VIRGINIA SURETY COMPANY INC – NEW ZEALAND BRANCH

ANNUAL FINANCIAL REPORT

FOR THE YEAR ENDED
31 DECEMBER 2017

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DIRECTOR'S REPORT

The Director presents the annual report together with the audited Financial Statements for the year ended 31 December 2017.

No disclosure has been made pursuant to Section 211(1) (a) and (e) to (j) of the *Companies Act 1993* following a unanimous decision by the shareholders in accordance with Section 211 (3) of the Act.

RESULTS
The loss for the year after income tax was $756,139 (2016: loss $239,227).

DIVIDEND
The Director recommends that no dividend be paid (2016: $Nil).

AUDITORS
In terms of the *Companies Act 1993*, Ernst & Young are to continue in office as the Branch's auditors.

ACTIVITIES
The principal activities during the year were those of insurance underwriting and investment.

DIRECTORS INTERESTS IN TRANSACTIONS
Directors have no interests to declare in the transactions of the year ended 31 December 2017.

REVIEW OF OPERATIONS
The loss for the financial year reflects a change in accounting policy that has been adopted to recognise claims handling expenses and risk margin with the claims provision liability. This is to align the accounting recognition to NZ IFRS 4.

SUBSEQUENT EVENTS
There were no events since 31st December 2017 which have significantly affected, or may significantly affect, the operations of the branch in future financial years, the results of those operations, or the state of affairs of the company in future financial years.

ON BEHALF OF THE BOARD

_______________Director
30 April 2018

_______________Director
30 April 2018

Building a better working world

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Independent Auditor's Report

The Shareholders of Virginia Surety Company Inc. (New Zealand Branch)

Report on the Financial Statements

We have audited the financial statements of the New Zealand branch of Virginia Surety Company Inc. on pages 5 to 26, which comprise the statement of financial position of the New Zealand branch of Virginia Surety Company Inc. as at 31 December 2017, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

This report is made solely to the company's shareholders, as a body. Our audit has been undertaken so that we might state to the company's shareholders those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the New Zealand branch of the company and the company's shareholders as a body, for our audit work, for this report, or for the opinions we have formed.

Directors' Responsibility for the Financial Statements

The directors are responsible on behalf of the company for the preparation and fair presentation of the financial statements in accordance with New Zealand Equivalents to International Financial Reporting Standards and International Financial Reporting Standards, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on the financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing (New Zealand). These auditing standards require that we comply with relevant ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we have considered the internal control relevant to the New Zealand branch of the company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the New Zealand branch of the company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates, as well as evaluating the overall presentation of the financial statements.

We believe we have obtained sufficient and appropriate audit evidence to provide a basis for our audit opinion.

Other than in our capacity as auditor we have no relationship with, or interest in, the New Zealand branch of the company.

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Partners and employees of our firm may deal with the New Zealand branch of the company on normal terms within the ordinary course of trading activities of the business of the New Zealand branch of the company.

Opinion

In our opinion, the financial statements on pages 5 to 26 present fairly, in all material respects, the financial position of the New Zealand branch of the company as at 31 December 2017 and its financial performance and cash flows for the year then ended in accordance with New Zealand Equivalents to International Financial Reporting Standards and International Financial Reporting Standards.

Ernst + Young

Ernst & Young

Brett Kallio

Brett Kallio
Partner
Melbourne
30 April 2018

VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH

STATEMENT OF COMPREHENSIVE INCOME

FOR THE YEAR ENDED 31 DECEMBER 2017

	Notes	2017 $	Restated 2016 $
REVENUE			
Premium revenue		1,534,227	1,524,118
Decrease in unearned premium reserve		1,495,390	1,957,065
		3,029,617	**3,481,183**
EXPENSES			
Gross claims incurred	5	1,116,481	1,104,825
Acquisition costs	17	2,837,870	1,950,331
		3,954,351	**3,055,156**
Investment income	8	506,879	174,482
Gain on investments	9	727,053	296
		1,233,932	**174,778**
Other operating and administration expenses	7	(1,598,889)	(927,465)
Profit/(Loss) before income tax		**(1,289,691)**	**(326,660)**
Income tax benefit	10	533,552	87,433
Profit/(Loss) after income tax		**(756,139)**	**(239,227)**
Total comprehensive income		**(756,139)**	**(239,227)**

Operating profit for the year attributable to:		
Non-controlling interest	-	-
Owners of the parent	(756,139)	(239,227)
Operating Profit after tax	(756,139)	(239,227)
Total comprehensive income is attributable to:		
Non-controlling interest	-	-
Owners of the parent	(756,139)	(239,227)
Operating Profit after tax	(756,139)	(239,227)

The attached notes on pages 9 to 26 form part of and should be read in conjunction with these financial statements, together with the Auditors' Report on page 3 and 4.

VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH

STATEMENT OF FINANCIAL POSITION

AS AT 31 DECEMBER 2017

	Notes	2017 $	Restated 2016 $
ASSETS			
Current assets			
Cash and cash equivalents	11	837,516	1,270,576
Trade and other receivables	12	2,952,063	233,390
Deferred acquisition costs	17	1,535,342	3,517,170
Current tax asset	10	84,786	66,820
Total current assets		5,409,707	5,087,956
Non-current assets			
Investments	14	46,505,869	5,377,205
Deferred tax assets	10	681,607	154,817
Total non-current assets		47,187,476	5,532,022
TOTAL ASSETS		52,597,183	10,619,978
LIABILITIES			
Current liabilities			
Trade and other payables	13	1,775,965	1,301,934
Outstanding claims	16	977,026	583,579
Unearned premiums	19	4,496,029	5,991,392
Total current liabilities		7,249,020	7,876,905
TOTAL LIABILITIES		7,249,020	7,876,905
NET ASSETS		45,348,163	2,743,073
TOTAL EQUITY	21	45,348,163	2,743,073

For and on behalf of the board of directors, who authorised the issue of this financial report on the date of signing.

____________________ Director 30 April 2018

____________________ Director 30 April 2018

The attached notes on pages 9 to 26 form part of and should to be read in conjunction with these financial statements, together with the Auditors' Report on page 3 and 4.

VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH

STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 DECEMBER 2017

	2017 $	Restated 2016 $
Total Equity as at 1 January	2,743,073	2,982,300
Capital contribution	43,361,229	-
(Loss) for the year	(756,139)	(239,227)
Total comprehensive income/(loss)	(756,139)	(239,227)
Total Equity as at 31 December	45,348,163	2,743,073

The attached notes on pages 9 to 26 form part of and should be read in conjunction with these financial statements, together with the Auditors' Report on page 3 and 4.

VIRGINIA SURETY COMPANY INC - NEW ZEALAND BRANCH

STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED 31 DECEMBER 2017

	Note	2017 $	2016 $
Cash flows from operating activities			
Receipts from customers		3,374,973	2,997,807
Payments to suppliers and employees		(5,044,075)	(2,622,763)
Interest received		1,248,146	169,601
Net cash flows provided by/(used in) operating activities	11	(420,956)	544,645
Cash flows from investing activities			
Purchase of investment assets		(43,928,664)	(716,272)
Payment received from investment		2,800,000	-
Net cash flows used in investing activities		(41,128,664)	(716,272)
Cash flows from financing activities			
Capital contribution		43,444,770	-
Repayments (to)/from related parties		(2,328,210)	(647,953)
Net cash flows from financing activities		41,116,560	(647,953)
Net decrease in cash and cash equivalents		(433,060)	(819,580)
Cash and cash equivalents at beginning of period		1,270,576	2,090,156
Cash and cash equivalents at end of period		837,516	1,270,576

The attached notes on pages 9 to 26 form part of and should be read in conjunction with these financial statements, together with the Auditors' Report on page 3 and 4.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1. CORPORATE INFORMATION

These financial statements have been prepared for the New Zealand branch of the Virginia Surety Company Inc., which is incorporated in the United States of America.

Corporate Information
Virginia Surety Company Inc for the year ended 31 December 2017, incorporated in the United States of America, is the Branch's immediate parent company.

The registered office of Virginia Surety Company Inc New Zealand branch (the Branch) for the year ended 31 December 2017 is
359 Lincoln Road,
Christchurch,
New Zealand, 8024

TPG Capital, incorporated in U.S, is the Branch's ultimate holding company.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Insurance Contract
All of the insurance products offered or utilised by the Branch meet the definition of insurance contracts under the New Zealand equivalents to International Financial Reporting Standards (NZ IFRS), and are accounted for and reported in accordance with these standards.

These products do not contain embedded derivatives or deposits that are required to be unbundled.

Basis of Preparation

The financial statements have been prepared in accordance with NZ IFRS and the requirements of the *Companies Act 1993* and the *FMC Act 2014* on a historical cost basis. For the purposes of complying with NZ GAAP the entity is a for-profit entity.

The financial report has been prepared on an accrual basis of accounting including the historical cost convention and the going concern assumption.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The financial statements are presented in New Zealand dollars.

The following particular accounting policies have been applied:

a) Revenue

Premium revenue for insurance comprises amounts charged to policyholders. The earned portion of premium received and receivable is recognised as revenue. The pattern of recognition of income over the policy or indemnity periods is based on time, which closely approximates the pattern of risks underwritten. Interest on investment income is accounted for on an accrual basis.

b) Unearned Premium

Provisions in respect of the proportion of premiums relating to risk in future periods of account are calculated on the straight-line basis over the period of risk.

c) Deferred Acquisition Expenses

Acquisition expenses, principally comprising commissions and fees incurred on insurance contracts, are deferred and expensed over the period in which the related premiums are earned. Deferred acquisition costs are measured at the lower of cost and recoverable amount.

Changes in the expected useful life or the expected pattern of consumption of future economic benefits embodied in the asset are accounted for by changing the amortisation period and are treated as a change in an accounting estimate.

An impairment review is performed at each reporting date or more frequently when an indication of impairment arises. When the recoverable amount is less than the carrying value, an impairment loss is recognised in the statement of comprehensive income. Deferred acquisition expenses are also considered in the liability adequacy test for each reporting period.

d) Outstanding Claims

The Outstanding Claims provision comprises the estimated costs of claims incurred including indirect claims settlement costs, whether reported or not, and claims not settled at balance date. Reported claims have been assessed in the light of the information available at balance date and after taking account of present value of the expected future payments. The provision for claims incurred but not reported has been assessed having regard for the Branch's claim performance. The expected future payments include claims handling costs which are to be incurred in settling the insured claims.

e) Taxation

Current tax is calculated by reference to the amount of income taxes payable or recoverable in respect of the taxable profit or tax loss for the period. It is calculated using tax rates and tax laws that have been enacted or substantively enacted by reporting date. Current tax for current and prior periods is recognised as a liability (or asset) to the extent that it is unpaid (or refundable).

Deferred tax is accounted for using the comprehensive balance sheet liability method in respect of temporary differences arising from differences between the carrying amount of assets and liabilities in the financial statements and the corresponding tax base of those items.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

e) Taxation (continued)

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period(s) when the asset and liability giving rise to them are realised or settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by reporting date. The measurement of deferred tax liabilities and assets reflects the tax consequences that would follow from the manner in which the Branch expects, at the reporting date, to recover or settle the carrying amount of its assets and liabilities.

Current and deferred tax is recognised as an expense or income in the statement of comprehensive income, except when it relates to items credited or debited directly to equity, in which case the deferred tax is also recognised directly in equity.

f) Goods and Services Tax (GST)

Revenues, expenses and assets are recognised net of the amount of GST, except:

- where the amount of GST incurred is not recoverable from the taxation authority, it is recognised as part of the cost of acquisition of an asset or as part of an item of expense; or

- for receivables and payables which are recognised inclusive of GST.

The net amount of GST recoverable from, or payable to, the taxation authority is included as part of receivables or payables.

g) Investments

Financial assets at fair value through profit and loss:

Financial assets at fair value through profit or loss include financial assets held for trading and financial assets designated upon initial recognition at fair value through profit or loss. Financial assets at fair value through profit or loss are carried in the statement of financial position at fair value with net changes in fair value presented as finance costs (negative net changes in fair value) or finance income (positive net changes in fair value) in the statement of profit or loss.

h) Foreign Currency Translation

(i) Functional and presentation currency
Both the functional and presentation currency of Virginia Surety Company Inc – New Zealand Branch is New Zealand dollars ($).

(ii) Transactions & balances
Transactions in foreign currencies are initially recorded in the functional currency by applying the exchange rates ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange ruling at the reporting date.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

h) Foreign Currency Translation (continued)

Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate as at the date of the initial transaction. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

i) Claims

Reported claims have been assessed in the light of the information available at balance date and after taking account of expected trends in future settlements. The outstanding claims liability is measured as the central estimate of the present value of expected future payments relating to claims incurred at the reporting date with an additional risk margin to allow for the inherent uncertainty in the central estimate. The liability is measured based on valuations performed by the Appointed Actuary. The liability is discounted to present value using a risk free rate. Refer to Note (o).

The liability adequacy test is an assessment of the carrying value of the unearned premium liability and is conducted at each reporting date. If current estimates of the present value of the expected future cash flows relating to future claims arising from the rights and obligations under current general insurance contracts, plus an additional risk margin to reflect the inherent uncertainty in the central estimate, exceed the unearned premium liability (net of reinsurance) less relevant deferred acquisition costs (if any), then the unearned premium liability is deemed to be deficient. The test is performed at the level of a portfolio of contracts that are subject to broadly similar risks and that are managed together as a portfolio. In these accounts, this represents the overall New Zealand portfolio of contracts. Any deficiency arising from the test is recognised in the profit or loss with the corresponding impact on the Statement of Financial Position recognised first through the write down of deferred acquisition costs (if any) for the relevant portfolio of contracts, with any remaining balance being recognised on the Statement of Financial Position as an unexpired risk liability.

j) Trade and other receivables

Trade receivables, which generally have 30 day terms, are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method, less an allowance for impairment.

Collectability of trade receivables is reviewed on an ongoing basis at an operating unit level. Individual debts that are known to be uncollectible are written off when identified. An impairment provision is recognised when there is objective evidence that the Group will not be able to collect the receivable. Financial difficulties of the debtor, default payments or debts more than 30 days overdue are considered objective evidence of impairment. The amount of the impairment loss is the receivable carrying amount compared to the present value of estimated future cash flows discounted at the original effective interest rate.

k) Trade and other payables

Trade and other payables are carried at amortised cost and due to their short-term nature they are not discounted. They represent liabilities for goods and services provided to the Branch prior to the end of the financial year that are unpaid and arise when the Branch becomes obliged to make future payments in respect of the purchase of these goods and services. The amounts are unsecured and are usually paid within 30 days of recognition.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

l) Cash and cash equivalents

Cash and cash equivalents in the statement of financial position comprise cash at bank and in hand and short term deposits with an original maturity of three months or less that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

m) Impairment of assets

At each reporting date, the Branch reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any). Where the asset does not generate cash flows that are independent from other assets, the Branch estimates the recoverable amount of the cash-generating unit to which the asset belongs.

Recoverable amount is the higher of fair value less costs to sell 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 which the estimates of future cash flows have not been adjusted.

If the recoverable amount of an asset (or cash-generating unit) is estimated to be less than its carrying amount, the carrying amount of the asset (cash-generating unit) is reduced to its recoverable amount. An impairment loss is recognised in profit or loss immediately, unless the relevant asset is carried at fair value, in which case the impairment loss is treated as a revaluation decrease.

Where an impairment loss subsequently reverses, the carrying amount of the asset (cash-generating unit) is increased to the revised estimate of its recoverable amount, but only to the extent that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset (cash-generating unit) in prior years. A reversal of an impairment loss is recognised in profit or loss immediately, unless the relevant asset is carried at fair value, in which case the reversal of the impairment loss is treated as a revaluation increase.

n) New Accounting Standards and Interpretations

New Zealand Accounting standards and interpretations that have been recently issued or amended but are not yet effective have not been adopted by the group for the annual reporting period ending 31 December 2017.

- NZ IFRS 17 Insurance Contracts

The branch has not elected to early adopt any new standards or interpretations that are issued but not yet effective, as it continues to determine the impact on the financial statements.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

o) Significant Accounting Judgements, Estimates & Assumption

The preparation of the financial statements requires management to make judgements, estimates and assumptions that affect the reported amounts in the financial statements. Management continually evaluates its judgements and estimates in relation to assets, liabilities, contingent liabilities, revenue and expenses. Management bases its judgements and estimates on historical experience and on other various factors it believes to be reasonable under the circumstances, the result of which form the basis of the carrying values of assets and liabilities that are not readily apparent from other sources.

(i) Valuation of outstanding claims provision

For insurance contracts, estimates have to be made both for the expected ultimate cost of claims reported at the reporting date and for the expected ultimate cost of claims incurred but not yet reported at the reporting date (IBNR). It can take a significant period of time before the ultimate claims form the majority of the liability in the statement of financial position. The IBNR included assumptions such as claims frequency, cancellations and average claim size.

The ultimate cost of outstanding claims is estimated by using a range of standard actuarial claims projection techniques, including Paid Chain Ladder, Inflation-Adjusted Payments Per Claims Incurred and Bornheutter-Ferguson method.

The main assumption underlying these techniques is that a Group's past claims development experience can be used to project future claims development and hence ultimate claims costs. As such, these methods extrapolate the development of paid and incurred losses, average costs per claim and claim numbers based on the observed development of earlier years and expected loss ratios. Historical claims development is mainly analysed by accident years, but can also be further analysed by geographical area, as well as by significant business lines and claim types. Large claims are usually separately addressed, either by being reserved at the face value of loss adjuster estimates or separately projected in order to reflect their future development.

In most cases, no explicit assumptions are made regarding future rates of claims inflation or loss ratios. Instead, the assumptions used are those implicit in the historical claims development data on which the projections are based. Additional qualitative judgement is used to assess the extent to which past trends may not apply in future, (e.g., to reflect one-off occurrences, changes in external or market factors such as public attitudes to claiming, economic conditions, levels of claims inflation, judicial decisions and legislation, as well as internal factors such as portfolio mix, policy features and claims handling procedures) in order to arrive at the estimated ultimate cost of claims that present the likely outcome from the range of possible outcomes, taking account of all the uncertainties involved.

Similar judgements, estimates and assumptions are employed in the assessment of adequacy of provisions for unearned premium. Judgement is also required in determining whether the pattern of insurance service provided by a contract requires amortisation of unearned premium on a basis other than time apportionment.

The carrying value at the reporting date of expected claims liabilities is $1,072,368 (2016: $583,579).

Claims provisions are expected to be settled within one year. The amount of expected future payments does not differ materially from the present value; therefore the claims provision has not been discounted.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

p) Change in accounting policy

A change in accounting policy has been adopted to recognise claims handling expenses and risk margin with the claims provision liability. This is to align the accounting recognition to NZ IFRS 4.

The change has had the following impact on the Financial Statements:

Statement of Comprehensive Income

	2016	Adjustment	2016 restated
Gross claims incurred	806,465	298,360	1,104,825
Loss before income tax	(28,300)	(298,360)	(326,660)
Income tax benefit	3,892	83,541	87,433
Loss after income tax	(24,408)	(214,819)	(239,227)

	2017	Adjustment	2017 restated
Gross claims incurred	572,309	544,172	1,116,481
Loss before income tax	(745,519)	(544,172)	(1,289,691)
Income tax benefit	97,104	436,449	533,553
Loss after income tax	(648,416)	(107,723)	(756,139)

Statement of Financial Position

	2016	Adjustment	2016 restated
Deferred tax assets	71,276	83,541	154,817
Total non-current assets	5,448,481	83,541	5,532,022
Total assets	10,536,437	83,541	10,619,978
Outstanding claims	391,198	192,381	583,579
Total current liabilities	7,684,524	192,381	7,876,905
Total liabilities	7,684,524	192,381	7,876,905
Net assets	2,851,913	(108,840)	2,743,073
Total equity	2,851,913	(108,840)	2,743,073

	2017	Adjustment	2017 restated
Deferred tax assets	161,617	436,449	598,066
Total non-current assets	46,667,486	436,449	47,103,935
Total assets	50,333,008	436,449	50,769,457
Outstanding claims	240,473	736,553	977,026
Total current liabilities	4,690,961	736,553	5,427,514
Total liabilities	4,690,961	736,553	5,427,514
Net assets	45,564,726	(300,104)	45,264,622
Total equity	45,564,726	(300,104)	45,264,622

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

p) Change in accounting policy (continued)

Statement of Changes in equity

	2016	**Adjustment**	**2016 restated**
Total equity as at 1 January	2,876,321	105,979	2,982,300
(Loss) for the year	(24,408)	(214,819)	(239,227)
Total equity as at 31 December	2,851,913	(108,840)	2,743,073

	2017	**Adjustment**	**2017 restated**
Total equity as at 1 January	2,851,913	(108,840)	2,743,073
(Loss) for the year	(68,416)	(107,723)	(756,139)
Total equity as at 31 December	45,372,345	(107,723)	45,264,622

3. RISK MANAGEMENT

(a) Risk management framework

The financial condition and operation of the branch is affected by a number of key risks including insurance risk, credit risk, market risk and liquidity risk.

The branch has developed, implemented and maintained a Risk Management Strategy (RMS) and Reinsurance Risk Management Strategy (ReMS). The RMS and ReMS identify the branch's policies and procedures, processes and controls that comprise its risk management and control systems. The RMS and ReMS have been approved by the Audit and Compliance Committee and provided to APRA.

(b) Insurance risk

Insurance Risk is defined as the risk of loss due to the actual experience being different than that assumed when an insurance product was designed and priced.

VSC's local underwriter is responsible for pricing the risk. When the value is above the underwriter's delegated authority it is referred to the US Underwriting Group for review and approval.

These files provide guidance on the willingness to accept risk and such issues as geographic and monetary limits.

The following processes are undertaken:

- Continuous assessment of product characteristics to ensure that pricing and outcomes remain consistent with the assumptions used in product design.
- Systems of claims categorisation and loss measurement by risk category.
- Effective correction strategies for underpricing of risk.
- Anticipation of factors leading to changes in claims incidence and claims costs.

Unless approved by the local Underwriter or confirmation is received from the US Underwriting Group, no business will be accepted nor new classes of business introduced.
In accordance with the Reinsurance Policy no liability which exceeds the maximum retention levels shall be approved by the Executive Management Committee.

The Underwriting Committee meets on a monthly basis to review and monitor portfolio performance.

On a monthly basis all product programs are reviewed by the underwriter and presented to the Underwriting Committee who review them, in particular the loss ratio.

(c) Credit risk

Credit risk refers to the risk that a customer or counterparty to a financial instrument fails to meet its contractual obligations resulting in financial loss to the branch and arises principally from the branch's premium receivables and investments.

VSC's exposure to credit risk is concentrated in the following key activities:

Investments: These activities involve the investment of a significant proportion of assets in fixed interest and bonds. VSC's New Zealand investment policy ensures that it only invests in assets that are of investment grade BBB- or above and that no more than 5% is invested in the one asset. The Branch does hold a US dollar denominated corporate bond fund of which no single issuer is greater than 10%.

(c) Credit risk (continued)

Business partner risk: Intermediaries and business partners, act on behalf of VSC in insurance sales, premium collection and remittance to VSC. To counteract counterparty risk, VSC receives monthly remittance from their business partners. If this is not received on time, investigative action is undertaken.

Intermediaries and business partners are subject to a variety of statutory regulatory controls in addition to controls within VSC management framework. Financial Institutions in general are subject to a range of regulatory control processes. Agents tend to be less subject to statutory regulatory control with greater emphasis on monitoring and supervision on the part of VSC.

The Branch does not have any significant credit risk exposure to any single counterparty or any group of counterparties having similar characteristics. The maximum exposure to credit risk is the amounts shown in the statement of financial condition and notes. The maximum credit risk to the Branch is the carrying value of the assets. The Branch does not have any concentration of credit exposure.

(d) Market risk

Market risk is the risk that changes in market prices, such as changes in interest rates and foreign exchange, will affect the branch's interest income, claims expense or the value of its holdings in financial instruments.

Foreign currency risk:

The Branch has minimal exposure to foreign currency risk as core investments are undertaken in New Zealand dollars. The Branch does hold a US dollar denominated corporate bond fund of which the future liabilities are also denominated in US dollars thus mitigating any foreign currency risk.

(e) Liquidity risk

Liquidity risk can be defined as the risk that the branch will not be able to meet its payment obligations as they fall due without excessive cost.

Ultimate responsibility for liquidity risk management rests with the board of directors, who have built an appropriate liquidity risk management framework for the management of the Branch's short, medium and long term funding and liquidity management requirements.

The Branch manages liquidity risk by maintaining adequate reserves and banking facilities by continuously monitoring forecast and actual cash flows and matching the maturity profiles of financial assets and liabilities.

4. RELATED PARTY TRANSACTIONS

The following table provides the total amount of transactions that were entered into with related parties for the relevant financial year (for information regarding outstanding balances for trade and other receivables, refer to Note 11):

		Sales to Related Parties	Purchases from Related Parties	Expenses Charged by Related Parties
Fellow subsidiaries :		$	$	$
The Warranty Group Australasia Pty Ltd - expenses paid for on behalf of the Branch	**2017**	-	-	**(742,978)**
	2016	-	-	**(567,961)**
The Warranty Group Australasia Pty Ltd - marketing & administration fees	**2017**	-	-	**(216,915)**
	2016	-	-	**(237,523)**

During the year, The Warranty Group Australasia Pty Ltd, paid expenses of $742,978 (2016: $567,961) on behalf of the New Zealand Branch of Virginia Surety Company Inc. These expenses were recharged to the Branch at year end.

During the year, the New Zealand Branch of Virginia Surety Company Inc paid $2,800,000 (2016: nil) to the Australia Branch of Virginia Surety Company Inc. There remains an amount outstanding of $2,761,895 (2016: nil) as at 31 December 2017.

Unless otherwise stated, related parties are fellow subsidiaries of the ultimate parent company.

Terms and conditions of transactions with related parties
Sales to and purchases from related parties are made in arm's length transactions both at normal market prices and on normal commercial terms.

Outstanding balances at year-end are unsecured, interest free and settlement occurs in cash.

5. CLAIMS INCURRED

Current year claims relate to risks borne in the current financial year. Prior year claims relate to a reassessment of the risks borne in all previous financial periods.

	2017	Restated 2016
	$	$
Current year	335,657	708,878
Prior years	236,652	97,587
Total incurred claims	572,309	806,465
Movement in claims provision	295,040	257,907
Net claims expense – discounted	867,349	1,064,372
Net risk margin	249,132	40,453
Total incurred claims	1,116,481	1,104,825

6. AUDITORS' REMUNERATION

The auditor of the Branch is Ernst & Young.

Auditors' fees payable for the audit of the financial report of the company as at 31st December 2017 amounted to $21,529 (2016: $30,030).

Auditors' fees charged for the year comprises:

	2017 $	2016 $
Auditor Remuneration:		
Audit fee	26,328	21,227
Tax compliance	39,750	28,056
	66,078	49,283

7. OTHER OPERATING AND ADMINISTRATION EXPENSES

Other Operating and administration expenses comprises:

	2017 $	2016 $
Salaries & benefits	11,429	2,299
Other operating and administrative expenses recharged to the Branch	775,659	657,750
Office & communication	182,959	72,486
Travel & entertainment	37,329	118,115
Bank charges	678	3,291
Bad debts	(28,906)	20,463
Legal fees	-	2,995
Auditors & consultants fees	66,078	49,283
Loss on foreign exchange	535,120	-
Other expenses	18,543	783
	1,598,889	927,465

8. INVESTMENT INCOME

	2017 $	2016 $
Investment income comprises:		
Interest on government stock	157,789	171,056
Dividend income	348,223	-
Other interest	867	3,426
	506,879	174,482

9. GAIN ON INVESTMENTS

	2017 $	2016 $
Unrealised gains on Corporate bond fund	729,556	-
(Loss) / gain on other investments	(2,503)	296
	727,053	296

10. CURRENT YEAR'S TAXATION

	2017	Restated 2016
Taxation expense comprises:	$	$
Profit before taxation	(1,289,691)	(326,600)
Current tax (expense) / benefit @ 28%	361,113	91,465
Non-assessable income for tax purposes	156,829	-
Non-deductible expenses for tax purposes	(1,653)	(756)
Adjustments recognised in the current period in relation to the current tax of prior periods	6,764	-
Utilisation of previously unrecognised tax losses	10,499	(3,276)
Total tax (expense) / benefit	533,552	87,433
Current tax assets and liabilities		
Tax receivable	84,786	66,820
Current tax asset	84,786	66,820
Tax payable	-	-
Current tax liability	-	-
Deferred tax balances		
Provision for doubtful debts	185	64,204
Deferred acquisition costs	-	-
Carry forward tax losses	589,350	947
Other	92,072	89,666
Net deferred tax (liability)/asset	681,607	154,817

11. CASH AND CASH EQUIVALENTS

	2017	2016
	$	$
Cash at bank and in hand	837,516	1,270,576

Reconciliation to Cash Flow Statement

For the purpose of the Cash Flow statement, cash and cash equivalents comprise the following at 31 December:

Cash at bank and in hand	837,516	1,270,576

11. CASH AND CASH EQUIVALENTS (Continued)

Reconciliation of net profit after tax to net cash flows from operations

	2017 $	2016 $
Net profit	(756,139)	(24,408)
Adjustments for:		
(Decrease) / Increase in allowance for doubtful debts	(228,638)	20,270
Changes in Assets and Liabilities:		
Decrease / (Increase) in trade and other receivables	257,646	(44,969)
Decrease / (Increase) in Investment Assets	14,214	(5,177)
(Decrease) / Increase in outstanding claims	393,447	184,550
(Decrease) / Increase in trade and other payables	40,346	1,235,863
(Increase) in deferred tax asset	(610,331)	(3,893)
(Increase) / Decrease in current tax receivable	(17,966)	28,211
(Decrease) in unearned premium	(1,495,363)	(1,957,075)
Decrease in deferred acquisition cost	1,981,828	1,111,273
Net cash flows provided by/ (used in) operating activities	(420,956)	544,645

12. TRADE AND OTHER RECEIVABLES

	2017 $	2016 $
Investment income receivable	26,493	40,707
Premium debtors	159,774	421,606
Provision for doubtful debts	(662)	(229,300)
Prepayments	4,563	377
Related party receivable	2,761,895	-
	2,952,063	233,390

13. TRADE AND OTHER PAYABLES

	2017 $	2016 $
Trade payables and accruals	31,780	(8,566)
Related party payable	1,744,185	1,310,500
	1,775,965	1,301,934

14. INVESTMENTS

	2017 $	2016 $
Non current		
Government stock	2,768,669	5,377,205
Corporate bond fund	43,737,200	-
Total investments	46,505,869	5,377,205

14. INVESTMENTS (Continued)

The investments included in the Statement of financial position are carried at fair value. The major methods used in determining fair value of investments are disclosed below.

The table below analyses financial instruments carried at fair value according to the inputs used in their valuation. The different levels have been defined as follows:

- Level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities
- Level 2: inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices)

31 December 2017	**Level 1**	**Level 2**	**Total**
Government stock	2,768,669		2,768,669
Corporate bond fund		43,737,200	43,737,200
31 December 2016			
Government stock	5,377,205		5,377,205

15. FINANCIAL ASSETS AND LIABILITIES

Categories of financial assets and liabilities

	2017 **$**	**2016** **$**
Cash and cash equivalents	837,516	1,270,576
Investments	46,505,869	5,377,205
Loans and receivables	2,952,063	233,390
Liabilities at amortised cost	(1,775,965)	(1,301,934)

Financial assets carried at fair value through profit or loss have been designated as such upon initial recognition.

The carrying value of all financial assets and liabilities approximate to their fair value.

16. CLAIMS PROVISIONS

Composition of claims provision

	2017 **$**	**2016** **$**
Undiscounted central estimate	335,874	391,198
Net discount to present value	(2,475)	(1,851)
Discounted central estimate	333,399	389,347
Discounted claims administration expenses	394,495	153,779
Net claims expense – discounted	727,894	543,126
Net risk margin	249,132	40,453
Net outstanding claims – discounted including risk margin	977,026	391,198

16. CLAIMS PROVISIONS (CONTINUED)

Claims provisions are expected to be settled within one year. The amount of expected future payments does not differ materially from the present value; therefore, the claims provision has not been discounted.

a) Process for determining net outstanding claims provision
Discounting:
A projection of future claims payments both gross and net of reinsurance and other recoveries is undertaken. Projected future claims payments and associated claims handling costs are discounted to a present value as required, using appropriate risk free discount rates.

Risk margin:
The central estimate of the outstanding claims liability is an estimate which is intended to contain no deliberate or conscious over or under estimation and is commonly described as providing the mean of the distribution. It is considered appropriate for the measurement of the claims liability to represent a higher degree of certainty regarding the sufficiency of the liability over time, and so a risk margin is added to the central estimate. The risk margin refers to the amount by which the liability recognised in the financial statements is greater that the actuarial central estimate of the liability. The risk margin added to the central estimate increases the probability that the net outstanding claims provision will ultimately prove to be adequate to 75%.
Risk margins are held to allow for uncertainty surrounding the outstanding claims provision estimation process. Potential uncertainties include those relating to the actuarial model and assumptions, the quality of the underlying data used in the model, general statistical uncertainty, and the general insurance environment.

b) Description for Assumptions made
Discount rate
Because the outstanding claims provision represents payments that will be made in the future, they are discounted to reflect the time value of money, effectively recognising that the assets held to back insurance liabilities will earn a return during that period. Discount rates represent a risk free rate derived from market yields on Australian government securities.

Risk Margin Rate
Due to the short term nature of the provisions, and the level of reinsurance cover, the approach adopted for determining the risk inherent in the provision, involved review of statistical variation in the incremental cost movement of gross incurred costs net of facultative reinsurance recoveries, allowing for additional variation in the Excess of Loss (XoL) reinsurance recoveries, loss adjustment expenses and claims handling costs.

CLAIMS RESERVE	**2017** **$**	**2016** **$**
At beginning of year	583,579	334,218
Claims incurred	1,116,481	1,104,825
Claims settled	(723,034)	(855,464)
At end of year	977,026	583,579

17. DEFERRED ACQUISITION COSTS

	2017 $	2016 $
At beginning of year	3,517,170	4,628,443
Costs incurred	856,042	839,058
LAT write down	(1,014,575)	-
Recognised in statement of comprehensive income	(1,823,295)	(1,950,331)
At end of year	1,535,342	3,517,170

18. ASSETS BACKING GENERAL INSURANCE LIABILITES

In determining which assets back general insurance liabilities, a comparison between the asset values and the amount needed to meet claims liabilities and solvency requirements was carried out.

19. LIABILITY ADEQUACY TEST

The liability adequacy test carried out on the insurance portfolio in the current year in accordance with NZ IFRS 4 identified a deficiency of $1,014,575 (2016: $130,362).

	2017 $	2016 $
<u>Insurance Portfolio</u>		
Gross unearned premium reserve	4,496,029	5,991,392
Reinsurance	-	-
Net unearned premium	**4,496,029**	**5,991,392**
Ultimate net loss ratio	65.8%	39.1%
Future claims provision - discounted	(2,314,072)	(2,149,764)
Claims handling costs	(394,495)	(153,643)
Risk margin	(249,132)	(40,453)
Expected future claims	**(2,957,699)**	**(2,343,860)**
Deferred acquisition costs		
Commission expense	(1,886,076)	(2,601,275)
Administration	(663,841)	(915,895)
LAT deficiency	1,014,575	-
Total deferred acquisition costs	**(1,535,342)**	**(3,517,170)**
Level of (deficiency) / surplus	**(1,014,575)**	**130,362**

The liability adequacy test carried out on the insurance portfolio in the current year identified a deficiency resulting in a write down. The liability adequacy test carried out in the prior year identified surpluses.

20. INSURER FINANCIAL STRENGTH RATING AND SOLVENCY DISCLOSURE

Virginia Surety Company Inc has a financial strength rating of A- issued by A M Best (2016: A-) and the following solvency information:

20. INSURER FINANCIAL STRENGTH RATING AND SOLVENCY DISCLOSURE (CONTINUED)

	2017 USD $	2016 USD $
Actual solvency capital	406,282,296	409,997,635
Minimum solvency capital	104,429,518	98,453,185
Solvency margin	301,852,778	311,544,450
Solvency ratio	3.89	4.16

21. EQUITY

	2017 $	2016 $
Paid in Capital		
At start of year	650,000	650,000
Capital contribution	43,361,229	-
At end of year	44,011,229	650,000

22. EQUITY RETAINED FOR THE PURPOSES OF FINANCIAL SOUNDNESS

The branch retains a level of equity and retained reserves which enable it to maintain an adequate solvency margin for ongoing ability to pay clients. These financial statements relate to a branch of an overseas company. Its assets are available to support the liabilities of the company outside of New Zealand.

23. SUBSEQUENT EVENTS

No matters or circumstances have arisen since the end of the financial year which has significantly affected, or may significantly affect, the operations of the branch in future financial years, the results of those operations, or the state of affairs of the branch in future financial years.