) (2004 – £nil) have been issued under the unsecured portion of the Lloyd's Facility.

#### Other secured letters of credit

The Company has also obtained two (2004 – five) letters of credit outside of the above facilities in the aggregate amount of \$9,729 (2004 – \$102,836), which have been collateralized with cash and short term investments amounting to \$7,362 (2004 – \$101,011).

### (ii) Line of Credit

Effective June 23, 2005, the Company entered into a 365 day Line of Credit (the "Line") in the aggregate amount of \$100,000 with Trilon International Inc, a shareholder of the Company. The Line will automatically renew for successive 365 day periods unless 90 days written notice is provided by either party to the agreement. The Line is intended to provide the Company with a liquid and readily-available source of capital to meet any short term liquidity requirements that may arise from time to time. Outstanding amounts under the Line bear interest at six-month U.S. LIBOR plus 100 basis points. Borrowings under the Line will be subordinated to the letter of credit obligations under both of the letter of credit facilities described in part (i) of Note 17 above. At December 31, 2005 no drawings have been made under the Line.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

## 18. Net investment income

Net investment income is comprised of the following:

	<u>2005</u>	<u>2004</u>
Interest income	\$ 20,862	\$ 20,755
Dividend income	1,648	-
Commission income (Note 10)	7,794	1,355
Investment income on funds held by ceding companies	31,289	11,993
Investment income on purchased insurance claims (Note 10)	2,919	1,368
Impairment losses recognized during the year	(2,954)	-
Investment expenses	(4,210)	(2,633)
Net unrealized investment loss on derivative financial instruments	(1,468)	(1,808)
Unrealized investment gain on embedded derivatives (Note 10)	<u>1,530</u>	<u>4,923</u>
	<u>\$ 57,410</u>	<u>\$ 35,953</u>

Impairment losses amounting to \$2,954 (2004 – \$nil) were recognized during the year with respect to two collateralized debt obligations as a result of observable data indicating that there was a measurable decrease in the estimated future cash flows from these financial instruments since their initial recognition.

## 19. Personnel expenses

Included within operating expenses are the following personnel expenses:

	<u>2005</u>	<u>2004</u>
Salaries and bonus	\$ 21,488	\$ 10,735
Vested portion of the Long Term Incentive Plan (ii)	8,529	7,381
Contributions to defined contribution plans (iii)	1,113	794
Other employee benefits	<u>4,218</u>	<u>1,493</u>
	<u>\$ 35,348</u>	<u>\$ 20,403</u>

- (i) As at December 31, 2005, there were 150 employees (2004 – 128) of the Company.
- (ii) The Company has in place 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 annual accretion or reduction in net present value of all reinsurance and capital transactions entered into by the Company since its inception. The LTIP awards vest over a four-year period.
- (iii) 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.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 19. Personnel expenses (Continued)

- (iv) On September 30, 2004, 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. When issued these options vested immediately upon their issuance and were stated to expire on September 24, 2014. None of these options have been exercised since they were granted.
- (v) Included within the personnel expenses above are key management personnel compensations detailed within the categories prescribed by IAS 24 as follows:

	<u>2005</u>		<u>2004</u>
Short-term employee benefits	\$ 2,773	\$	2,504
Vested portion of Long Term Incentive Plan	5,704		3,884
Post employment benefits	<u>193</u>		<u>161</u>
	\$ <u>8,670</u>	\$	<u>6,549</u>

## 20. Related party balances and transactions

Included within cash and cash equivalents are amounts totaling \$690 (2004 – \$7,295) on deposit with Trilon International Inc., a shareholder of the Company. These amounts earn interest at rates ranging from 1.90% to 3.80% (2004 – 0.59% to 1.79%) per annum.

Included within investment contract assets is \$25,000 (2004 – \$25,000) recoverable from Trilon International Inc. with respect to a reinsurance contract.

Included within reinsurance balances payable is an amount payable of \$25,574 (2004 – \$28,613) due to Century Property & Casualty Insurance Corporation, an affiliated company, with respect to a reinsurance contract. The net underwriting income recorded on this contract during the year was \$498 (2004 – \$292).

Included within net investment income are investment asset management fees of \$1,250 (2004 – \$2,500) for services provided by Brascan Strategic Asset Management LLC, and \$491 (2004 – \$nil) to Hyperion Capital Management Inc. both of which are considered to be affiliated companies.

Included within operating expenses is rent expense of \$110 (2004 – \$87), for the rental of a property owned by an affiliated company.

Included within finance costs is interest expense incurred on the subordinated loan from Trilon International Inc. in the amount of \$231.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## 21. Commitments

The Company leases office space under operating leases expiring in various years through 2012 (2004 – 2012). The future minimum rental payments related to these commitments are as follows:

	<u>2005</u>		<u>2004</u>
Less than one year	\$ 1,063	\$	1,633
Between one and five years	2,099		5,321
More than five years	<u>114</u>		<u>919</u>
	\$ <u>3,276</u>	\$	<u>7,873</u>

On December 31, 2005, a subsidiary of the Company concluded a sublease arrangement which ran from April 22, 2002 to December 31, 2005 on its premises in New York. This sublease arrangement reimbursed the Company \$68 monthly (\$816 per annum) amounting to \$2,998 over the term of the arrangement.

Included in operating expenses for the year is rent expense on all of the Company's leased premises of \$1,844 (2004 – \$860).

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

## 22. Statutory requirements

The Company is required to maintain certain measures of solvency and liquidity as prescribed by regulations in the domiciles in which the Company and its subsidiaries operate. The Company's ability to pay dividends is therefore subject to the regulatory restrictions on the payment of dividends by its licensed insurance subsidiaries. Actual and minimum statutory capital and surplus as of December 31, 2005 and December 31, 2004 of the Company's subsidiaries are as follows:

<u>Subsidiary</u>	<u>Actual</u> <u>2005</u>	<u>Minimum</u> <u>2005</u>	<u>Actual</u> <u>2004</u>	<u>Minimum</u> <u>2004</u>
Imagine Insurance Company Limited	\$ 573,814	\$ 30,467	\$ 482,433	\$ 23,432
Imagine Reinsurance SCC	7,616	125	3,799	125
Imagine Insurance A/S	15,061	8,150	14,104	6,292
Imagine Re (Luxembourg) S.A.	20,482	1,839	1,841	1,671
Pillar Insurance Company (Bermuda) Limited	3,823	1,000	1,560	1,000
Affiliated Chemical Insurance Limited	383	250	388	250
Imagine Reinsurance U.S. Limited	172	125	160	125
Imagine International Reinsurance Limited	55,811	749	41,746	866
Imagine Corporate Capital Limited	30,422	30,422	30,493	30,493
Pillar Insurance Company Limited	4,314	3,821	4,271	4,092
Imagine Underwriting Limited	1,034	688	1,248	771
Danish Re Syndicates Limited	688	688	1,140	771
Danish Re (Capital) Limited	101,742	101,742	94,876	92,164
Danish Re (Bermuda) Limited	102,272	24,525	81,364	27,937
Abacus Syndicates Limited	688	688	-	-
SOC Corporate Member No. 6 Limited	64,182	63,846	-	-
Polder Limited	15,744	15,744	46,326	46,326
Fenwall Limited	22,054	22,054	24,488	24,488

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## **23. 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 30% (2004 – 33%). However, as their income is exclusively earned from foreign insurance business, the Companies are also 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 2.10% (2004 – 2.31%).

In addition to the above, Imagine Reinsurance U.S. Limited has 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% (2004 – 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 corporate income 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% (2004 – 34%).

Imagine Insurance A/S and Danish Re Underwriting Agencies ApS are subject to a corporate tax rate of 28% (2004 – 30%) in Denmark. Imagine Re (Luxembourg) S.A. is subject to a corporate tax rate of 30% (2004 – 30%) in Luxembourg. Imagine International Reinsurance Limited is subject to a tax rate of 12.5% (2004 – 12.5%) in Ireland.

Danish Re Capital Limited, Danish Re Syndicates Limited, Danish Re (U.K.) Group Limited, Fenwall Limited, Polder Limited, Imagine Corporate Capital Limited, GMA Imagine Limited, Imagine Underwriting Limited, Imagine Management Services Limited, Greenfield Underwriting Limited, SOC Corporate Member No. 6 Limited, Abacus Underwriting Agencies Limited and Abacus Syndicates Limited are subject to a corporate tax rate of 30% (2004 – 30%) in the United Kingdom.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

## 23. Taxation (Continued)

Corporation tax recoveries comprise:

	<u>2005</u>	<u>2004</u>
<i>Current tax</i>		
Current year	\$ 5,669	\$ (1,050)
Over provision in prior years	<u>(21)</u>	<u>(639)</u>
	<u>5,648</u>	<u>(1,689)</u>
<i>Deferred tax</i>		
Decelerated tax depreciation	-	8
Other temporary differences	1,206	680
Benefits of tax losses recognized	(20,881)	(1,463)
Under provision in prior years	(4,537)	126
Foreign exchange differences	<u>-</u>	<u>(1)</u>
	<u>(24,212)</u>	<u>(650)</u>
Corporation tax recoveries	\$ <u><u>(18,564)</u></u>	\$ <u><u>(2,339)</u></u>
Reconciliation of taxes calculated at the applicable tax rate with corporation tax recoveries:		
(Loss) income before corporation taxes	\$ <u>(15,994)</u>	\$ <u>47,522</u>
Tax calculated at a tax rate of 0% (2004 – 0%)	-	-
Effect of different tax rates in other countries	(6,459)	7,595
Tax effect of rate at which deferred liability is computed	(1,203)	439
Income not subject to tax	-	(111)
Expenses not deductible for tax purposes	49	98
Utilization of previously unrecognized tax losses	(828)	(276)
Over provision in prior years' current tax	(21)	(639)
Under provision in prior years' deferred tax	555	126
Tax credit for net foreign currency earnings of QICs	(10,033)	(8,666)
Use of unrecognized tax assets	(991)	(1,463)
Under provision of current year's current tax	<u>367</u>	<u>558</u>
Corporation tax recoveries	\$ <u><u>(18,564)</u></u>	\$ <u><u>(2,339)</u></u>

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

## 24. Deferred taxes

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

	<u>2005</u>	<u>2004</u>
At beginning of year	\$ 13,245	\$ 2,584
Foreign exchange differences	(257)	306
Acquisition of subsidiaries (Note 5)	(299)	11,614
Income statement credit (Note 23)	(24,212)	(650)
Other	<u>3,269</u>	<u>(609)</u>
At end of year	\$ <u>(8,254)</u>	\$ <u>13,245</u>

The net deferred tax account is comprised as follows:

Deferred tax assets	\$ (18,835)	\$ (1,074)
Deferred tax liabilities	<u>10,581</u>	<u>14,319</u>
Net deferred tax account	\$ <u>(8,254)</u>	\$ <u>13,245</u>

Included within tax assets and recoveries on the Consolidated Balance Sheet are deferred tax assets attributable to the following items:

	<u>2005</u>	<u>2004</u>
<b>Deferred tax assets:</b>		
Decelerated tax depreciation	\$ 133	\$ 141
Provisions	34	-
Tax losses	18,658	933
Other	<u>10</u>	<u>-</u>
	\$ <u>18,835</u>	\$ <u>1,074</u>

The remaining amount of \$37 (2004 – \$2,207) relates to current taxes recoverable.

Included within tax liabilities on the Consolidated Balance Sheet are deferred tax liabilities attributable to the following items:

	<u>2005</u>	<u>2004</u>
<b>Deferred tax liabilities:</b>		
Accelerated tax depreciation	\$ 2	\$ 2
Accrued interest	173	91
Fair value gains	2,411	2,299
Reserves	<u>7,995</u>	<u>11,927</u>
	\$ <u>10,581</u>	\$ <u>14,319</u>

The remaining amount of \$1,844 (2004 – \$2,464) relates to current taxes payable.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

(Expressed in Thousands of United States Dollars)

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## 25. 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 believes that it will not 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 this industry, received a subpoena in November 2004 from the U.S. Securities and Exchange Commission related to non-traditional products. The Company also received a similar subpoena in June 2005 from the U.S. District Court for the Southern District of New York. The Company is cooperating fully with these agencies and has submitted information in compliance with the subpoenas.

## 26. Earnings per share

Basic earnings per share is calculated by dividing the net income attributable to equity holders of the Company by the weighted average number of ordinary shares in issue during the year.

Diluted earnings per share is calculated adjusting the weighted average number of ordinary shares outstanding to assume conversion of all dilutive potential ordinary shares at the beginning of the year. The Company has one category of dilutive potential ordinary shares, namely share options as described in Note 19. For the share options, a calculation is performed to determine the number of shares that could have been acquired at fair value based on the monetary value of the subscription rights attached to the outstanding share options. The number of shares calculated as above is compared with the number of shares that would have been issued assuming the exercise of the share options.

	<u>2005</u>	<u>2004</u>
<b>Earnings basic and fully diluted</b>		
Net Income attributable to ordinary equity holders of the parent	\$ <u>2,393</u>	\$ <u>49,860</u>
<b>Common shares</b>		
<b>Basic:</b>		
Weighted average shares outstanding	<u>49,544</u>	<u>18,648</u>
<b>Diluted:</b>		
Weighted average shares outstanding	49,544	18,648
Effect of dilutive securities:		
Share options	<u>142</u>	<u>74</u>
Weighted average, as adjusted	<u>49,686</u>	<u>18,722</u>
<b>Earnings per share:</b>		
Basic	\$ 0.05	\$ 2.67
Diluted	\$ 0.05	\$ 2.66

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2005

*(Expressed in Thousands of United States Dollars)*

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## **27. Comparative figures**

Certain comparative amounts for 2004 have been reclassified to conform to the current year's presentation. These reclassifications include the following:

In the current year's presentation, net foreign exchange gains have been reported separately on the Consolidated Statement of Income. As a result of this change to the current year's presentation, the comparative amounts for net investment income, policy acquisition costs and operating expenses have been reclassified accordingly.

In the current year's presentation, goodwill has been reported separately on the Consolidated Balance Sheet. As a result of this change to the current year's presentation, the comparative amount for other assets, where goodwill was reported previously, has been reclassified accordingly.

In the current year's presentation, net derivative financial instruments have been split out between derivative financial assets and derivative financial liabilities and reported appropriately on the Consolidated Balance Sheet. This change in the current year's presentation has resulted in a corresponding reclassification to the comparatives.