**Insurance Australia Group Limited**
ABN 60 090 739 923
388 George Street
Sydney NSW 2000
Telephone 02 9292 9222
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IAG Insurance Australia Group

25 August 2006

Manager, Company Announcements Office
Australian Stock Exchange Limited
Level 4, Exchange Centre
20 Bridge Street
SYDNEY NSW 2000

Dear Sir/Madam

**INSURANCE AUSTRALIA GROUP LIMITED ('IAG')**

**FINANCIAL RESULTS – YEAR ENDED 30 JUNE 2006**

Attached for immediate release to the market is Insurance Australia Group Limited's Appendix 4E – Preliminary Financial Report 30 June 2006.

The documents below will follow and be lodged separately:

1. Media Release
2. Investor Report – 30 June 2006
3. Investor Presentation Slides

Yours sincerely

Glenn Revell
**Group Company Secretary**

# INSURANCE AUSTRALIA GROUP LIMITED

# ABN 60 090 739 923

# PRELIMINARY FINAL REPORT 30 JUNE 2006
# APPENDIX 4E (ASX listing rule 4.3A)

CONTENTS

# INSURANCE AUSTRALIA GROUP LIMITED

## APPENDIX 4E – PRELIMINARY FINAL REPORT 30 JUNE 2006

## RESULTS FOR ANNOUNCEMENT TO THE MARKET

| | Up/Down | % change | 2006 $m | Restated 2005 [1] $m |
|---|---|---|---|---|
| Revenue from ordinary activities | Down | 2.55% | 8,228 | 8,443 |
| Profit from ordinary activities after tax attributable to shareholders | Down | 6.41% | 759 | 811 [2] |
| Net profit attributable to shareholders of Insurance Australia Group Limited | Down | 6.41% | 759 | 811 [2] |

Note:

(1) This is the first annual financial report to be prepared in accordance with Australian equivalents to International Financial Reporting Standards ("AIFRS"). Comparative figures have been restated to reflect the adjustments on several recognition and measurement differences between Australian Generally Accepted Accounting Principles ("Australian GAAP") and AIFRS. Reconciliation and explanations of the impact of the transition from Australian GAAP to AIFRS on the financial performance are provided in note 38 to the financial statements as attached in Appendix A – Insurance Australia Group Limited Financial Report 30 June 2006.

(2) For 2005, profit attributable to shareholders included $29 million of dividends attributable to the shareholders of reset preference shares (which was presented as equity under Australian GAAP). From 1 July 2005, the reset preference shares are presented as debt and thus the distributions on reset preference shares were deducted from the profit or loss before profit after tax attributable to shareholders.

| Dividends – ordinary shares | Amount per security | Franked amount per security |
|---|---|---|
| Final dividend | 16.0 cents | 16.0 cents |
| Interim dividend | 13.5 cents | 13.5 cents |

The record date of the dividend is 6th September 2006. The dividend will be paid on 9th October 2006. The last date for the receipt of an election notice for participation in any dividend reinvestment plan is 6th September 2006.

INSURANCE AUSTRALIA GROUP LIMITED

APPENDIX 4E – PRELIMINARY FINAL REPORT 30 JUNE 2006

## APPENDIX 4E COMPLIANCE MATRIX

| **Appendix 4E disclosure requirements** | **Insurance Australia Group Appendix 4E** | **Page Number** | **Note Number** |
|---|---|---|---|
| 1. Details of the reporting period and the previous corresponding period | All financial data headings | | |
| 2. Key information in relation to the following. This information must be identified as "Results for announcement to the market".<br><br>2.1 The amount and percentage change up or down from the previous corresponding period of revenue from ordinary activities.<br><br>2.2 The amount and percentage change up or down from the previous corresponding period of profit (loss) from ordinary activities after tax attributable to members.<br><br>2.3 The amount and percentage change up or down from the previous corresponding period of net profit (loss) for the period attributable to members.<br><br>2.4 The amount per security and franked amount per security of final and interim dividends or a statement that it is not proposed to pay dividends.<br><br>2.5 The record date for determining entitlements to the dividends (if any).<br><br>A brief explanation of any of the figures in 2.1 to 2.4 necessary to enable the figures to be understood. | "Results for announcement to the market" page 1 Appendix 4E | | |
| 3. A statement of financial performance together with notes to the statement, prepared in compliance with AASB 1018 or the equivalent foreign accounting standard. | Attachment A: Financial report 30 June 2006:<br>• Income Statement<br>• Notes to the financial statements<br>- Summary of significant accounting policies<br>- Analysis of income<br>- Analysis of expenses<br>- Income tax<br>- Claims expense | <br>P.32<br><br>P.37<br>P.52<br>P.53<br>P.56<br>P.67 | <br><br><br>Note 1<br>Note 3<br>Note 4<br>Note 6<br>Note 11 (a) |

INSURANCE AUSTRALIA GROUP LIMITED

APPENDIX 4E – PRELIMINARY FINAL REPORT 30 JUNE 2006

| Appendix 4E disclosure requirements | Insurance Australia Group Appendix 4E | Page Number | Note Number |
|---|---|---|---|
| 4. A statement of financial position together with notes to the statement. The statement of financial position may be condensed but must report as line items each significant class of asset, liability, and equity element with appropriate sub-totals. | Attachment A: Financial report 30 June 2006:<br>• Balance Sheet<br>• Notes to the financial statements<br>- Assets – Reinsurance and other recoveries<br>- Assets – Deferred acquisition costs<br>- Assets – Investments<br>- Assets – Trade and other receivables<br>- Assets – Deferred tax assets<br>- Assets – Property, plant and equipment<br>- Assets – Intangible assets<br>- Assets – Goodwill<br>- Liabilities - Outstanding claims liability<br>- Liabilities – Unearned premium liability<br>- Liabilities – Trade and other payables<br>- Liabilities – Restructuring provision<br>- Liabilities – Interest-bearing liabilities<br>- Contributed equity<br>- Outside equity interests in controlled entities<br>- Liabilities – Employee benefits provision | <br>P.33<br><br>P.76<br>P.78<br>P.79<br>P.79<br>P.80<br>P.82<br>P.83<br>P.84<br>P.70<br>P.78<br>P.85<br>P.85<br>P.86<br>P.89<br>P.90<br>P.100 | <br><br><br>Note 12<br>Note 13<br>Note 15<br>Note 16<br>Note 17<br>Note 18<br>Note 19<br>Note 20<br>Note 11 (d)<br>Note 14<br>Note 21<br>Note 22<br>Note 23<br>Note 24<br>Note 24 (e)<br>Note 29 (a) |
| 5. A statement of cash flows together with notes to the statement. The statement of cash flows may be condensed but must report as line items each significant form of cash flow and comply with the disclosure requirements of AASB 1026 Statement of Cash Flows, or for foreign entities, the equivalent foreign accounting standard. | Attachment A: Financial report 30 June 2006:<br>• Cash Flow Statement<br>• Notes to the financial statements<br>- Reconciliation of cash<br>- Reconciliation of net cash provided by operating activities to profit from ordinary activities after income tax | <br>P.35<br><br>P.92<br>P.92 | <br><br><br>Note 25 (a)<br>Note 25 (b) |
| 6. Details of individual and total dividends or distributions and dividend or distribution payments. The details must include the date on which each dividend or distribution is payable and (if known) the amount per security of foreign sourced dividend or distribution. | Attachment A: Financial report 30 June 2006:<br>• Notes to the financial statements<br>- Dividends<br>- Dividend franking account | <br><br>P.62<br>P.63 | <br><br>Note 9<br>Note 9 (f) |
| 7. Details of any dividend or distribution reinvestment plans in operation and the last date for the receipt of an election notice for participation in any dividend or distribution reinvestment plan. | Attachment A: Financial report 30 June 2006:<br>• Notes to the financial statements<br>- Contributed equity<br>- Dividends<br>- Dividend franking account | <br><br>P.89<br>P.62<br>P.63 | <br><br>Note 24<br>Note 9<br>Note 9 (f) |
| 8. A statement of retained earnings showing movements. | Attachment A: Financial report 30 June 2006:<br>• Notes to the financial statements<br>- Retained profits | <br><br>P.90 | <br><br>Note 24 (d) |
| 9. Net tangible assets per security with the comparative figure for the previous corresponding period. | Attachment A: Financial report 30 June 2006:<br>• Notes to the financial statements<br>- Plant, property and equipment | <br><br>P.82 | <br><br>Note 18 |

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APPENDIX 4E – PRELIMINARY FINAL REPORT 30 JUNE 2006

| **Appendix 4E disclosure requirements** | **Insurance Australia Group Appendix 4E** | **Page Number** | **Note Number** |
|---|---|---|---|
| 10. Details of entities over which control has been gained or lost during the period, including the following. | Attachment A: Financial report 30 June 2006:<br>• Notes to the financial statements<br>- Acquisition and disposal of businesses | P.93 | Note 26 |
| 10.1 Name of the entity.<br><br>10.2 The date of the gain or loss of control.<br><br>10.3 Where material to an understanding of the report – the contribution of such entities to the reporting entity's profit from ordinary activities during the period and the profit or loss of such entities during the whole of the previous corresponding period. | Disposal of subsidiaries<br><br>Attachment A: Financial report 30 June 2006:<br>• Notes to the financial statements<br>- Acquisition of subsidiaries<br><br>- Disposal of subsidiaries | P.95<br><br>P.93<br><br>P.95 | Note 26 (c)<br><br>Note 26 (a)<br>Note 26 (c) |
| 11. Details of associates and joint venture entities including the following.<br><br>11.1 Name of the associate or joint venture entity.<br><br>11.2 Details of the reporting entity's percentage holding in each of these entities.<br><br>11.3 Where material to an understanding of the report - aggregate share of profits (losses) of these entities, details of contributions to net profit for each of these entities, and with comparative figures for each of these disclosures for the previous corresponding period. | Attachment A: Financial report 30 June 2006:<br>• Notes to the financial statements<br>- Details of subsidiaries | P.96 | Note 27 |
| 12. Any other significant information needed by an investor to make an informed assessment of the entity's financial performance and financial position. | Attachment A: Financial report 30 June 2006 | | |
| 13. For foreign entities, which set of accounting standards is used in compiling the report (e.g. International Accounting Standards). | Not applicable | | |
| 14. A commentary on the results for the period. The commentary must be sufficient for the user to be able to compare the information presented with equivalent information for previous periods. The commentary must include any significant information needed by an investor to make an informed assessment of the entity's activities and results, which would include but not be limited to discussion of the following. | Attachment A: Financial report 30 June 2006 | | |

INSURANCE AUSTRALIA GROUP LIMITED

APPENDIX 4E – PRELIMINARY FINAL REPORT 30 JUNE 2006

| Appendix 4E disclosure requirements | Insurance Australia Group Appendix 4E | Page Number | Note Number |
|---|---|---|---|
| (14. Continued) | | | |
| 14.1 The earnings per security and the nature of any dilution aspects. | Attachment A: Financial report 30 June 2006:<br>• Notes to the financial statements<br>- Earnings per share | P.61 | Note 8 |
| 14.2 Returns to shareholders including distributions and buy backs. | Attachment A: Financial report 30 June 2006:<br>• Notes to the financial statements<br>- Contributed equity<br>- Dividends<br>- Dividend franking account | P.89<br>P.62<br>P.63 | Note 24<br>Note 9<br>Note 9 (f) |
| 14.3 Significant features of operating performance. | Attachment A: Financial report 30 June 2006:<br>• Directors' report | P.1 | |
| 14.4 The results of segments that are significant to an understanding of the business as a whole. | Attachment A: Financial report 30 June 2006:<br>• Notes to the financial statements<br>- Segment reporting | P.57 | Note 7 |
| 14.5 A discussion of trends in performance. | Attachment A: Financial report 30 June 2006:<br>• Directors' report<br>- Operating and financial review | P.4 | |
| 14.6 Any other factors which have affected the results in the period or which are likely to affect results in the future, including those where the effect could not be quantified. | Attachment A: Financial report 30 June 2006:<br>• Directors' report<br>• Notes to the financial statements<br>- Events subsequent to reporting date | P.1<br>P.132 | Note 39 |
| 15. A statement as to whether the report is based on accounts which have been audited or subject to review, are in the process of being audited or reviewed, or have not yet been audited or reviewed. | The financial report 30 June 2006 has been fully audited.<br>• Independent audit report | P.134 | |
| 16. if the accounts have not yet been audited or subject to review and are likely to be subject to dispute or qualification, a description of the likely dispute or qualification. | Not applicable | | |

# ATTACHMENT A

# INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES

# FINANCIAL REPORT – 30 JUNE 2006

# INSURANCE AUSTRALIA GROUP LIMITED

# ABN 60 090 739 923

# AND CONTROLLED ENTITIES

# FINANCIAL REPORT - 30 JUNE 2006

**CONTENTS**

# INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES

## DIRECTORS' REPORT

The Directors present their report together with the financial report of Insurance Australia Group Limited and the consolidated financial report of the Insurance Australia Group for the year ended 30 June 2006 and the audit report thereon.

The following terminology is used throughout the financial report:

* IAG, Parent or Company - Insurance Australia Group Limited.

* IAG Group, Group or Consolidated entity - the Consolidated entity consists of Insurance Australia Group Limited and its subsidiaries.

**Directors of Insurance Australia Group Limited**

The names and details of the Company's Directors in office at any time during or since the end of the financial year are as follows. Directors were in office for this entire period unless otherwise stated.

**Chairman:**
**Mr JA (James) Strong** AO, age 62 – Independent non-executive Director
Mr James Strong was appointed Chairman of IAG in August 2001. He is Chairman of the IAG Nomination, Remuneration & Sustainability Committee.

Mr Strong is Chairman of Woolworths Limited, Rip Curl Group Pty Limited and the Australian Council for the Arts. He is also a Director of the Australian Grand Prix Corporation, Dorna Sports SL and has been appointed a Director of Qantas Airways Limited, effective 1 July 2006.

Mr Strong was Chief Executive and Managing Director of Qantas Airways Limited from 1993 to 2001. Previous positions he has held include Group Chief Executive of DB Group Limited in New Zealand, National Managing Partner and later Chairman of law firm Corrs Chambers Westgarth, Chief Executive of Trans Australian Airlines (later Australian Airlines) and Executive Director of the Australian Mining Industry Council. Mr Strong has been admitted as a barrister and/or solicitor in various state jurisdictions in Australia.

In 2006 Mr Strong was made an Officer of the Order of Australia.

*Directorships of other listed companies held in past 3 years*
- Woolworths Limited - since 10 March 2000;
- IAG Finance (New Zealand) Limited - since 9 November 2004; and
- Qantas Airways Limited – since 1 July 2006.

**Other directors:**
**Ms YA (Yasmin) Allen** BCom, FAICD, age 42 – Independent non-executive Director
Ms Yasmin Allen was appointed as a Director of IAG in November 2004. She is a member of the IAG Risk Management & Compliance Committee.

Ms Allen has extensive experience in investment banking, as an equities analyst and in senior management.

Ms Allen was previously a Vice President at Deutsche Bank AG, a Director at ANZ Investment Bank in Australia, an Associate Director at James Capel UK Ltd (HSBC Group) and an analyst at Kleinwort Benson plc Investment Bank in the UK.

Ms Allen is currently a Director of Export Finance & Insurance Corporation (EFIC), Macquarie Specialised Asset Management (and the Chairperson of its Audit Committee), Film Australia (and the Chairperson of its Audit Committee), the Salvation Army Advisory Board and the Salvation Army Investment Advisory Board.

*Directorships of other listed companies held in past 3 years*
- None.

**Mr JF (John) Astbury** FAICD, age 62 – Independent non-executive Director
Mr John Astbury was appointed as a Director of IAG in July 2000. He is Chairman of the IAG Audit Committee and serves on the IAG Nomination, Remuneration & Sustainability Committee.

Mr Astbury is a Director of Woolworths Limited and AMP Limited. He was previously the Finance Director of Lend Lease Corporation Limited and a Chief General Manager of National Australia Bank Limited. He has a long career in banking and financial services in both the UK and Australia.

*Directorships of other listed companies held in past 3 years*
- Woolworths Limited - since 29 January 2003; and
- AMP Limited - since 1 September 2004.

**Directors of Insurance Australia Group Limited (continued)**

**Mr GA (Geoffrey) Cousins**, age 63 – Independent non-executive Director
Mr Geoffrey Cousins was appointed as a Director of IAG in July 2000. He is a member of the IAG Audit Committee.

Mr Cousins has more than 26 years experience as a company director. Mr Cousins was previously the Chairman of George Patterson Australia and is a former Director of Publishing and Broadcasting Limited, the Seven Network, Hoyts Cinemas Group and NM Rothchild and Sons Limited. He was the first Chief Executive of Optus Vision and before that held a number of executive positions at George Patterson, including Chief Executive of George Patterson Australia.

Mr Cousins is a consultant to the Prime Minister and is the Chairman of the Cure Cancer Australia Foundation.

*Directorships of other listed companies held in past 3 years*
- None

**Mr ND (Neil) Hamilton** LLB, age 54 – Independent non-executive Director
Mr Neil Hamilton was appointed as a Director of IAG in June 2000 and as a Director of Insurance Australia Limited (formerly NRMA Insurance Limited) in 1999. He is a member of the IAG Risk Management & Compliance Committee.

Mr Hamilton is the Chairman of IRESS Market Technology Limited and Integrated Group Limited. He was formerly the Chairman of Western Power Corporation.

*Directorships of other listed companies held in past 3 years*
- IRESS Market Technology Limited - since 15 September 2000;
- Integrated Group Limited - since 2 August 1999;
- Sons of Gwalia Ltd – from 19 January 2004 to 28 January 2005; and
- Chieftain Securities Limited - from 12 June 2002 to 19 November 2004.

**Mr RA (Rowan) Ross** BEc, BCom, FCPA, SF Fin, age 57 – Independent non-executive Director
Mr Rowan Ross was appointed as a Director of IAG in July 2000 and acted as Chairman from April to August 2001. He is Chairman of the IAG Risk Management & Compliance Committee and serves on the IAG Nomination, Remuneration & Sustainability Committee.

Mr Ross is currently Chairman of Macquarie Capital Alliance Limited and Sydney IVF Limited. He is the former Chairman of Bankers Trust Investment Bank, former National President of the Securities Institute of Australia and former Chairman of the Sydney Dance Company and the Australian Major Performing Arts Group. Mr Ross has more than 30 years experience in investment banking and is an Executive Director of Macquarie Bank Limited.

*Directorships of other listed companies held in past 3 years*
- Macquarie Capital Alliance Limited - since 25 January 2005; and
- IAG Finance (New Zealand) Limited - since 9 November 2004.

**Mr B (Brian) Schwartz** FCA, AM, age 53 – Independent non-executive Director
Mr Brian Schwartz was appointed as a Director of IAG in January 2005. He is a member of the IAG Audit Committee.

Mr Schwartz is the Chief Executive of Investec Bank (Australia) Limited. Prior to this, he was with Ernst & Young Australia (1979 – 2004), becoming its Chief Executive in 1998. He was a member of Ernst & Young's global board and Managing Partner of the Oceania region.

Mr Schwartz serves as a Trustee and Vice President of The Australian Museum and Deputy Chairman of the Board of the Football Federation of Australia Limited. He was appointed a Member of the Order of Australia in 2004 for his services to business and the community.

*Directorships of other listed companies held in past 3 years*
- None.

**Directors of Insurance Australia Group Limited (continued)**

**Mr MJ (Michael) Hawker** BSc, FAICD, FAIM, F Fin, age 46 – Chief Executive Officer and Managing Director
Mr Michael Hawker was appointed Managing Director and Chief Executive Officer of IAG in December 2001.

Before joining IAG, Mr Hawker was Group Executive, Business and Consumer Banking at Westpac Banking Corporation. Previous positions include Executive Director of Citibank International PLC in Europe and Deputy Managing Director of Citibank Limited in Australia.

Mr Hawker was listed by Euromoney as one of the top 50 bankers under the age of 40 and one of the Australian Financial Review's "True Leaders" in 2004 and 2005. He was awarded the Australian Banking & Finance Magazine Millennium Banker of the Year Award in 2000, and the Best Insurance Executive Award in 2003 and 2004. In 2006, he was awarded Insurance Personality of the Year at the Australian and New Zealand Insurance Industry Awards, and Leader of the Year at the Human Capital Leadership Awards. He is a recipient of an Australian Sports Medal, having played 25 Rugby Union Internationals for the Australian Wallabies.

Mr Hawker is President of the Insurance Council of Australia; Member of the Financial Sector Advisory Council; Chairman of the Australian Business in the Community Network; Member of the Business Council of Australia; Member of the Business Roundtable for Sustainable Development; Member of the Australian Business Arts Foundation (AbaF) and Advisory Board Member for the Police Commission of New South Wales. He was previously the Chairman of the Australian Financial Markets Association; Director of the Australian Chamber of Commerce and Industry; Member of the Federal Treasury's Consumer and Financial Literacy Council and an Advisory Board Member of the Australian Graduate School of Management.

*Directorships of listed companies held in past 3 years*

- IAG Finance (New Zealand) Limited - since 9 November 2004.

**Secretaries of Insurance Australia Group Limited**

The name and details of the Company's secretaries at any time during or since the end of financial year are as follows:

**Ms AB (Anne) O'Driscoll** FCA, ANZIIF (Fellow), GAICD
Ms Anne O'Driscoll was appointed to the position of company secretary in July 2002. Before this appointment, Ms O'Driscoll has held a number of senior positions in the IAG Group, including the position of General Manager, Finance. Currently, Ms O'Driscoll is also the Head of Investor Relations & Capital Planning of IAG.

**Mr GD (Glenn) Revell** BCom, MBus, FCPA, FCIS, GAICD
Mr Revell was appointed Group Company Secretary in August 2006. Before this appointment, Mr Revell held the position of company secretary in the IAG Group. Prior to joining IAG, he held the position of General Manager Corporate Affairs & Company Secretary of Howard Smith Limited for eight years.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**DIRECTORS' REPORT**

## Meetings of directors

The number of meetings each Director was eligible to attend and actually attended during the financial year is summarised as follows:

| | Board of Directors | | Audit Committee | | Nomination, Remuneration & Sustainability Committee | | Risk Management & Compliance Committee | | IAG Board Sub-Committee | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Total number of meetings held** | 16 | | 5 | | 5 | | 10 | | 4 | |
| **Directors** | A | B | A | B | A | B | A | B | A | B |
| Mr JA Strong | 16 | 16 | - | - | 5 | 5 | - | - | 3 | 3 |
| Ms YA Allen | 16 | 16 | - | - | - | - | 10 | 10 | 1 | 1 |
| Mr JF Astbury | 16 | 15 | 5 | 4 | 5 | 4 | - | - | - | - |
| Mr GA Cousins* | 16 | 13 | 5 | 5 | - | - | - | - | - | - |
| Mr ND Hamilton | 16 | 15 | - | - | - | - | 10 | 10 | - | - |
| Mr RA Ross | 16 | 15 | - | - | 5 | 4 | 10 | 10 | 1 | 1 |
| Mr B Schwartz | 16 | 15 | 5 | 5 | - | - | - | - | - | - |
| Mr MJ Hawker | 16 | 15 | - | - | - | - | - | - | 4 | 4 |

A - Meetings eligible to attend as a member
B - Meetings attended as a member
* Mr GA Cousins was granted a leave of absence by the Board from 23 May 2006 to 31 July 2006.

## Principal activities

The principal continuing activities of the IAG Group are the underwriting of general insurance and related corporate services and investing activities.

## Operating and financial review

### *Operating result for the year*

The IAG Group's net profit after tax for the year was $862 million (2005 - $928 million). After adjusting for minority interests in the IAG Group result, net profit attributable to equity holders of the Company was $759 million (2005 - $811 million). The current year result has been determined based on the adoption of the Australian equivalents of the International Financial Reporting Standards and where applicable, the prior year information has been updated to reflect this change. Notes 1 and 38 of the financial statements provide detailed information on the accounting policies applied and the resultant impact on the prior year financial performance and financial position.

The following discussion includes analysis that is affected by a reclassification of the financial performance of the IAG Group's captive insurer, by allocating the profit (or loss) earned by the captive from reinsuring the IAG Group's consolidated operations back to those businesses on a basis which reflects the profit (or loss) it earned from those businesses. The adjustments are summarised in the following table:

| | **2006** | | | 2005 | | |
|---|---|---|---|---|---|---|
| | Financial statements | Captive financial performance | Adjusted financial performance | Financial statements | Captive financial performance | Adjusted financial performance |
| | $m | $m | $m | $m | $m | $m |
| Premium revenue | 6,537 | | 6,537 | 6,561 | | 6,561 |
| Reinsurance expense | (405) | (162) | (567) | (417) | (53) | (470) |
| Net earned premium | 6,132 | (162) | 5,970 | 6,144 | (53) | 6,091 |
| Net claims expense | (3,900) | 145 | (3,755) | (4,090) | 42 | (4,048) |
| Underwriting expenses | (1,699) | 25 | (1,674) | (1,624) | 19 | (1,605) |
| Underwriting profit | 533 | 8 | 541 | 430 | 8 | 438 |
| Net investment income on assets backing insurance liabilities | 310 | (8) | 302 | 516 | (8) | 508 |
| Insurance profit | 843 | - | 843 | 946 | - | 946 |

### *Underwriting result*

The IAG Group produced an underwriting profit before investment income on technical reserves of $541 million (2005 - $438 million). The underwriting profit is affected by interest rate movements which change the discount rate applicable to claims reserves. In 2006, this resulted in a decrease in claims expense by $107 million compared to an increase in claims expense of $88 million in 2005. This resulted in a decrease in the loss ratio to 62.9% (2005 – 66.5%) and the combined ratio to 90.9% (2005 – 92.8%). The increase in the expense ratio to 28.0% (2005 – 26.3%) was mainly attributable to an adverse fire service levy adjustment due to under collection in the first half of the financial year (due to the adoption of ICA rates) and a higher allowance for anticipated assessment for the second half of the financial year. Excluding the impact of movement in interest rates on claims expense, the underlying loss ratio improved to 64.7% (2005 – 65.0%) while the combined ratio worsened to 92.7% (2005 – 91.4%) reflecting the increased expense ratio.

### Operating and financial review (continued)

The insurance profit of $843 million (2005 - $946 million), which is considered to be a sound insurance trading result, equated to an insurance margin of 14.1% (2005 – 15.5%). This margin was achieved despite challenging market conditions including the effect of Cyclone Larry.

(a) Australian personal lines insurance operations
The personal lines insurance operations produced an insurance margin of 12.6% for the financial year (2005 – 15.5%). The decline in the insurance margin is directly attributable to the impact of Cyclone Larry as well as the competitive price pressures in all segments and additional expense related to fire service levies. Despite these competitive pressures and the reduction of insurance margin, the business has regained positive momentum with renewal rates higher than they have been for two years and new business volumes recovering. The improved performance is directly related to the initiatives implemented to address the issues arising from the public debate with the Motor Traders Association in the first half of the financial year and selective pricing adjustments.

Gross written premiums decreased by 3.0% to $3,860 million (2005 - $3,978 million), due to strong competition.

(b) Australian commercial lines insurance operations
The commercial lines insurance operations produced an insurance margin of 18.0% for the financial year (2005 – 16.1%). The increase in the margin over the prior year was due to a strong performance in the long tail classes of liability and workers' compensation and consequent reserve releases. These were significantly offset by deterioration in the claims experience of the short tail commercial portfolio (including the impact of Cyclone Larry) and additional expense related to fire service levies.

Gross written premiums decreased by 9.1% to $1,539 million (2005 - $1,694 million) due to strong competition in a softening rate environment.

Fee based income produced a profit of $8 million (2005 – loss of $14 million). The significant turn around was due to improved profitability in the non-risk workers' compensation schemes. The premium funding business also continued to generate profits.

(c) International insurance operations
*New Zealand insurance operations:*
The New Zealand insurance operations produced an insurance margin of 14.5% for the financial year (2005 – 14.4%). The insurance profit was adversely impacted by a snowstorm in June 2006 in the South Island which incurred around $18m of gross claims. Nevertheless, a strong insurance result was still achieved in the face of slowing economic growth and strong competition in a concentrated market.

Gross written premiums decreased by 3.0% to $971 million (2005 - $1,001 million), the reduction being entirely attributable to the depreciation of the New Zealand dollar. In New Zealand dollar terms, the New Zealand operations achieved growth in gross written premium of around 0.5%.

*Thailand insurance operations:*
The IAG Group acquired IAG Insurance (Thailand) Ltd (formerly Royal and Sun Insurance Alliance (Thailand) Ltd) on 4 July 2005 and Safety Insurance Public Company Limited on 31 March 2006. Gross written premium for the date of acquisition to 30 June 2006 was $65 million with a combined ratio of 95.2%. The IAG Group has identified and implemented initiatives to capitalise on growth relevant to the Thailand insurance market, including introducing new products, skills, technology and distribution strategies.

*AmAssurance, Malaysia:*
On 10 March 2006, IAG completed its acquisition of a 30% stake in AmAssurance. The agreement includes a right to increase the IAG Group's holding to 40% by March 2008 and an option, subject to regulatory approval, to increase to 49% over time. The increase is likely to occur if the business needs more capital to support its expansion whether organically or through acquisition.

Under the principles of equity accounting, IAG recognised 30% of AmAssurance's profit as a share of profits from associates in the income statement. This amounted to $2 million for the quarter ended 30 June 2006.

*Captive reinsurer:*
The Captive acts solely as the IAG Group's reinsurer assuming risk from other parts of the business and obtaining reinsurance protections for the IAG Group in the open market. The insurance result decreased by $133 million due to a loss of $56 million in the financial year. This was mainly driven by losses from Cyclone Larry in tandem with the IAG Group's decision to accept higher catastrophe retention levels, facilitated in part through the issue of contingent capital in the form of reset exchangeable securities by the IAG Group in January 2005. As previously discussed, the Captive's financial performance has been allocated to the Australian personal and commercial lines, the New Zealand and Thailand insurance operations.

(d) Corporate and investments
Investment income on corporate and equity holders' funds (net of investment expenses) increased by 7.4% to $537 million. The increase was due to the strong investment performance by all the major asset classes, particularly Australian equities, in the current financial year. The net corporate expenses have increased by $6 million or 4.2% to $148 million. This increase was mainly attributable to the increase in borrowing costs by $17 million in the current financial year due to the reclassification of reset preference shares as debt under AIFRS, offset to some extent by the netting off of interest on the reset exchangeable securities against portfolio investment income. This was offset by a decrease in amortisation of intangibles by $5 million and a decrease in other fee based business expenses of $6 million.

**Operating and financial review (continued)**

***Review of Financial Condition***

(a) Financial position

*Assets:*

The total assets of the IAG Group as at 30 June 2006 are $16,972 million (2005 - $17,102 million). The decrease is mainly attributable to the payment of a special dividend in June 2006 and an increase in income taxes paid resulting in a reduction in total investments.

*Liabilities:*

The total liabilities of the IAG Group as at 30 June 2006 are $13,301 million (2005 - $12,599 million) with the major component being general insurance liabilities of $10,430 million (2005 - $10,426 million). The increase in liability is mainly attributable to the:

- reclassification of $550 million of reset preference shares (issued by IAG in 2002 and 2003) as an interest bearing liability from 1 July 2005 on transition to AIFRS. Previously under AGAAP they were classified as equity; and
- reclassification of minority interests in unitholder funds as liability from 1 July 2005 on transition to AIFRS. Previously under AGAAP these were classified as minority interests in equity.

The increases were offset to some extent by decreases in current tax liabilities and employee benefits provisions. The decrease in current tax liabilities was mainly attributable to a significant increase in PAYG payments during the year and the settlement of income tax payable for the 2005 financial year. The decrease in employee benefits provisions was mainly attributable to actuarial gains on the defined benefit plan during the financial year.

*Equity:*

Equity was impacted by the following activities during the year:

Increase:

- Net profit of $862 million.

Decrease:

- reclassification of reset preference shares and minority interests in unitholder funds to liability (see comment in liabilities above); and
- payment of dividends of $647 million.

(b) Cash from operations

*Cash flows from operating activities:*

Cash flows from operating activities have decreased by 58% to $387 million. The decrease is mainly attributable to a decrease in premiums received and an increase in gross claims paid. Other factors contributing to the decrease were:

- an increase in reinsurance expense paid due to an advance reinsurance payment in June 2006;
- timing of income tax paid which resulted in the 2006 cash flows including instalments for two years;
- an increase in interest payments due to the reclassification of reset preference shares to liabilities; and
- an increase in other operating payments due to commencement of superannuation contributions in June 2005 (as a result of the cessation of the contribution holiday in the IAG & NRMA Superannuation Plan) and increase in fire service levies.

The decrease was offset to some extent by the increase in reinsurance and other recoveries received which includes recoveries on an aggregate excess of loss cover.

*Cash flows from investing activities:*

Cash inflows from investing activities have increased by $1,018 million to $822 million. The increase is largely attributable to the higher level of redemption of investments in 2006 to fund the surplus capital fund in light of acquisitions in Thailand and Malaysia, as well as increased dividend and income tax payments. In addition there was a net redemption of units in IAG controlled trusts by minority interests.

**Operating and financial review (continued)**

*Cash flows from financing activities:*
Cash outflows from financing activities have increased by $245 million to $937 million. This increase is attributable to:

- $205 million in additional dividends paid in the 2006 financial year;
- net redemptions of units in IAG controlled trusts of $136 million in the year compared with $128 million in the prior year;
- the repayment of $46 million of NZ senior term notes during the financial year; and
- the purchase of treasury shares.

There was no issue of reset exchangeable securities ("RES") during the year. In the prior year, the issue of RES and the investment of the proceeds from RES in the Portfolio involved a net outflow of $13 million, mainly attributable to the transaction costs associated with the issue.

(c) Capital adequacy / minimum capital requirements
The IAG Group minimum capital requirement ("MCR") multiple, calculated by applying APRA standards for individual licensed insurers to the consolidated results, is 1.83 times MCR as at 30 June 2006 (2005 – 2.00 times MCR). The multiple remains above the IAG Group's current benchmark multiple of 1.55 times MCR.

Further information on the IAG Group's result and review of operations can be found in the 30 June 2006 Investor Report on the Company's website, www.iag.com.au.

**Likely developments**

Insurance and investment operations are, by their nature, volatile due to the exposure to natural disasters and industry cycles and thus profit predictions are difficult.

The IAG Group expects to grow and diversify its earnings in the 2007 financial year and:

- generate gross written premium growth of 5-10%, including acquisitions;
- deliver a return on equity ("ROE") of at least 1.5x the weighted average cost of capital ("WACC") on a normalised basis; and
- maintain its strong balance sheet and prudent reserving philosophy.

The organic growth expectation takes account of:

- leveraging the IAG Group's current competitive position and positive momentum in direct motor and home insurance;
- reduced premium in New South Wales compulsory third party ("CTP") due to changes in the scheme structure which result in lower premiums;
- the soft cycle in commercial insurance in Australia and New Zealand; and
- ongoing strong growth in the IAG Group's Thai subsidiaries.

Acquisitive growth is likely to be sourced in Asia and Europe. Delivering on ROE at least 1.5x WACC is considered achievable based on:

- continued focus on cost management including leveraging the capacity in the existing business to write additional business at marginal additional cost;
- maintaining pricing discipline for premiums;
- being disciplined in the price paid for acquisitions; and
- continued active capital management.

Delivery of these returns is also subject to not incurring any large losses or catastrophes beyond the IAG Group's normal allowances and experiencing no major falls in bond values.

**Dividends**

Details of dividends paid or declared by the Company are set out in note 9.

**Significant changes in the state of affairs**

Significant changes in the state of affairs of IAG Group during the financial year were as follows:

(a) On 9 December 2005, the IAG Group announced that it had agreed to acquire a 30% interest in a general insurer in Malaysia, AmAssurance Berhad, for approximately A$69million (MYR 193 million);

(b) On 30 March 2006, the IAG Group announced that it has completed its tender offer for shares in Thailand for Safety Insurance Public Company Limited ("Safety"). As a result, the IAG Group has acquired approximately 96.1% which has increased from 21.6% since its initial investment in 1998;

(c) On 12 April 2006, IAG announced a special fully franked dividend of 12.5 cents per shares to be paid to its shareholders on 26 June 2006. This payment is in line with its commitment to return $200 million in surplus capital to shareholders by 30 June 2006;

(d) On 15 June 2006, IAG announced it agreed to acquire a newly-formed Lloyd's managing agency and specialist Asian syndicate to support the development and management of its expanding Asian business. The businesses operate as Alba Group Pte Limited (Alba) and have been newly established. The syndicate has access to all markets in which Lloyd's is licensed. The terms of the acquisition are confidential but neither the purchase price nor the capital required in the first two years from completion is material to the IAG Group. A letter of credit was issued in support of the IAG Group's participation. The terms of the acquisition are subject to final regulatory approval from the relevant regulatory authorities in Singapore and the United Kingdom.

**Events subsequent to reporting date**

Details of matters subsequent to the end of the financial year are set out in note 39. These include:
- Declaration of final dividend of 16 cents per ordinary share; and
- Progress of negotiations with a China based general insurance business.

**Officers who were previously partners of the auditors**

The following person is currently an officer of the IAG Group and was a partner of KPMG, the Company's auditor, at a time when KPMG was the auditor of the Company:
- Mr NB Hawkins: Chief Executive Officer – IAG New Zealand (left KPMG in October 2001).

**Non-audit services**

During the financial year, KPMG has performed certain other services for the IAG Group in addition to their statutory duties.

The Directors have considered the non-audit services provided during the financial year by KPMG and, in accordance with written advice provided by resolution of the Audit Committee, are satisfied that the provision of those non-audit services by the Company's auditor is compatible with, and did not compromise, the auditor independence requirements of the Corporations Act 2001 for the following reasons:

- All non-audit assignments were approved in accordance with the process set out in the IAG Audit Committee Charter ("Charter") on the agreed framework for engaging auditors for non-audit services; and

- The non-audit services provided do not undermine the general principles relating to auditor independence as set out in Professional Statement F1 Professional independence of the Institute of Chartered Accountants in Australia and CPA Australia, as they did not involve reviewing or auditing the auditor's own work, acting in a management or decision making capacity for the Company, acting as an advocate for the Company or jointly sharing risks and rewards.

A copy of the auditor's independence declaration as required under section 307C of the Corporations Act is included in the director's report.

The level of fees for non-audit services amount to approximately 27.8% of total audit fees (refer to note 5 to the financial statements for further details on costs incurred on individual non-audit assignments).

**Lead Auditor's independence declaration under Section 307C of the Corporations Act 2001**

The lead auditor's independence declaration is set out on page 31 and forms part of the directors' report for the year ended 30 June 2006.

**Indemnification and insurance of directors and officers**

The Company's constitution contains an indemnity in favour of every person who is or has been:

(a) a Director of the Company;
(b) a secretary of the Company or of a subsidiary of the Company; or
(c) a person making or participating in making decisions that affect the whole or a substantial part of the business or Company or of a subsidiary of the Company; or
(d) a person having the capacity to affect significantly the financial standing of the Company or of a subsidiary of the Company.

The indemnity applies to liabilities incurred by the person in the relevant capacity (except a liability for legal costs). That indemnity also applies to legal costs incurred in defending or resisting certain legal proceedings. The indemnity does not apply where the Company is forbidden by statute or, if given, would be made void by statute. In addition, the Company has granted deeds of indemnity to certain current and former Directors and secretaries and members of senior management of the Company and its subsidiaries and associated companies. Under these deeds, the Company indemnifies, to the maximum extent permitted by the law, the former or current Directors or secretaries or members of senior management against liabilities incurred by the person in the relevant capacity. The indemnity does not apply where the liability is owed to the Company or any of its subsidiaries or associated companies, or (in general terms) where the liability arises out of a lack of good faith, willful misconduct, gross negligence, reckless misbehavior or fraud.

Under each deed, the Company is also effectively required to maintain and pay the premiums on a contract of insurance covering the current or former Directors or members of senior management against liabilities incurred in respect of the relevant office. The insurance must be maintained until the seventh anniversary after the date when the relevant person ceases to hold office. Disclosure of the insurance premiums and the nature of liabilities covered by such insurance is prohibited by the relevant contract of insurance.

**Environmental regulation**

The IAG Group's operations are subject to environmental regulations under either Commonwealth or State legislation. These regulations do not have a significant impact on the IAG Group's operations. The Board of Directors believes that the IAG Group has adequate systems in place for the management of its environmental requirements and is not aware of any breach of those environmental requirements as they apply to the IAG Group.

**Remuneration Report**

This report outlines the Board's policy in relation to, and details of, the remuneration of IAG key management personnel ("KMP") being, the IAG directors (including the Chief Executive Officer and Managing Director) and the senior executives having the greatest authority and responsibility for planning, directing and controlling the activities of the IAG Group, including the five executives receiving the highest remuneration during the financial year.

It is important to note that the Company's Non-executive Directors are specifically required to be included as key management personnel in accordance with the accounting standard AASB124 *Related Party Disclosures*. However, the Non-executive Directors do not consider that they are part of "management".

The term "remuneration" used in the remuneration report has the same meaning as compensation as prescribed in the accounting standard AASB124.

This report provides the disclosures which meet the remuneration reporting requirements of the Corporations Act 2001 and the accounting standard AASB 124.

***Nomination, Remuneration & Sustainability Committee***

The role and responsibilities of the Nomination, Remuneration & Sustainability Committee ("Committee" or "NRSC") are set out in the Committee's charter which is available at www.iag.com.au The key responsibilities of the NRSC in relation to remuneration are to:

(a) provide assurance to the Board relating to the effectiveness, integrity and compliance of the Company's remuneration policies and practices; and
(b) ensure the overall remuneration policy and approach fits the strategic goals of IAG.

The Chief Executive Officer ("CEO"), Group Executive Culture & Reputation and Head of Human Resources regularly attend Committee meetings and assist the Committee in its deliberations.

The Committee receives reports from Mercer Human Resources Consulting and various other consultants on remuneration for executives and directors. Mallesons Stephen Jacques provides legal advice to the Committee as required.

**Remuneration Report - Audited information**

**A. Executives**

**1. Executive remuneration policy**

IAG's approach to executive remuneration is to ensure that IAG can attract and retain the best people and reward performance in line with returns delivered to shareholders. Building and retaining a high quality management team has enabled IAG to achieve superior long term performance.

The principles that underpin IAG's approach to executive remuneration are that:

- the quantum and mix of remuneration is sufficiently competitive to attract and retain a high calibre executive team;
- remuneration practices are consistent with IAG's values;
- the mix of fixed and variable remuneration reflects the impact of each executive position on IAG's short term and long term results;
- remuneration levels take account of both external market practice and internal relativities; and
- measures of performance are based on a balanced scorecard with a focus on the delivery of sustainable value to our shareholders.

IAG aims to set base pay around the market median and total potential reward (which includes short and long term incentives) between the median and the 75th percentile depending on individual performance and contribution to the IAG Group's results. Market positioning is determined by reference to a number of comparator groups, being: the largest 50 companies in the S&P/ASX 100 index: financial services companies that are among the largest 50 companies in the S&P/ASX 100 index and companies in the S&P/ASX 100 index with a market capitalisation of between 50% and 200% of IAG's capitalisation.

**Remuneration Report – Audited information (continued)**

**A. Executives (continued)**

**2. Executive remuneration structure**

Executive remuneration consists of four components:

- base salary
- superannuation
- short term incentives
- long term incentives

**(a) Base salary**

Base salary is defined as the total value of components that make up an executive's salary. Components are cash, salary sacrifice items such as superannuation, cars or parking and any related taxes. Base salary is determined by a review of job size, internal relativities and market benchmarking. Mercer Human Resources Consulting provides advice on job responsibility and market benchmarking. The comparator groups for market benchmarking are the largest 50 companies in the S&P/ASX 100 index, financial services companies that are among the largest 50 companies in the S&P/ASX 100 index and companies in the S&P/ASX 100 index with a market capitalisation of between 50% and 200% of IAG's capitalisation. Base salary is targeted at the median of the market. Unless there has been a significant change in job responsibility, increases in base salary generally do not exceed external market movements.

**(b) Superannuation**

Executives are defined contribution members of the IAG & NRMA Superannuation Plan. Employer superannuation contributions are 13% of base salary. This contribution rate is consistent with the contribution provided to other employees of IAG.

**(c) Short term incentives**

Executives have the opportunity to earn a short term incentive payment based on both IAG's performance and achievement of individual goals.

IAG uses a balanced scorecard for setting goals and measuring performance. This ensures that assessment of performance is viewed holistically and assists the development of a sustainable business that meets the performance expectations of IAG's shareholders, stakeholders and the communities in which it conducts its business.

The balanced scorecard sets goals under the following broad categories:

- financial
- customer
- people
- risk
- community / environment

At the commencement of each financial year, IAG and individual goals are set for each executive. The goals set are stretch goals and are designed to encourage executives to strive for exceptional performance. At the end of the financial year the amount of any incentive payment is determined based on measured achievement against those goals and a review of the executive's overall performance by the CEO and NRSC. The NRSC reviews the performance of the CEO and makes a recommendation to the Board in relation to any incentive payment for the CEO.

**Remuneration Report – Audited information (continued)**

**A. Executives (continued)**

**2. Executive remuneration structure (continued)**

**(c) Short term incentives (continued)**

The following table is a summary of IAG's key goals for the current year:

| ***Category*** | ***Goal*** | ***Reason Chosen*** | ***Method of Assessment*** | ***Outcome*** |
|---|---|---|---|---|
| Finance | Group Insurance Margin target | Measures the profitability of the core business of IAG | Comparison of achievement against target | Not met |
| Customer | Improvement across customer satisfaction measures | Meeting or exceeding customer expectations is a key part of establishing and maintaining a competitive advantage | Outcome of customer satisfaction surveys and measurement of customer retention rates compared to outcomes from previous years | Met |
| Risk | Improvement in risk management behaviours | Positive risk management behavior in relation to prevention, detection and recovery from operational risks and issues is critical for a sustainable business | Increased employee awareness of risk prevention, detection and recovery compared to target set at the start of the year | Partially met (1) |
| People management | Employee engagement score target | Measures how engaged employees are with IAG's purpose, strategy and goals | Outcome of annual employee survey compared to target set at the start of the year | Partially met (1) |
| People management | Reduction in employee turnover | A solid employee base is critical for growing IAG's business for the benefit of customers, shareholders and the wider community | Comparison of outcome achieved against target set at the start of the year | Not met |
| Community / Environment | Reduction in workers' compensation claims per million hours worked | A safe work environment and the well being of employees is vital for growing IAG's business for the benefit of customers, shareholders and the wider community | Comparison of reduction achieved against target set at the start of the year | Partially met (1) |

(1) Where a goal is partially met, there has been improvement in performance but the stretch goal has not been met.

The methods of assessment have been selected as they can be objectively measured and verified.

Actual short term incentive payments made to executives for the year ended 30 June 2006 reflect the degree of achievement against these goals and the degree of achievement against each individual executive's goals.

**(d) Long term incentives - Equity based remuneration**

IAG utilises long term incentives to create a link between the delivery of value to shareholders, financial performance and rewarding and retaining employees. IAG's program for delivering long term incentives is its Performance Award Rights ("PARs") Plan. Note 30 (a) of the financial statements sets out further details of the PARs Plan.

PARs are rights over issued shares held by a trustee. The rights are granted at no cost to executives and may be exercised for a nominal price if a performance hurdle related to IAG's Total Shareholder Return ("TSR") is met or if some specified events occur, such as a takeover bid for the Company. During the year PARs were issued to executives. Previously IAG delivered long term incentives using its Performance Share Rights ("PSRs") Plan with the last issue to the executives on 5 March 2002. Note 30 (b) of the financial statements sets out further details of the PSRs Plan.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**DIRECTORS' REPORT**

**Remuneration Report – Audited information (continued)**

**A. Executives (continued)**

**2. Executive remuneration structure (continued)**

**(d) Long term incentives - Equity based remuneration (continued)**

Details of the terms of allocations made to executives under IAG's long term incentive plans, including those allocations that at the date of this report are not exercisable, are summarised below:

| Plan | PARs Plan 2002/2003 - Series 1 | PARs Plan 2003/2004 - Series 2 | PARs Plan 2004/2005 - Series 3 | PARs Plan 2005/2006 - Series 4 |
|---|---|---|---|---|
| Grant Date | 24/12/2002 | 22/09/2003<br>10/12/2003<br>26/03/2004 | 17/09/2004<br>30/11/2004 | 19/09/2005<br>30/11/2005<br>22/03/2006 |
| Performance Period Definition[(i)] | 3-5 years from Grant Date | 3-5 years from Base Date[(ii)] | 3-5 years from Base Date[(ii)] | 3-5 years from Base Date[(ii)] |
| TSR Performance Condition | IAG TSR compared to a Peer Group of companies. The Peer Group comprises the companies in the S&P/ASX 100 index with such inclusions and exclusions as the Board may determine. | | | |
| Vesting Schedule | < 50th percentile - 0% vesting<br>= 50th percentile - 50% vesting<br>>=75th percentile - 100% vesting<br>The percentage of PARs which vest and become exercisable increases proportionately where IAG's performance ranks between the 50th and 75th percentile | | | |
| Performance Hurdle Test Schedule | Quarterly - Last trading day of each calendar quarter in Performance Period | Quarterly - Last trading day of each calendar quarter in Performance Period | Quarterly - Last trading day of each calendar quarter in Performance Period | Quarterly - Last trading day of each calendar quarter in Performance Period |
| 1st Test Day | 30/12/2005 | 29/09/2006 | 28/09/2007 | 30/09/2008 |
| Last Test Day | 28/09/2007 | 30/06/2008 | 30/06/2009 | 30/06/2010 |
| Last Exercise Date *(Continuing employees only)* | 24/12/2012 | 22/09/2013<br>10/12/2013<br>26/03/2014 | 17/09/2014<br>30/11/2014<br>30/03/2015 | 19/09/2015<br>30/11/2015<br>22/03/2016 |
| Plan Exercise Status | Partially exercisable[(iii)] | Not exercisable | Not exercisable | Not exercisable |

Notes:

(i) The performance period will be shortened if the employee ceases employment with the IAG Group due to redundancy or in other special circumstances.

(ii) The Base Date is the date which is the second trading day after the date on which IAG's financial results for the twelve month period ending on the 30 June that immediately precedes the Grant Date are announced to the ASX.

(iii) 56% of Series 1 PARs are exercisable.

**Remuneration Report – Audited information (continued)**

**A. Executives (continued)**

**3. Relationship between executive reward and IAG's performance**

A significant component of executive remuneration is "at risk" which ensures a direct link between IAG's performance and reward for executives. For further details of the percentage of "at risk" remuneration, refer to the table in section 6.

The payment of short-term incentives is directly linked to IAG's performance over the previous year based on a balanced scorecard of measures, which includes a measure of the profitability of IAG's core business. Non-financial measures are also used as they are lead indicators of delivering future value for shareholders. For the 2005/2006 year the IAG key goals were partially met. This will determine the portion of an executive's short term incentive payment that is linked to IAG's goals.

The use of the balanced scorecard to assess and reward executive performance has assisted IAG to deliver superior returns for shareholders since listing in August 2000:

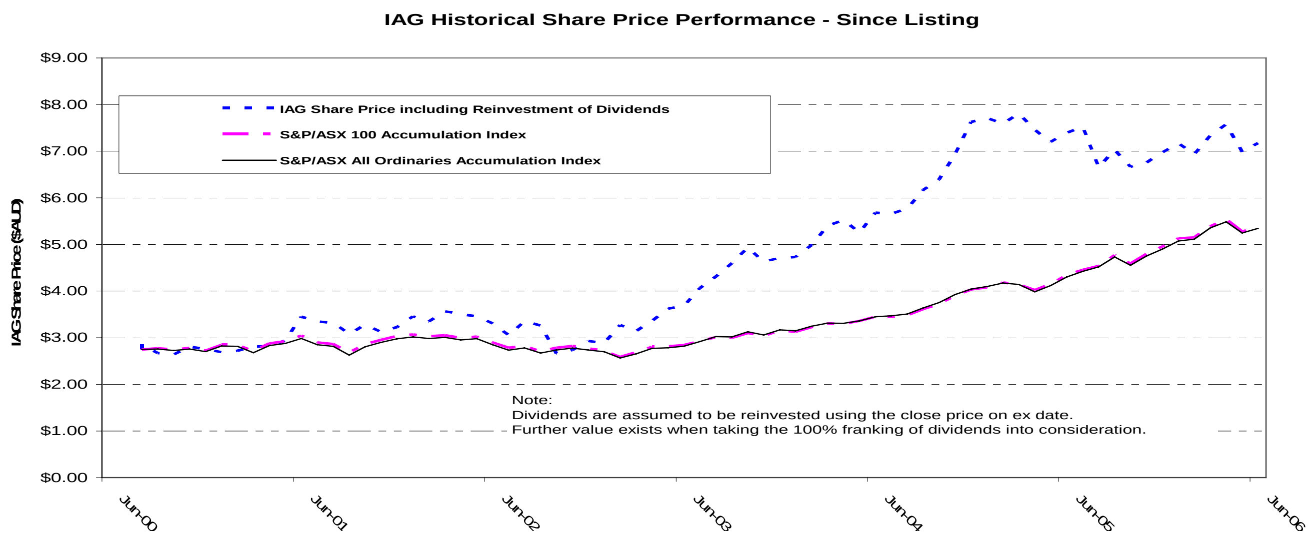
| | Year ended 30 June 2001 | Year ended 30 June 2002 | Year ended 30 June 2003 | Year ended 30 June 2004 | Year ended 30 June 2005 | Year ended 30 June 2006 |
|---|---|---|---|---|---|---|
| **Closing share price ($)** | 3.40 | 3.15 | 3.40 | 5.00 | 6.01 | 5.35 |
| **Dividends paid (cents)** | 10.00 | 10.50 | 11.50 | 22.00 | 26.50 | 42.00 |
| **Earnings per share (cents)*** | 9.40 | (1.78) | 8.65 | 37.87 | 49.31 | 47.87 |
| **Normalised net profit after tax ($ million)*** | 178 | 294 | 360 | 434 | 601 | 542 |

* Amounts in 2005 and 2006 have been measured under Australian equivalent to International Financial Reporting Standards ("AIFRS"). All amounts prior to 2005 were measured under previous Australian Accounting Standards.

IAG's long term incentive plans provide a direct link between return to shareholders over a 3 to 5 year period and executive reward. IAG's TSR measured from March 2003 until January 2006 was at the 53rd percentile compared to the TSR of companies in the S&P/ASX 100 index. As a result of this 56% of PARs issued to executives in December 2002 became exercisable for IAG shares.

Grants of PARs to executives are based on an assessment of each executive against a range of factors including the executive's performance, their strategic impact and leadership capability. This process strengthens the link between individual executive reward outcomes and the creation of value for shareholders.

IAG's share price performance from the period since IAG's listing in August 2000 is shown in the following graph:



**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**DIRECTORS' REPORT**

**Remuneration Report – Audited information (continued)**

**A. Executives (continued)**

**4. Service agreements**

During the year the following persons were the executives identified as key management personnel, with the greatest authority and responsibility for planning, directing and controlling the activities of the IAG Group:

| Name | Current title |
|---|---|
| Mr MJ Hawker | Chief Executive Officer and Managing Director |
| Mr JP Breheny[(i)] | Chief Executive Officer – Asia |
| Mr AM Coleman | Chief Risk Officer and Group Actuary |
| Mr NB Hawkins [(ii)] | Chief Executive Officer – IAG New Zealand |
| Mr DA Issa [(ii)] | Chief Executive Officer – Personal Insurance |
| Ms JS Johnson [(ii)] | Chief Executive Officer – Business Partnerships |
| Ms CF McLoughlin [(iii)] | Group Executive – Strategy |
| Ms SJ Mostyn | Group Executive – Culture & Reputation |
| Mr MJ Pirone | Chief Executive Officer – CGU Insurance |
| Mr J van der Schalk[(iv)] | Chief Executive Officer – Asset Management and Reinsurance |
| Mr G Venardos | Chief Financial Officer |

(i) Mr JP Breheny, joined the Group as Chief Executive Officer – Asia, on 20 March 2006.

(ii) On 8 February 2006, IAG announced a new structure for its operations. This led to a change in the executive team structure. Mr DA Issa has held his current positions since this time and previously held the position of Chief Information Officer. Mr NB Hawkins and Ms JS Johnson were appointed to their roles on 1 March 2006 and 13 February 2006 respectively.

(iii) Ms CF McLoughlin, joined the Group on 2 August 2005 and her current position is Group Executive – Strategy.

(iv) On 26 May 2006 Mr Jan van der Schalk was appointed to the role of Chief Executive Officer – Asset Management and Reinsurance following Mr RJ Jackson leaving the IAG Group.

Mr IF Brown retired on 31 December 2005. Mr DRA Pearce left on 31 August 2005, Mr DJP Smith left on 8 February 2006 and Mr RJ Jackson left on 26 May 2006.

**Remuneration Report – Audited information (continued)**

**A. Executives (continued)**

**4. Service agreements (continued)**

All service agreements for executives are unlimited in term but may be terminated by written notice from either party or by IAG making a payment in lieu of notice. The service agreements outline the components of remuneration paid to executives and require the remuneration of executives to be reviewed annually. The service agreements do not require IAG to increase base salary, pay a short term incentive or offer a long term incentive in any given year.

| Name | Notice period, Company | Notice period, Employee | Termination provisions | Additional payment if IAG invokes a restraint clause |
|---|---|---|---|---|
| Mr MJ Hawker | 12 months | 6 months | 12 months base salary, plus payment for annual leave, long service leave and short-term incentive that would have accrued had termination not occurred. | 6 months base salary |
| Mr JP Breheny | 12 months | 3 months | 12 months base salary | - |
| Mr AM Coleman | 12 months | 3 months | 12 months base salary | 6 months base salary |
| Mr NB Hawkins | 12 months | 3 months | 12 months base salary | - |
| Mr DA Issa | 12 months | 3 months | 12 months base salary | - |
| Ms JS Johnson | 12 months | 3 months | 12 months base salary | - |
| Ms CF McLoughlin | 6 months | 2 months | 6 months base salary | - |
| Ms SJ Mostyn | 12 months | 3 months | 12 months base salary | - |
| Mr MJ Pirone | 12 months | 3 months | 12 months base salary | 6 months base salary |
| Mr J van der Schalk | 12 months | 3 months | 12 months base salary | - |
| Mr G Venardos | 12 months | 3 months | 12 months base salary | 6 months base salary |

Executives are employed by Insurance Australia Group Services Pty Limited, except for Mr NB Hawkins who is employed by IAG New Zealand Limited.

*Retrenchment*

In the event of retrenchment, the executives listed above (except for Mr MJ Hawker) are entitled to the greater of:

(a) the written notice or payment in lieu of notice as provided in their service agreement; or

(b) the retrenchment benefits due under the relevant company retrenchment policy.

For Mr MJ Hawker, the retrenchment payment is in accordance with the termination provisions set in the table above.

*Company retrenchment policy*

On retrenchment, employees with less than 25 years service will receive:

(a) at least eight weeks notice or payment in lieu of notice (calculated on the employee's base salary); and

(b) three weeks base salary for each year of continuous service to a maximum of 75 weeks base salary.

The minimum benefit that can be received is 11 weeks base salary and the maximum benefit that can be received is 83 weeks base salary.

On retrenchment, employees with 25 or more years of service or who are over 45 years of age will receive:

(a) at least twelve weeks notice or payment in lieu of notice (calculated on the employee's base salary); and

(b) three weeks base salary for each year of continuous service to a maximum of 75 weeks base salary.

The minimum benefit that can be received is 15 weeks base salary and the maximum benefit that can be received is 87 weeks base salary.

*Termination of employment without notice and without payment in lieu of notice*

The employment of the executives may be terminated without notice or payment in lieu of notice in some circumstances. Generally, this could occur where the executive: is charged with a criminal offence that is capable of bringing the organisation into disrepute; is declared bankrupt; breaches a provision of their employment agreement; is guilty of serious and willful misconduct; or unreasonably fails to comply with any material and lawful direction given by the Company.

*Termination of employment with notice or payment in lieu of notice*

The employment of the executives may be terminated at any time by the Company with notice or payment in lieu of notice (which also includes a pro rata short-term incentive earned but not paid). The amount of notice the Company must provide or the payment in lieu of notice is specified above.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**DIRECTORS' REPORT**

**Remuneration Report – Audited information (continued)**

**A. Executives (continued)**

**5. Remuneration details**

**(a) Remuneration of executives for the IAG Group for 2006**

| | Short-term employment benefits | | | | | | Post-employment benefits | | Other long-term employment benefits | | Termination benefits | Share-based payment | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash Salary (1) | Non-monetary benefits (2) | Base salary (Sub-total of (1) & (2)) | Annual leave accruals (3) | Short term incentive (4) | Other(5) | Superannuation (6) | Retirement benefits | Long service leave accruals (7) | Long term incentive plan (8) | | Value of PSRs/ PARs granted (9) | |
| **2006** | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 |
| *Executives (including Executive Director)* | | | | | | | | | | | | | |
| Mr MJ Hawker | **1,201** | **23** | ***1,224*** | **15** | **632** | **-** | **164** | **-** | **23** | **-** | **-** | **982** | **3,040** |
| Mr JP Breheny (i) | **172** | **-** | ***172*** | **16** | **76** | **-** | **22** | **-** | **1** | **-** | **-** | **21** | **308** |
| Mr AM Coleman | **613** | **8** | ***621*** | **44** | **367** | **-** | **81** | **-** | **14** | **-** | **-** | **213** | **1,340** |
| Mr NB Hawkins (i) | **187** | **-** | ***187*** | **12** | **84** | **25** | **25** | **-** | **2** | **-** | **-** | **52** | **387** |
| Mr DA Issa | **571** | **8** | ***579*** | **22** | **331** | **-** | **75** | **-** | **11** | **-** | **-** | **187** | **1,205** |
| Ms JS Johnson (i) | **149** | **6** | ***155*** | **22** | **94** | **-** | **19** | **-** | **7** | **-** | **-** | **21** | **318** |
| Ms CF McLoughlin (i) | **428** | **7** | ***435*** | **12** | **195** | **-** | **57** | **-** | **3** | **-** | **-** | **49** | **751** |
| Ms SJ Mostyn | **511** | **8** | ***519*** | **41** | **336** | **-** | **67** | **-** | **10** | **-** | **-** | **211** | **1,184** |
| Mr MJ Pirone | **558** | **59** | ***617*** | **16** | **395** | **-** | **80** | **-** | **20** | **-** | **-** | **203** | **1,331** |
| Mr J van der Schalk(i) | **38** | **1** | ***39*** | **2** | **17** | **-** | **5** | **-** | **1** | **-** | **-** | **9** | **73** |
| Mr G Venardos | **654** | **61** | ***715*** | **29** | **393** | **-** | **91** | **-** | **20** | **-** | **-** | **247** | **1,495** |
| *Executives who ceased as key management personnel during the year:* | | | | | | | | | | | | | |
| Mr IF Brown | **324** | **22** | ***346*** | **39** | **225** | **-** | **47** | **-** | **41** | **-** | **-** | **136** | **834** |
| Mr RJ Jackson | **573** | **73** | ***646*** | **10** | **351** | **-** | **84** | **-** | **23** | **-** | **650** | **176** | **1,940** |
| Mr DRA Pearce | **71** | **10** | ***81*** | **(1)** | **17** | **-** | **11** | **-** | **6** | **-** | **820** | **117** | **1,051** |
| Mr DJP Smith | **436** | **-** | ***436*** | **41** | **545** | **100** | **59** | **-** | **5** | **-** | **970** | **195** | **2,351** |
| Total remuneration | **6,486** | **286** | ***6,772*** | **320** | **4,058** | **125** | **887** | **-** | **187** | **-** | **2,440** | **2,819** | **17,608** |

(i) These executives were all newly appointed to the executive team during this financial year. Therefore, the remuneration information provided in the table above relates to the period from the date of their appointment to the executive team to 30 June 2006. The balances are calculated based on the proportion of the year that they were key management personnel.

Refer to section (c) below for details of Notes (1) - (9) referencing in the above table 5 (a).

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**DIRECTORS' REPORT**

**Remuneration Report – Audited information (continued)**

**A. Executives (continued)**

**5. Remuneration details (continued)**

**(b) Remuneration of executives for the IAG Group for 2005**

| | Short-term employment benefits | | | | | | Post-employment benefits | | Other long-term employment benefits | | Termination benefits | Share-based payment | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash Salary (1) | Non-monetary benefits (2) | Base salary (Sub-total of (1) & (2)) | Annual leave accruals (3) | Short term incentive (4) | Other(5) | Superannuation (6) | Retirement benefits | Long service leave accruals (7) | Long term incentive plan (8) | | Value of PSRs/ PARs granted (9) | |
| **2005** | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 |
| *Executives (including Executive Director)* | | | | | | | | | | | | | |
| Mr MJ Hawker | 1,151 | 36 | *1,187* | 18 | 1,270 | - | 157 | - | 18 | - | - | 614 | 3,264 |
| Mr IF Brown | 566 | 161 | *727* | (16) | 342 | - | 94 | - | 24 | - | - | 127 | 1,298 |
| Mr AM Coleman | 583 | 7 | *590* | (31) | 434 | - | 77 | - | 12 | - | - | 145 | 1,227 |
| Mr DA Issa | 508 | 7 | *515* | 1 | 476 | - | 67 | - | 7 | - | - | 125 | 1,191 |
| Mr RJ Jackson | 554 | 78 | *632* | 2 | 402 | - | 82 | - | 27 | 275 | - | 109 | 1,529 |
| Ms SJ Mostyn | 478 | 7 | *485* | 31 | 366 | - | 63 | - | 7 | - | - | 167 | 1,119 |
| Mr DRA Pearce | 441 | 48 | *489* | (9) | 230 | - | 63 | - | 12 | - | - | 110 | 895 |
| Mr MJ Pirone | 520 | 66 | *586* | 7 | 520 | - | 75 | - | 15 | - | - | 135 | 1,338 |
| Mr DJP Smith | 582 | - | *582* | 46 | 202 | 130 | 77 | - | 5 | - | - | 135 | 1,177 |
| Mr G Venardos | 619 | 48 | *667* | 50 | 451 | - | 86 | - | 19 | - | - | 171 | 1,444 |
| *Executives who ceased employment during the year:* | | | | | | | | | | | | | |
| Ms KL Baylis | 92 | 24 | *116* | 3 | 76 | - | 15 | - | (6) | - | 462 | 141 | 807 |
| Mr LF Power | 66 | 8 | *74* | (1) | 88 | - | 5 | - | 10 | - | 600 | 38 | 814 |
| Mr RJ Wagstaffe | 77 | 6 | *83* | 6 | 10 | - | 6 | - | 10 | - | - | 38 | 153 |
| Total remuneration | 6,237 | 496 | *6,733* | 107 | 4,867 | 130 | 867 | - | 160 | 275 | 1,062 | 2,055 | 16,256 |

Refer to section (c) below for details of Notes (1) - (9) referencing in the above table 5 (b).

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**DIRECTORS' REPORT**

**Remuneration Report – Audited information (continued)**

**A. Executives (continued)**

**5. Remuneration details (continued)**

**(c) Details of notes (1) to (9) used in tables in sections 5 (a) and (b)**

(1) Salary represents amounts paid in cash during the financial year.
(2) Non-monetary benefits are valued in accordance with the cost to IAG for provision of cars, parking and related fringe benefits tax on a salary sacrifice basis.
(3) Annual leave accruals as determined in accordance with AASB 119 *Employee benefits.*
(4) Short term incentive to be settled for the current performance period accrual and prior performance periods over or under accruals. Executives may elect to receive some of their short term incentive in the form of IAG shares rather than cash through participation in the Bonus Equity Share Plan, which vests immediately and is valued in accordance with the market value of IAG shares at grant date. Refer to note 29 (c) for details.
(5) Represents an accommodation allowance in New Zealand.
(6) Superannuation includes the employer's contributions (2005 – the amount included the first 11 months contributions which was recognised on a deemed basis as the employer was on a contribution holiday).
(7) Long service leave accruals as determined in accordance with AASB 119 *Employee benefits.*
(8) Long term incentive to be settled in cash from the 2002/2003 IMA long term incentive plan (only relevant to Mr Jackson). The amount in the 2005 table represented the 2005 performance period accrual and prior performance periods over or under accruals.
(9) An allocated portion of Performance Share Rights ("PSRs" – related to unissued shares) and unvested Performance Award Rights ("PARs" – related to issued shares) is included in the total remuneration disclosure above. To determine these values the Monte Carlo model has been applied. The valuation takes into account the exercise price of the PSRs/PARs, life of the PSRs/PARs, current price of IAG shares, expected volatility of the IAG share price, expected dividends, risk free interest rate, the performance of the shares in the Peer Group of companies, early exercise and non transferability, and turnover.

**Remuneration Report – Audited information (continued)**

**A. Executives (continued)**

**6. At risk remuneration**

Total remuneration for executives is comprised of "at risk" and "not at risk" remuneration. Base salary and superannuation is "not at risk", while short term incentives and long term incentives are "at risk".

**(a) Details of total remuneration that is "at risk"**

| Name | Total remuneration | Short term incentives | Long term incentives (IMA LTI/PSRs/PARs) | Percentage of remuneration at risk (1) | Percentage of option/right remuneration |
|---|---|---|---|---|---|
| **2006** | $000 | $000 | $000 | % | % |
| Mr MJ Hawker | **3,040** | **632** | **982** | **53** | **32** |
| Mr JP Breheny | **308** | **76** | **21** | **31** | **7** |
| Mr AM Coleman | **1,340** | **367** | **213** | **43** | **16** |
| Mr NB Hawkins | **387** | **84** | **52** | **35** | **13** |
| Mr DA Issa | **1,205** | **331** | **187** | **43** | **16** |
| Ms JS Johnson | **318** | **94** | **21** | **36** | **7** |
| Ms CF McLoughlin | **751** | **195** | **49** | **32** | **7** |
| Ms SJ Mostyn | **1,184** | **336** | **211** | **46** | **18** |
| Mr MJ Pirone | **1,331** | **395** | **203** | **45** | **15** |
| Mr J van der Schalk | **73** | **17** | **9** | **36** | **12** |
| Mr G Venardos | **1,495** | **393** | **247** | **43** | **17** |
| | | | | | |
| 2005 | | | | | |
| Mr MJ Hawker | 3,264 | 1,270 | 614 | 58 | 19 |
| Mr IF Brown | 1,298 | 342 | 127 | 36 | 10 |
| Mr AM Coleman | 1,227 | 434 | 145 | 47 | 12 |
| Mr DA Issa | 1,191 | 476 | 125 | 50 | 10 |
| Mr RJ Jackson | 1,529 | 402 | 384 | 51 | 7 |
| Ms SJ Mostyn | 1,119 | 366 | 167 | 48 | 15 |
| Mr DRA Pearce | 895 | 230 | 110 | 38 | 12 |
| Mr MJ Pirone | 1,338 | 520 | 135 | 49 | 10 |
| Mr DJP Smith | 1,177 | 202 | 135 | 29 | 11 |
| Mr G Venardos | 1,444 | 451 | 171 | 43 | 12 |

(1) Reductions in the percentage of remuneration at risk from 2005 to 2006 are largely the result of lower actual short term incentives being awarded in 2006.

**(b) Short term incentives**

The portion of the short term incentives that either vested or were forfeited during the year cannot be determined as no maximum or target amount is set. Executives may be paid a short term incentive based on IAG's performance and their own performance. The amount of short term incentives paid to an executive is recommended by the CEO and approved by the NRSC. The amount of short term incentives paid to the CEO is recommended by the NRSC and approved by the Board.

**(c) Long term incentives**

For the year ended 30 June 2006, 56% of PARs issued to the eligible executives in December 2002 are exercisable. There was no forfeited PARs because the person did not meet the service and performance criteria. No part of the forfeited rights are payable in future years.

It is not practical to provide an estimate of the maximum possible total value of long term incentives that may vest in future years for any PARs issued up to 30 June 2006 because the value is directly linked to the IAG share price at the time of vesting. The minimum possible total value of long term incentives is zero.

**Remuneration Report – Audited information (continued)**

**A. Executives (continued)**

**7. Long term incentives – PARs and PSRs**

Rights under the PARs Plan and PSRs Plan were issued by the IAG Group and used as long term incentives. Refer to sections 2 (d) for further details.

The following sections provided details movements in PARs and PSRs for each executive during the financial year ended 30 June 2006.

**(a) PARs**

(i) Details of PARs granted

The IAG Group has issued PARs to the executives during the financial year for nil consideration. Each executive who participates in the plan becomes eligible to receive an ordinary share per PAR, by paying the exercise price of $1 per tranche of PARs exercised, subject to a specific performance hurdle being met. Refer to section 2 (d) for details of the performance hurdle.

Following are details of the number of PARs granted to each executive during the financial year ended 30 June 2006:

| | **Grant date** | **Date first exercisable** | **Last expiry date** | **Value per PAR at grant date** | **Number of PARs granted during the year(1)** |
|---|---|---|---|---|---|
| | | | | $ | Number |
| Mr MJ Hawker | 30/11/2005 | 30/09/2008 | 30/11/2015 | 2.596 | 600,000 |
| Mr JP Breheny | 22/03/2006 | 30/09/2008 | 22/03/2016 | 3.150 | 100,000 |
| Mr AM Coleman | 19/09/2005 | 30/09/2008 | 19/09/2015 | 3.187 | 90,000 |
| Mr NB Hawkins | * | * | * | * | * |
| Mr DA Issa | 19/09/2005 | 30/09/2008 | 19/09/2015 | 3.187 | 83,500 |
| Ms JS Johnson | * | * | * | * | * |
| Ms CF McLoughlin | 19/09/2005 | 30/09/2008 | 19/09/2015 | 3.187 | 80,000 |
| Ms SJ Mostyn | 19/09/2005 | 30/09/2008 | 19/09/2015 | 3.187 | 80,000 |
| Mr MJ Pirone | 19/09/2005 | 30/09/2008 | 19/09/2015 | 3.187 | 90,000 |
| Mr J van der Schalk | * | * | * | * | * |
| Mr G Venardos | 19/09/2005 | 30/09/2008 | 19/09/2015 | 3.187 | 100,000 |
| *Executives who ceased as key management personnel during the year:* | | | | | |
| Mr IF Brown | - | - | - | - | - |
| Mr RJ Jackson | 19/09/2005 | 30/09/2008 | 19/09/2015 | 3.187 | 90,000 |
| Mr DRA Pearce | - | - | - | - | - |
| Mr DJP Smith | 19/09/2005 | 30/09/2008 | 19/09/2015 | 3.187 | 80,000 |
| | | | | | 1,393,500 |

* All PARs granted prior to Mr Hawkins', Ms Johnson's and Mr van der Schalk's appointment to their executive role are excluded.

**Remuneration Report – Audited information (continued)**

**A. Executives (continued)**

**7. Long term incentives – PARs and PSRs (continued)**

**(a) PARs**

(ii) Movements in total number of PARs on issue by each executive

| | PARs on issue 1 Jul 2005 | PARs granted during the year | PARs exercised during the year (2) | PARs lapsed during the year | PARs on issue 30 Jun 2006 | PARs vested and exercisable 30 June 2006 |
|---|---|---|---|---|---|---|
| | Number | Number | Number | Number | Number | Number |
| Mr MJ Hawker | 1,200,000 | 600,000 | ( 168,000 ) | - | 1,632,000 | - |
| Mr JP Breheny | - | 100,000 | - | - | 100,000 | - |
| Mr AM Coleman | 258,195 | 90,000 | ( 54,176 ) | - | 294,019 | - |
| Mr NB Hawkins | 168,456[1] | - | - | - | 168,456 | - |
| Mr DA Issa | 223,177 | 83,500 | ( 47,675 ) | - | 259,002 | - |
| Ms JS Johnson | 87,300[1] | - | ( 5,972 ) | - | 81,328 | - |
| Ms CF McLoughlin | - | 80,000 | - | - | 80,000 | - |
| Ms SJ Mostyn | 214,307 | 80,000 | ( 45,508 ) | - | 248,799 | - |
| Mr MJ Pirone | 239,881 | 90,000 | ( 47,675 ) | - | 282,206 | - |
| Mr J van der Schalk | 149,004[1] | - | - | - | 149,004 | 22,753 |
| Mr G Venardos | 305,048 | 100,000 | ( 66,745 ) | - | 338,303 | - |
| **Total** | 2,845,368 | 1,223,500 | ( 435,751 ) | - | 3,633,117 | 22,753 |
| *Executives who ceased as key management personnel during the year:* | | | | | | |
| Mr IF Brown | 221,716 | - | - | - | 221,716 | 45,508 |
| Mr RJ Jackson | 161,451 | 90,000 | - | - | 251,451 | - |
| Mr DRA Pearce | 196,232 | - | - | - | 196,232 | 49,029 |
| Mr DJP Smith | 238,167 | 80,000 | ( 48,560 ) | - | 269,607 | - |
| **Total** | 817,566 | 170,000 | ( 48,560 ) | - | 939,006 | 94,537 |

(1) This balance represents the PARs held by Mr Hawkins, Ms Johnson and Mr van der Schalk at the date of appointment as executive.

(2) $1 per tranche of PARs is payable to exercise. Nil remains unpaid per issued share acquired. For each PAR exercised, one ordinary IAG share was issued.

**(b) PSRs**

The PSRs Plan was closed for issuing further PSRs from the financial year ended 30 June 2003. Following is a summary of the movements in total number of PSRs on issue by each executive:

| | PSRs on issue 1 Jul 2005 | PSRs exercised during the year (2) | PSRs lapsed during the year | PSRs on issue 30 Jun 2006 | PSRs vested and exercisable 30 Jun 2006 |
|---|---|---|---|---|---|
| | Number | Number | Number | Number | Number |
| Mr MJ Hawker | 60,000 | ( 60,000 ) | - | - | - |
| Ms SJ Mostyn | 68,670 | ( 68,670 ) | - | - | - |
| Mr J van der Schalk | 40,000 [1] | - | - | 40,000 | 40,000 |

(1) This balance represents the PSRs held by Mr van der Schalk at the date of appointment as executive.

(2) The exercise price was $1 per tranche of PSRs. Nil remains unpaid per issued share acquired. For each PSR exercised, one ordinary IAG share was issued.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**DIRECTORS' REPORT**

**Remuneration Report – Audited information (continued)**

**A. Executives (continued)**

**7. Long term incentives – PARs and PSRs (continued)**

**(c) Analysis of movements in PARs and PSRs**

Following is a summary of the movement during the financial year, by value, of PARs and PSRs by each executive:

| | **Total value of PARs granted during the year (1)** | **Total value of PSRs exercised during the year (2)** | **Total value of PARs exercised during the year (3)** | **Total value PARs and PSRs that lapsed during the year (4)** | **Total of (1) to (4)** |
|---|---|---|---|---|---|
| | $000 | $000 | $000 | $000 | $000 |
| Mr MJ Hawker | 1,558 | 338 | 918 | - | 2,814 |
| Mr JP Breheny | 315 | - | - | - | 315 |
| Mr AM Coleman | 287 | - | 296 | - | 583 |
| Mr NB Hawkins | * | * | * | * | * |
| Mr DA Issa | 266 | - | 259 | - | 525 |
| Ms JS Johnson | * | * | * | * | * |
| Ms CF McLoughlin | 255 | - | - | - | 255 |
| Ms SJ Mostyn | 255 | 366 | 246 | - | 867 |
| Mr MJ Pirone | 287 | - | 260 | - | 547 |
| Mr J van der Schalk | * | * | * | * | * |
| Mr G Venardos | 319 | - | 362 | - | 681 |
| **Total** | 3,542 | 704 | 2,341 | - | 6,587 |
| *Executives who ceased as key management personnel during the year:* | | | | | |
| Mr IF Brown | - | - | - | - | - |
| Mr RJ Jackson | 287 | - | - | - | 287 |
| Mr DRA Pearce | - | - | - | - | - |
| Mr DJP Smith | 255 | - | 265 | - | 520 |
| **Total** | 542 | - | 265 | - | 807 |

Notes:
(1) The value of PARs granted in the year is the fair value of the PARs calculated at grant date using a Monte Carlo model. The total value of the PARs granted is included in the table above. This amount is allocated to remuneration over the vesting period (ie in years 30 June 2006 to 30 June 2010).

(2) The PSRs and PARs exercised during the year by the executives were issued to them on 13 December 2001, 5 March 2002 and 24 December 2002. The respective values at grant date were allocated to their remuneration during the three years' vesting period between 30 June 2002 to 30 June 2006. PSRs and PARs are exercisable only if a performance hurdle is reached in relation to IAG's TSR.

The value of PSRs and PARs exercised during the year is calculated as the weighted average of the prices at which IAG shares were traded over 5 days before and including date of exercise after deducting the $1 exercise price per tranche of PSRs exercised.

(3) No PARs or PSRs lapsed during the year.

(4) Related parties of executives cannot participate in the PARs or PSRs Plans.

* The above table excludes all PARs and PSRs movement prior to the date when Mr Hawkins, Ms Johnson and Mr van der Schalk were appointed to their executive roles.

**Remuneration Report – Audited information (continued)**

**B. Non-executive Directors**

**1. Remuneration policy**

The principles that underpin IAG's approach to remuneration for Non-executive Directors are that remuneration should be:

- sufficiently competitive to attract and retain a high calibre of Non-executive Director; and
- consistent with IAG's values.

The aggregate limit of remuneration is approved by shareholders and is currently $2 million per annum. The aggregate annual remuneration is inclusive of employer superannuation contributions paid by IAG on behalf of Non-executive Directors.

The Board has agreed that each Non-executive Director should take a minimum of 20% and up to a maximum of 90% of their annual base fee (at the time shares are allocated), on a fee sacrifice basis, in the form of IAG shares provided under the Non-Executive Directors' Share Plan, which was approved by shareholders on 13 November 2002. IAG shares are purchased by the trustee on market and allocated to directors in December each year. Non-executive Directors may elect to restrict the disposal of these shares for a minimum period of one year and up to 10 years or until the Director retires. No other equity-based remuneration is available to Non-executive Directors.

The current elements of Non-executive Director remuneration are:

| Board / Committee | Role | Fee |
|---|---|---|
| IAG Board | Chairman<br>Director | $360,000 (includes committee fees*)<br>$120,000 |
| Audit Committee | Chairman<br>Member | $30,000<br>$15,000 |
| Risk Management & Compliance Committee | Chairman<br>Member | $30,000<br>$15,000 |
| Nomination, Remuneration & Sustainability Committee | Member | $15,000 |

* The Chairman does not receive additional fees for serving on the Nomination, Remuneration & Sustainability Committee or for serving as a director of IAG Re Limited. The Chairman is, however, paid a fee for his role as Chairman of Insurance Manufacturers of Australia Pty Limited, a 70% owned subsidiary of IAG.

In addition, IAG pays a superannuation contribution of 9% of a Director's fees into a superannuation fund nominated by the Director. Directors' fees and superannuation contributions are paid monthly.

IAG has a Non-executive Directors' Expenses policy. Under this policy IAG reimburses expenses reasonably incurred by Directors in connection with the discharge of their duties.

**2. Increase to Directors fees**

Following a review of the remuneration of Non-executive Directors, taking into account the remuneration paid to the Non-executive Directors of the 50 largest companies in the S&P / ASX 100 index and market movements in directors fees, the Board has determined that fees payable to Non-executive Directors should be increased with effect from 1 July 2006 as follows:

| Board / Committee | Role | Fee |
|---|---|---|
| IAG Board | Chairman<br>Director | $390,000 (includes committee fees*)<br>$130,000 |
| Audit Committee | Chairman<br>Member | $32,500<br>$16,250 |
| Risk Management & Compliance Committee | Chairman<br>Member | $32,500<br>$16,250 |
| Nomination, Remuneration & Sustainability Committee | Member | $16,250 |

**Remuneration Report –Audited information (continued)**

**B. Non-executive Directors (continued)**

**3. Performance**

Directors' performance is subject to evaluation by the Chairman at least every two years, by discussion between the Chairman and the individual Director. In these discussions, the individual Directors also evaluate the Chairman's performance. Performance measures for Directors considered by the Chairman and Board include:

- contribution of the Director to Board teamwork;
- contribution to debates on significant issues and proposals;
- advice and assistance given to management;
- in the case of the Chairman's performance, the fulfilment of his or her additional role as Chairman; and
- input regarding regulatory, industry and social developments surrounding the business.

The Nomination, Remuneration & Sustainability Committee has responsibility for coordinating the Board's review of the Chairman's performance.

**4. Remuneration details**

**(a) Remuneration of Non-executive Directors for 2006**

| | **Short-term benefits** | | **Post-employment benefits** | | **Other long-term employment benefits** | **Termination benefits** | **Share-based payment** | **Total** |
|---|---|---|---|---|---|---|---|---|
| | Board fees received as cash | Committee fees | Superannuation | Retirement benefits | | | Board fees received as IAG Shares | |
| **2006** | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 |
| Mr JA Strong[(i)] | **352** | **-** | **47** | **-** | **-** | **-** | **168** | **567** |
| Ms YA Allen | **98** | **15** | **12** | **-** | **-** | **-** | **22** | **147** |
| Mr JF Astbury | **98** | **45** | **15** | **-** | **-** | **-** | **22** | **180** |
| Mr GA Cousins | **98** | **15** | **12** | **-** | **-** | **-** | **22** | **147** |
| Mr ND Hamilton | **20** | **15** | **12** | **-** | **-** | **-** | **100** | **147** |
| Mr RA Ross | **64** | **45** | **15** | **-** | **-** | **-** | **56** | **180** |
| Mr B Schwartz | **87** | **15** | **12** | **-** | **-** | **-** | **33** | **147** |
| Total remuneration | **817** | **150** | **125** | **-** | **-** | **-** | **423** | **1,515** |

Notes:
(i) Board fees for Mr Strong included $160,000 for his service as Chairman of the Board of Insurance Manufacturers of Australia Pty Limited ("IMA").

**Remuneration Report – Audited information (continued)**

**B. Non-executive Directors (continued)**

**4. Remuneration details (continued)**

**(b) Remuneration of Non-executive Directors for 2005**

| | **Short-term benefits** | | **Post-employment benefits** | | **Other long-term employment benefits** | **Termination benefits** | **Share-based payment** | **Total** |
|---|---|---|---|---|---|---|---|---|
| | Board fees received as cash | Committee fees | Superannuation | Retirement benefits | | | Board fees received as IAG Shares | |
| 2005 | $000 | $000 | $000 | $000 | $000 | $000 | $000 | $000 |
| Mr JA Strong(i) | 280 | - | 39 | - | - | - | 150 | 469 |
| Ms YA Allen(ii) | 52 | 8 | 6 | - | - | - | 12 | 78 |
| Mr JF Astbury | 80 | 30 | 12 | - | - | - | 20 | 142 |
| Mr GA Cousins | 80 | 12 | 10 | - | - | - | 20 | 122 |
| Ms DG Fisher(iii) | 18 | 4 | 4 | 259 | - | - | 18 | 303 |
| Mr ND Hamilton(iv) | 10 | 19 | 11 | - | - | - | 90 | 130 |
| Ms AJ Keating(v) | 29 | 8 | 4 | 250 | - | - | 7 | 298 |
| Mr RA Ross | 50 | 30 | 12 | - | - | - | 50 | 142 |
| Mr B Schwartz(vi) | 37 | 6 | 5 | - | - | - | 13 | 61 |
| Total remuneration | 636 | 117 | 103 | 509 | - | - | 380 | 1,745 |

Notes:
(i) Board fees for Mr Strong included $130,000 for his service as Chairman of the Board of IMA.
(ii) Ms Allen was appointed to the Board on 10 November 2004.
(iii) Ms Fisher retired from the Board on 10 November 2004.
(iv) Board fees for Mr Hamilton included $7,000 for his services as Director of Mutual Community General Proprietary Limited ("MCGI"), a 51% owned controlled entity of IAG.
(v) Ms Keating retired from the Board on 10 November 2004. During the period, Board fees for Ms Keating included $4,000 for her services as Director of MCGI.
(vi) Mr Schwartz was appointed to the Board on 1 January 2005.

**Remuneration Report – Audited information (continued)**

**B. Non-executive Directors (continued)**

**5. Retirement benefits**

IAG decided to freeze the operation of the Non-executive Director retirement benefit scheme adopted by IAG in 2001 with effect from 1 September 2003.

The terms of the retirement benefits scheme provided for:
(a) Any Non-executive Director of IAG who had completed five years' continuous service with the IAG (including service with any subsidiaries) at the date of retirement, a retirement benefit equivalent to the last three years' Directors' fees, employer superannuation contributions, committee fees and fees for extra services received from IAG and its subsidiaries.
(b) A pro-rata retirement benefit for Non-executive Directors who have completed at least three years' service but less than five years' service at the date of their retirement, based on a specified formula.
(c) No retirement benefit to be paid to a Non-executive Director who had served for a period of less than three years.

IAG determined that the frozen retirement benefits would be calculated as follows:
(a) Non-executive Directors joining the Board from 1 September 2003 would have no retirement benefit;
(b) For each Non-executive Director as at 31 August 2003 who had served a minimum of three years, the retirement benefit was assessed as if they had retired at 31 August 2003; and
(c) For a Non-executive Director with less than three years of service at 31 August 2003, a retirement benefit was assessed as if they had three years of service as at that date, and then reduced on a pro-rata basis based on their uncompleted period of service as a proportion of three years. The retirement benefit was not subsequently payable to such a Non-executive Director if they had less than three years of service as a Non-executive Director at the date of their retirement.

The following table sets out the frozen retirement benefits of the remaining Directors who held office on 31 August 2003 and who have continued in office since then:

| **Name** | **Retirement benefit** |
|---|---:|
| | $000 |
| Mr JA Strong | 295 |
| Mr JF Astbury | 184 |
| Mr GA Cousins | 169 |
| Mr ND Hamilton | 248 |
| Mr RA Ross | 232 |

On retirement, Directors may also be entitled to be paid a benefit from their company funded superannuation. Such a benefit would be in addition to the Director's frozen retirement benefit.

No amounts have been accrued in the accounts of the IAG Group for the frozen retirement benefits of the remaining Directors who held office on 31 August 2003 and who have continued in office since, as the Board has not exercised its discretion to pay these retirement benefits.

**C. Other benefits**

Remuneration does not include premiums paid by IAG for an insurance contract covering current and former Directors' and executives' liabilities and legal expenses incurred in respect of the relevant office, as the insurance policies do not specify premiums paid in respect of individual Directors and executives and the terms of contract specifically prohibited the disclosure of the premium paid. Insurance products provided by the IAG Group are also available to all directors and executives on the same terms and conditions available to other employees.

**Remuneration Report – Audited information**

**D. Equity and debt instrument disclosure**

**1. Holding of ordinary shares**

**(a) The relevant interest of each key management personnel and their related parties in ordinary shares of IAG**

| | Shares held at the beginning of the year | Shares granted as remuneration during the year | Shares received on exercise of PSRs | Shares received on exercise of PARs | Net movement of shares due to other changes(2) | Total shares held at the end of the year | Shares held nominally at the end of the year (1) |
|---|---|---|---|---|---|---|---|
| Mr JA Strong | 225,547 | 33,918 | - | - | - | 259,465 | 247,382 |
| Ms YA Allen | 3,437 | 4,522 | - | - | - | 7,959 | 7,959 |
| Mr JF Astbury | 51,772 | 4,522 | - | - | 9,400 | 65,694 | 55,611 |
| Mr GA Cousins | 171,689 | 4,522 | - | - | - | 176,211 | 26,211 |
| Mr ND Hamilton | 80,744 | 20,351 | - | - | 173 | 101,268 | 96,278 |
| Mr RA Ross | 154,100 | 11,306 | - | - | - | 165,406 | 62,849 |
| Mr B Schwartz | 3,906 | 6,783 | - | - | - | 10,689 | 10,689 |
| Mr MJ Hawker | 1,150,059 | - | 60,000 | 168,000 | - | 1,378,059 | - |
| Mr JP Breheny | - | - | - | - | - | - | - |
| Mr AM Coleman | 65,896 | - | - | 54,176 | ( 58,020 ) | 62,052 | 54,176 |
| Mr NB Hawkins | - | - | - | - | 24,332(3) | 24,332 | - |
| Mr DA Issa | - | - | - | 47,675 | ( 47,675 ) | - | - |
| Ms JS Johnson | - | - | - | 5,972 | - | 5,972 | - |
| Ms CF McLoughlin | - | - | - | - | - | - | - |
| Ms SJ Mostyn | 16,083 | - | 68,670 | 45,508 | - | 130,261 | - |
| Mr MJ Pirone | 31,388 | - | - | 47,675 | - | 79,063 | 11,432 |
| Mr J van der Schalk | - | - | - | - | - | - | - |
| Mr G Venardos | 38,289 | - | - | 66,745 | 5,746 | 110,780 | 27,632 |
| *Executives who ceased employment during the year:* | | | | | | | |
| Mr IF Brown | 253,691 | 36,920 | - | - | ( 2,530 ) | * | * |
| Mr RJ Jackson | 7,351 | - | - | - | - | * | * |
| Mr DRA Pearce | 7,806 | - | - | - | ( 6,738 ) | * | * |
| Mr DJP Smith | 129,591 | - | - | 48,560 | ( 54,511 ) | * | * |

(1) Nominally held shares are included in the column headed total shares held at the end of the year. These shares are held by the key management personnel's related parties, inclusive of domestic partner, dependents and entities controlled, jointly controlled or significantly influenced by the key management personnel.

(2) Net movement of shares relate to acquisition and disposal transactions by the key management personnel and their related parties during the year. It includes any opening balances of shares held by key management personnel who were appointed during the year.

(3) This balance represents the shares held by Mr Hawkins at the date of appointment as executive.

* These key management personnel ceased employment during the financial year. Information on shares held only disclosed up to the date of their cessation.

**Remuneration Report – Audited information (continued)**

**D. Equity and debt instrument disclosure (continued)**

**(b) The relevant interest of each Director and their related party in ordinary shares of IAG in accordance with the Corporations Act 2001**

| | For Section 205G of the Corporations Act 2001 | |
|---|---|---|
| | Shares held directly at the end of the year(1) | Shares held indirectly at the end of the year(1) (2) |
| Mr JA Strong | 12,083 | 198,819 |
| Ms YA Allen | - | 7,959 |
| Mr JF Astbury | 10,083 | 55,611 |
| Mr GA Cousins | 150,000 | 26,211 |
| Mr ND Hamilton | 4,990 | 96,278 |
| Mr RA Ross | 102,557 | 59,952 |
| Mr B Schwartz | - | 10,689 |
| Mr MJ Hawker | 1,378,059 | - |

(1) This represents the relevant interest of each Director in ordinary shares issued by the Company, as notified by the Directors to the Australian Stock Exchange in accordance with section 205G of the Corporations Act 2001. Trading in IAG shares is covered by the restrictions which limit the ability of an IAG Director to trade in the shares of the IAG Group where they are in a position to be aware, or are aware, of price sensitive information.

(2) These shares are held by the Director's related parties, inclusive of entities controlled, jointly controlled or significantly influenced by the Directors.

**2. Holdings of reset preference shares**

No key management personnel had any interest in reset preference shares at any time during the financial year.

**3. Holdings of reset exchangeable securities**

In respect of the relevant interest of each key management personnel in reset exchangeable securities ("RES") of IAG Finance (New Zealand) Limited , other than Mr Hawker, no other person held any RES directly or through their related party.

| | | | | | For Section 205G of the Corporations Act 2001 | |
|---|---|---|---|---|---|---|
| | RES held at the beginning of the year | Net movement of RES due to other changes | Total RES held at the end of the year | RES held nominally at the end of the year (1) | RES held directly at the end of the year(2) | RES held indirectly at the end of the year(2) |
| Mr MJ Hawker | 1,000 | - | 1,000 | 1,000 | - | 1,000 |

(1) Nominally held RES are included in the column headed total RES held at the end of the year. These RES are indirectly held by key management personnel's related parties.

(2) This represents the relevant interest of each Director in RES issued by IAG Finance (New Zealand) Limited, as notified by the Directors to the Australian Stock Exchange in accordance with section 205G of the Corporations Act 2001. Trading in RES is covered by the IAG Group's Continuous Disclosure & Insider Trading Policy.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**DIRECTORS' REPORT**

**Rounding of amounts**

Unless otherwise stated, amounts in the financial report and Directors' report have been rounded to the nearest million dollars. The Company is of a kind referred to in the class order 98/100 dated 10 July 1998 issued by the Australian Securities & Investments Commission. All rounding has been conducted in accordance with that class order.

Signed at Sydney this 25th day of August 2006 in accordance with a resolution of the Directors.

..................................................
Director

James Strong
Director

**LEAD AUDITOR'S INDEPENDENCE DECLARATION UNDER SECTION 307C OF THE CORPORATIONS ACT 2001**

To: the directors of Insurance Australia Group Limited

I declare that both the Firm and I were and remain independent in accordance with professional rules and statutory requirements on auditor independence in relation to the audit for the financial year ended 30 June 2006 ("the audit").

To the best of my knowledge and belief, in relation to the audit there have been:

(a) no contraventions of the auditor independence requirements of the Corporations Act 2001 other than contraventions (relating to minor matters rectified within seven days and reported to the directors) covered by ASIC Class Order 05/910; and

(b) no contraventions of any applicable code of professional conduct in relation to the audit.

KPMG

**KPMG**

**Dr Andries B Terblanché**
*Partner*

Sydney
25th August 2006

## INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES

## INCOME STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006

| | Notes | PARENT 2006 $m | PARENT 2005 $m | CONSOLIDATED 2006 $m | CONSOLIDATED 2005 $m |
|---|---|---|---|---|---|
| Premium revenue | 3 | **-** | - | **6,537** | 6,561 |
| Reinsurance expense | 4 | **-** | - | **( 405 )** | ( 417 ) |
| Net premium revenue (i) | | **-** | - | **6,132** | 6,144 |
| Claims expense | 4 | **-** | - | **( 4,466 )** | ( 4,750 ) |
| Reinsurance and other recoveries | 3 | **-** | - | **566** | 660 |
| Net claims expense (ii) | 11 | **-** | - | **( 3,900 )** | ( 4,090 ) |
| Acquisition costs | 4 | **-** | - | **( 1,081 )** | ( 1,070 ) |
| Other underwriting expenses | 4 | **-** | - | **( 395 )** | ( 377 ) |
| Fire service levies | 4 | **-** | - | **( 223 )** | ( 177 ) |
| Underwriting expenses (iii) | | **-** | - | **( 1,699 )** | ( 1,624 ) |
| Underwriting profit (i) + (ii) + (iii) | | - | - | **533** | 430 |
| Investment income on assets backing insurance liabilities | 3 | **-** | - | **329** | 525 |
| Investment expenses on assets backing insurance liabilities | 4 | **-** | - | **( 19 )** | ( 9 ) |
| Insurance profit | | **-** | - | **843** | 946 |
| Investment income on equity holders' funds | 3 | **746** | 585 | **576** | 518 |
| Other income | 3 | **3** | - | **218** | 179 |
| Share of net profit of associate | 3 | **-** | - | **2** | - |
| Finance costs | 4 | **( 57 )** | - | **( 86 )** | ( 69 ) |
| Corporate, administration and other expenses | 4 | **-** | - | **( 298 )** | ( 289 ) |
| Net income attributable to minority interests in unitholders' funds | 4 | **-** | - | **( 20 )** | - |
| **Profit before income tax** | | **692** | 585 | **1,235** | 1,285 |
| Income tax credit / (expense) | 6 | **10** | 2 | **( 373 )** | ( 357 ) |
| **Profit for the year** | | **702** | 587 | **862** | 928 |
| **Profit for the year attributable to:** | | | | | |
| Equity holders of the Parent | | **702** | 587 | **759** | 811 |
| Minority interests | | **-** | - | **103** | 117 |
| **Profit for the year** | | **702** | 587 | **862** | 928 |

| | Notes | CONSOLIDATED 2006 cents | CONSOLIDATED 2005 cents |
|---|---|---|---|
| Basic earnings per ordinary share | 8 | **47.87** | **49.31** |
| Diluted earnings per ordinary share | 8 | **47.59** | **49.00** |

The above income statements should be read in conjunction with the notes to the financial statements.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**BALANCE SHEETS AS AT 30 JUNE 2006**

| | | PARENT | | CONSOLIDATED | |
|---|---|---|---|---|---|
| | Notes | **2006** | 2005 | **2006** | 2005 |
| | | **$m** | $m | **$m** | $m |
| **Assets** | | | | | |
| Cash and cash equivalents | 25 | **1** | 1 | **718** | 456 |
| Investments | 15 | **-** | - | **9,929** | 10,370 |
| Premium receivable | | **-** | - | **1,652** | 1,710 |
| Trade and other receivables | 16 | **1** | - | **764** | 827 |
| Receivables from related bodies corporate | 34 | **160** | 215 | **4** | - |
| Current tax assets | | **-** | - | **1** | 4 |
| Loans to related bodies corporate | 34 | **-** | 5 | **-** | - |
| Reinsurance and other recoveries receivable on outstanding claims | 12 | **-** | - | **908** | 883 |
| Inventories | | **-** | - | **-** | 2 |
| Prepayments | | **-** | - | **25** | 38 |
| Deferred levies and charges | | **-** | - | **126** | 105 |
| Deferred reinsurance expense | | **-** | - | **221** | 194 |
| Deferred acquisition costs | 13 | **-** | - | **591** | 621 |
| Deferred tax assets | 17 | **1** | - | **159** | 131 |
| Property, plant and equipment | 18 | **-** | - | **257** | 259 |
| Investment in joint ventures and associates | 28 | **-** | - | **74** | 8 |
| Intangible assets | 19 | **-** | - | **57** | 31 |
| Investment in subsidiaries | 27 | **4,795** | 4,617 | **-** | - |
| Goodwill | 20 | **-** | - | **1,486** | 1,463 |
| **Total assets** | | **4,958** | 4,838 | **16,972** | 17,102 |
| **Liabilities** | | | | | |
| Trade and other payables | 21 | **2** | 1 | **743** | 721 |
| Reinsurance premiums payable | | **-** | - | **166** | 195 |
| Payables to related bodies corporate | 34 | **84** | 73 | **-** | - |
| Restructuring provision | 22 | **-** | - | **10** | 11 |
| Current tax liabilities | | **63** | 140 | **83** | 193 |
| Loans from related bodies corporate | 34 | **313** | 184 | **-** | - |
| Unexpired risk liability | | **-** | - | **11** | - |
| Unearned premium liability | 14 | **-** | - | **3,503** | 3,586 |
| Minority interest in unitholders' funds | | **-** | - | **305** | - |
| Lease provision | | **-** | - | **21** | 21 |
| Employee benefits provision | 29 | **-** | - | **207** | 229 |
| Deferred tax liabilities | 17 | **-** | - | **40** | 24 |
| Outstanding claims liability | 11 | **-** | - | **6,916** | 6,840 |
| Interest-bearing liabilities | 23 | **547** | - | **1,296** | 779 |
| **Total liabilities** | | **1,009** | 398 | **13,301** | 12,599 |
| **Net assets** | | **3,949** | 4,440 | **3,671** | 4,503 |
| **Equity** | | | | | |
| Share capital | 24(a) | **3,263** | 3,802 | **3,263** | 3,802 |
| Treasury shares held in trust | 24(b) | **-** | - | **( 40 )** | ( 34) |
| Reserves | 24(c) | **-** | - | **( 6 )** | 7 |
| Retained earnings | 24(d) | **686** | 638 | **274** | 142 |
| **Parent interest** | 24 | **3,949** | 4,440 | **3,491** | 3,917 |
| Minority interests | 24(e) | **-** | - | **180** | 586 |
| **Total equity** | 24 | **3,949** | 4,440 | **3,671** | 4,503 |

The above balance sheets should be read in conjunction with the notes to the financial statements.

## INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES

## STATEMENTS OF RECOGNISED INCOME AND EXPENSE FOR THE YEAR ENDED 30 JUNE 2006

| | Notes | PARENT 2006 $m | PARENT 2005 $m | CONSOLIDATED 2006 $m | CONSOLIDATED 2005 $m |
|---|---|---|---|---|---|
| **Income and expenses recognised directly in equity during the year, net of tax** | | | | | |
| Actuarial gains / (losses) on defined benefit plans | | **-** | - | **21** | ( 1 ) |
| Net movement in foreign currency translation reserve | | **-** | - | **( 9 )** | ( 1 ) |
| Net movement in hedging reserve | | **-** | - | **( 5 )** | - |
| Vesting of share based remuneration | | **-** | - | **( 1 )** | - |
| **Total net income and (expense) recognised directly in equity** | | **-** | - | **6** | ( 2 ) |
| **Profit for the year** | | **702** | 587 | **862** | 928 |
| **Total recognised income and expense for the year** | | **702** | 587 | **868** | 926 |
| **Total recognised income and expense for the year attributable to:** | | | | | |
| Equity holders of the Parent | | **702** | 587 | **765** | 809 |
| Minority interests | 24(e) | **-** | - | **103** | 117 |
| **Total recognised income and expense for the year** | | **702** | 587 | **868** | 926 |
| **Effect of changes in accounting policies made as part of the transition to AIFRS** | | | | | |
| **Income and expenses recognised directly in equity on 1 July 2005, net of tax** | | | | | |
| Initial recognition of AIFRS adjustments directly to retained earnings at 1 July 2005, net of tax | | | | | |
| - Adjustment to valuation of investments | | **-** | - | **1** | - |
| - Amortisation of reset preference shares transaction costs | | **( 6 )** | - | **( 6 )** | - |
| - Accrual for distribution on reset preference shares | | **( 1 )** | - | **( 1 )** | - |
| Initial recognition of AIFRS adjustments directly to reserves at 1 July 2005, net of tax | | | | | |
| - Recognition of hedging reserve, net of tax | | **-** | - | **( 5 )** | - |
| | 38 | **( 7 )** | - | **( 11 )** | - |
| **Net AIFRS adjustments at 1 July 2005 attributable to:** | | | | | |
| Equity holders of the Parent | | **( 7 )** | - | **( 10 )** | - |
| Minority interests | | **-** | - | **( 1 )** | - |
| | 38 | **( 7 )** | - | **( 11 )** | - |

Other movements in equity arising from transactions with equity holders acting in their capacity as equity holders are set out in note 24.

The above statements of recognised income and expense should be read in conjunction with the notes to the financial statements.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**CASH FLOW STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

| | Notes | PARENT 2006 | PARENT 2005 | CONSOLIDATED 2006 | CONSOLIDATED 2005 |
|---|---|---|---|---|---|
| | | **$m** | $m | **$m** | $m |
| **Cash flows from operating activities** | | | | | |
| Premium received | | **-** | - | **6,530** | 6,610 |
| Reinsurance and other recoveries received | | **-** | - | **589** | 452 |
| Claims costs paid | | **-** | - | **( 4,423 )** | ( 4,179 ) |
| Reinsurance expense paid | | **-** | - | **( 434 )** | ( 394 ) |
| Dividends received | | **745** | 585 | **85** | 93 |
| Interest and trust distributions received | | **-** | - | **415** | 412 |
| Finance costs paid | | **( 29 )** | - | **( 82 )** | ( 62 ) |
| Income taxes refunded | | **-** | - | **8** | 4 |
| Income taxes paid | | **( 300 )** | ( 154 ) | **( 497 )** | ( 315 ) |
| Other operating receipts | | **280** | - | **1,051** | 1,036 |
| Other operating payments | | **-** | - | **( 2,855 )** | ( 2,736 ) |
| **Net cash flows from operating activities** | 25(b) | **696** | 431 | **387** | 921 |
| **Cash flows from investing activities** | | | | | |
| Net cash flows on acquisition of subsidiaries | 26(a) | **-** | - | **( 92 )** | ( 7 ) |
| Dividend received from pre-acquisition profits of subsidiary | | **412** | **-** | **-** | - |
| Proceeds from disposal of investments and property, plant and equipment | | **-** | **-** | **19,503** | 19,987 |
| Outlays for investments and property, plant and equipment acquired | | **( 590 )** | ( 60 ) | **( 18,591 )** | (20,137) |
| Repayment of premium funding loans | | **-** | - | **448** | 375 |
| Advances of premium funding loans | | **-** | - | **( 446 )** | ( 414 ) |
| **Net cash flows from investing activities** | | **( 178 )** | ( 60 ) | **822** | ( 196 ) |
| **Cash flows from financing activities** | | | | | |
| Outlays for purchase of treasury shares | | **-** | - | **( 19 )** | (13) |
| Proceeds from issue of trust units | | **-** | - | **1,152** | 2,035 |
| Outlays for redemption of trust units | | **-** | - | **( 1,288 )** | ( 2,163 ) |
| Proceeds from issue of reset exchangeable securities, net of transaction costs | | **-** | - | **-** | 537 |
| Outlays to acquire Portfolio (see note 1(ff)) | | **-** | - | **-** | ( 550 ) |
| Proceeds from other borrowings inclusive of costs | | **129** | 71 | **-** | 9 |
| Repayment of borrowings | | **-** | - | **( 46 )** | ( 9 ) |
| Dividends paid to IAG equity holders | | **( 647 )** | ( 442 ) | **( 647 )** | ( 442 ) |
| Dividends paid to minority interests | | **-** | - | **( 89 )** | ( 96 ) |
| **Net cash flows from financing activities** | | **( 518 )** | ( 371 ) | **( 937 )** | ( 692 ) |
| **Net movement in cash held** | | **-** | - | **272** | 33 |
| Effects of exchange rate changes on balances of cash held in foreign currencies | | **-** | - | **( 10 )** | ( 1 ) |
| **Cash and cash equivalents at the beginning of the financial year** | | **1** | 1 | **456** | 424 |
| **Cash and cash equivalents at the end of the financial year** | 25(a) | **1** | 1 | **718** | 456 |

The above cash flow statements should be read in conjunction with the notes to the financial statements.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

## Index

For ease of reference we provide here an index of the notes to the financial statements showing those relevant to the financial statements of the Consolidated entity and those relevant to the financial statements of the Parent.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

**Note 1. Summary of significant accounting policies**

Insurance Australia Group Limited ("Company", "Parent" and "IAG") is a publicly listed company limited by shares, incorporated and domiciled in Australia. Its registered office and principal place of business is Level 26, 388 George Street, Sydney, NSW 2000. The consolidated financial report of the Company for the year ended 30 June 2006 comprises the Company and its subsidiaries (referred to as "Consolidated entity" and "IAG Group").

This general purpose financial report was authorised by the Board of Directors for issue on 25 August 2006.

**(a) Statement of compliance**

This general purpose financial report for the year ended 30 June 2006 has been prepared in accordance with the Corporations Act 2001, Australian equivalents to International Financial Reporting Standards ("AIFRS"), other authoritative pronouncements of the Australian Accounting Standards Board and the Australian Stock Exchange Listing Rules.

The financial reports were prepared in accordance with Australian Generally Accepted Accounting Principles ("Australian GAAP") for all periods up to and including the year ended 30 June 2005. From 1 July 2005, the financial reports are required to be prepared in accordance with AIFRS effective for the year ended 30 June 2006. The date of transition to AIFRS was 1 July 2004, which is the start of the comparative period.

Reconciliations and explanations of the impact of the transition from Australian GAAP to AIFRS on the financial position and financial performance of the Parent and the Consolidated entity are provided in note 38.

International Financial Reporting Standards ("IFRS") refer to the overall framework of standards and pronouncements approved by the International Accounting Standards Board ("IASB"). IFRS forms the basis of AIFRS being the Australian accounting standards adopted by the Australian Accounting Standards Board. This financial report of the Parent and the Consolidated entity comply with IFRS.

The current IFRS standard for insurance contracts does not include a comprehensive set of recognition and measurement criteria. The IASB continues to work on a project to issue a standard that does include such criteria. Until the issuance of that standard, the financial reports of insurers in different countries that comply with IFRS may not be comparable in terms of the recognition and measurement of insurance contracts.

**(b) Basis of preparation of the financial report**

The significant accounting policies adopted in the preparation of this financial report are set out below. The accounting policies adopted in the preparation of this financial report have been consistently applied by all entities in the Consolidated entity. The policies have been applied consistently to all periods presented in the financial report and in preparing the opening AIFRS balance sheet at 1 July 2004 for the purposes of transition to AIFRS, except for policies relating to the standards discussed in note 1(b)(ii) for which comparatives have not been restated. These financial statements have been prepared on the basis of historical cost principles, as modified by certain exceptions noted in the financial report, with the principal exceptions for the Consolidated entity being the measurement of all investments and derivatives at fair value and the measurement of the outstanding claims liability and related reinsurance and other recoveries at present value.

The presentation currency used for the preparation of these financial reports is Australian dollars.

The balance sheet is prepared using the liquidity format in which the assets and liabilities are presented broadly in order of liquidity. The assets and liabilities comprise both current amounts (expected to be recovered or settled within twelve months after the reporting date) and non-current amounts (expected to be recovered or settled more than twelve months after the reporting date). For those assets and liabilities that comprise both current and non-current amounts, information regarding the amount of the item that is expected to be outstanding longer than twelve months is included within the relevant note to the financial statements.

(i) Australian accounting standards issued but not yet effective

As at the date of this financial report, there are a number of new and revised accounting standards on issue with mandatory application dates after the end of this current reporting period. Of these, the following standards have been early adopted:

- AASB 119 Employee benefits (issued December 2004) and AASB 2004-3. These standards made available two additional options for accounting for defined benefit obligations one of which was selected by the IAG Group. Refer note 1(z).
- AASB 2005-4 restricting the use of the fair value option in AASB 139. This standard had no financial impact.

**Note 1. Summary of significant accounting policies (continued)**

**(b) Basis of preparation of the financial report (continued)**

(i) Australian accounting standards issued but not yet effective (continued)

The standards that have not been early adopted and that are relevant to current operations are:

- AASB 7 Financial Instruments: Disclosures applicable for the first time to the 30 June 2008 financial report. This standard was issued in conjunction with AASB 2005-10 which makes a number of consequential amendments to other standards arising from the issue of AASB 7. The changes will impact only on annual financial report disclosures.
- AASB 2005-9 which deals with the treatment of financial guarantee contracts and deals with the issue where an insurance product meets the definition of an insurance contract and a financial guarantee contract. This amendment is not expected to have a significant, if any, financial impact.

(ii) First time adoption of AIFRS

This is the first annual financial report to be prepared in accordance with AIFRS. AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards* has been applied in preparing these financial statements. There are several recognition and measurement differences between Australian GAAP and AIFRS. Preparation of this AIFRS compliant financial report has required amendment of certain accounting policies, changes to certain valuation methodologies, and reporting of certain information in a different manner than was the case under the previous Australian GAAP financial reports. Comparative figures have been restated to reflect these adjustments except for several exceptions noted below.

In preparing this financial report, certain elections have been made in relation to transitional provisions within AASB 1 which offer exemption from presenting comparative information or applying AIFRS retrospectively. The most significant impact arises from the exemption from presenting comparative information in accordance with AASB 132 *Financial Instruments: Disclosure and Presentation*, AASB 139 *Financial Instruments: Recognition and Measurement* and AASB 1023 *General Insurance Contracts*. Comparative information for financial instruments and insurance contracts has been prepared on the basis of the previous accounting policies. The differences between the accounting policies applied are provided below in notes 1(i), (n), 1(q), and 1(bb) with additional information disclosed in note 38. The AIFRS adjustments applicable for the first time from 1 July 2005 represent a change in accounting policy made in accordance with the provisions of AASB 1.

Upon transition to AIFRS the general principle is that the financial reports must be prepared as if the new standards had always been applied. However, in addition to exempting companies from the requirement to restate comparatives for particular standards, AASB 1 grants certain exemptions from the full requirements of AIFRS. The following first time adoption elections have been made:

*Business combinations* – The accounting treatment for business combinations transacted prior to 1 July 2004 has not been restated.
*Share based payments* – The AIFRS requirements have not been retrospectively applied to share based payments granted prior to 7 November 2002 and/or that vested prior to 1 January 2005.
*Property, plant and equipment* – The fair value of the property held as at 30 June 2004 has been used as the deemed cost of that property but the original cost has been used for plant and equipment.
*Foreign currency translation reserve* – The foreign currency translation reserve was not reset to zero.
*Insurance contracts* – Certain disclosure requirements, principally relating to the disclosure of assumptions, the sensitivities of those assumptions, and claims development tables, have not been applied to prior periods.
*Fair value measurement of financial instruments* – The first time adoption relief from the retrospective application of 'Day One' recognition requirements has not been applied.
*Financial instruments options* – Financial instruments have been designated to the various classifications available under AIFRS as follows:

- Investments - classified as "fair value through profit or loss";
- Receivables - classified as "loans and receivables"; and
- Payables and interest-bearing liabilities - classified as "amortised cost".

**Note 1. Summary of significant accounting policies (continued)**

**(b) Basis of preparation of the financial report (continued)**

(iii) Voluntary changes in accounting policies

There have been no voluntary changes in accounting policies made during the year other than those relating to the transition to AIFRS as referred to in note 1(b)(ii) and as disclosed in note 38.

(iv) Reclassifications of comparatives

Certain items have been reclassified from the Consolidated entity's prior period's financial reports to conform to the current period's presentation: capitalised transaction costs on interest-bearing liabilities previously presented as prepayments are now presented together with the liabilities (reclassification as at 30 June 2005 of $16 million); the value of the interest rate swap forming part of the hedge on the US subordinated term notes previously presented as a payable is now presented together with the liability (reclassification as at 30 June 2005 of $2 million); the net value of corporate treasury derivatives previously offset against payables is now included in trade and other receivables (reclassification as at 30 June 2005 of $3 million); reinsurance and other recoveries on paid claims previously presented together with reinsurance and other recoveries receivable on outstanding claims is now presented in trade and other receivables; reinsurance premiums payable previously included within trade and other payables is now presented separately on the balance sheet; and the value of an unlisted equity investment is now included in investment in joint ventures and associates (reclassification as at 30 June 2005 of $5 million).

(v) Rounding

Amounts in this financial report have been rounded to the nearest million dollars, unless otherwise stated. The Parent is the kind of company referred to in the class order 98/100 dated 10 July 1998 issued by the Australian Securities & Investment Commission. All rounding has been conducted in accordance with that class order.

**(c) Principles of consolidation**

(i) Subsidiaries

Consolidation is the incorporation of the assets and liabilities of the Parent and all subsidiaries as at the reporting date and the results of the Parent and all subsidiaries for the period then ended as if they had operated as a single entity. The balances and effects of intragroup transactions are eliminated from the consolidation. Subsidiaries are those entities controlled by the Parent. Control exists when one company has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control is presumed to exist when more than half of the voting power of an entity is owned either directly or indirectly. In assessing control, potential voting rights that are exercisable or convertible are taken into account. Where an entity either began or ceased to be controlled during the financial year, the results are included only from the date control commenced or up to the date control ceased.

The financial statements of all subsidiaries are prepared for consolidation for the same reporting period as the Parent, using consistent accounting policies. The financial statements of entities operating outside Australia that maintain accounting records in accordance with overseas accounting principles are adjusted where necessary to comply with the significant accounting policies of the Consolidated entity.

Where a subsidiary is less than wholly-owned, the equity interests held by external parties are presented separately as minority interests on the consolidated balance sheet, except where the subsidiary is a trust or similar entity for which the core equity is presented as a liability (this is the case with the IAG Asset Management Wholesale Trusts that are subsidiaries, refer note 27) in which case the third party interest is presented separately on the consolidated balance sheet as a liability.

(ii) Associates

Associates, those entities over which significant influence is exercised and which are not intended for sale in the near future, are accounted for using equity accounting principles. Significant influence is presumed to exist where between 20 per cent and 50 per cent of the voting rights of an entity are held, but can also arise where less than 20 per cent is held through active involvement and influencing policy decisions affecting the entity. The investment in associates is initially recognised at cost (fair value of consideration provided plus directly attributable costs) and is subsequently adjusted for the post-acquisition change in the investor's share of net assets of the investee (generally referred to as the equity method of accounting). The investor's share of the profit or loss of the investee is included in the profit or loss of the Consolidated entity and disclosed as a separate line in the income statement. Distributions received reduce the carrying amount of the investment and are not included as dividend revenue of the Consolidated entity. Movements in the total equity of the investee that are not recognised in the profit or loss of the investee are recognised directly in equity of the Consolidated entity and disclosed in the statement of recognised income and expense. The investments are reviewed annually for impairment.

**Note 1. Summary of significant accounting policies (continued)**

**(c) Principles of consolidation (continued)**

(ii) Associates (continued)

Where an entity either began or ceased to be an associate during the financial year, the investment is equity accounted from the date significant influence commenced, up to the date significant influence ceased.

The financial statements of associates are adjusted where necessary to comply with the significant accounting policies of the Consolidated entity.

When the investor's share of losses exceeds its interest in the investee, the carrying amount of the investment is reduced to nil and recognition of further losses is discontinued except to the extent that the investor has incurred obligations or made payments, on behalf of the investee.

***Significant accounting policies related to general insurance contracts***

All of the general insurance products and reinsurance products on offer, or utilised, meet the definition of an insurance contract (a contract under which one party, the insurer, accepts significance insurance risk from another party, the policyholder, by agreeing to compensate the policyholder if a specified uncertain future event, the insured event, adversely affects the policyholder) and none of the contracts contain embedded derivatives or are required to be unbundled. Insurance contracts that meet the definition of a financial guarantee contract are accounted for as insurance contracts. This means that all of the general insurance products are accounted for in the same manner.

**(d) Premium revenue**

Premium revenue comprises amounts charged to policyholders (direct premiums) or other insurers (inwards reinsurance premium) for insurance contracts. Premium includes fire service levies, but excludes stamp duties and taxes collected on behalf of third parties, including the goods and services tax. Premium is recognised as earned from the date of attachment of risk (generally the date a contract is agreed to) over the period of the related insurance contracts in accordance with the pattern of the incidence of risk expected under the contracts. The pattern of the risks underwritten is generally matched by the passing of time. Premium for unclosed business (business written close to reporting date where attachment of risk is prior to reporting date and there is insufficient information to accurately identify the business) is brought to account based on previous years' experience with due allowance for any changes in the pattern of new business and renewals. The unearned portion of premium is recognised as an unearned premium liability on the balance sheet.

Premium receivable is recognised at the amount due and is normally settled between 30 days and 12 months. The recoverability of premium receivable is assessed and provision is made for impairment based on objective evidence and having regard to past default experience. Premium receivable is presented on the balance sheet net of any provision for impairment.

**(e) Outwards reinsurance**

Premium ceded to reinsurers is recognised as an expense in accordance with the pattern of reinsurance service received. Accordingly, a portion of outwards reinsurance premium is treated as a prepayment and presented as deferred reinsurance expense on the balance sheet at the reporting date.

**(f) Claims**

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 the advice of/valuations performed by, or under the direction of, the Approved Actuary. The expected future payments include those in relation to claims reported but not yet paid or not yet paid in full, claims incurred but not enough reported ("IBNER"), claims incurred but not reported ("IBNR") and the anticipated direct and indirect claims handling costs. The liability is discounted to present value using a risk free rate.

Claims expense represents claim payments adjusted for the movement in the outstanding claims liability.

**Note 1. Summary of significant accounting policies (continued)**

**(f) Claims (continued)**

The estimation of the outstanding claims liability involves a number of key assumptions and is the most critical accounting estimate. All reasonable steps are taken to ensure that the information used regarding claims exposures is appropriate. However, given the uncertainty in establishing the liability, it is likely that the final outcome will be different from the original liability established. Changes in claims estimates are recognised in profit or loss in the year in which the estimates are changed.

**(g) Reinsurance and other recoveries**

Reinsurance and other recoveries received or receivable on paid claims and on outstanding claims liabilities (notified and not yet notified) are recognised as income. Recoveries receivable on paid claims are presented as part of trade and other debtors net of any provision for impairment based on objective evidence for individual receivables. All recoveries receivable on outstanding claims liabilities are measured as the present value of the expected future receipts calculated on the same basis as the outstanding claims liability. Reinsurance does not relieve the originating insurer of its liabilities to policyholders and is presented separately on the balance sheet.

**(h) Acquisition costs**

Costs associated with obtaining and recording general insurance contracts are referred to as acquisition costs. These costs include advertising expenses, commissions or brokerage paid to agents or brokers, premium collection costs, risk assessment costs and other administrative costs. Such costs are capitalised where they relate to the acquisition of new business, are presented as deferred acquisition costs, and are amortised on the same basis as the earning pattern of the premium over the period of the related insurance contracts. The balance of the deferred acquisition costs at the reporting date represents the capitalised acquisition costs relating to unearned premium.

**(i) Liability adequacy test**

The liability adequacy test is an assessment of the carrying amount 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 less related intangible assets and related deferred acquisition costs, 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 single portfolio. Any deficiency arising from the test is recognised in profit or loss with the corresponding impact on the balance sheet recognised first through the write down of any related intangible assets and then the related deferred acquisition costs, with any remaining balance being recognised on the balance sheet as an unexpired risk liability.

*Prior to 1 July 2005 (refer to note 38 for further details)*
Prior to the introduction of the liability adequacy test with effect from 1 July 2005, a recoverability test was performed on the carrying amount of deferred acquisition costs. Deferred acquisition costs were measured at the lower of cost and recoverable amount through the conduct of a loss recognition test such that when the sum of the expected future claims and associated settlements costs, in relation to business written to the reporting date, exceeded related unearned premium, the deferred acquisition costs were written down to recoverable amount and the write down was recognised as an expense. This test was conducted at the reporting entity level. The conduct of the test did not result in a write down of deferred acquisition costs for the financial year ended 30 June 2005.

**(j) Levies and charges**

Levies and charges, for which the amount paid does not depend on the amounts collected, as is the case with fire service levies in Australia, are expensed on the same basis as the recognition of premium revenue. The portion relating to unearned premium is treated as a prepayment and presented as deferred levies and charges on the balance sheet. A liability for levies and charges payable is recognised on business written to the reporting date. Other levies and charges that are simply collected on behalf of third parties are not recognised as income or expense in profit or loss.

**Note 1. Summary of significant accounting policies (continued)**

***Significant accounting policies applicable to other activities***

**(k) Fee based revenue**

Fee based revenue is brought to account on an accruals basis being recognised as revenue on a straight line basis in accordance with the passage of time as the services are provided.

**(l) Leases**

All leases entered into are operating leases, where the lessor retains substantially all the risks and benefits of ownership of the leased items. The majority of the lease arrangements are entered into as lessee for which the lease payments are recognised as an expense on a straight line basis over the term of the lease. Certain sub-lease arrangements are entered into as the lessor for which the lease payments are recognised as revenue on a straight line basis over the term of the lease.

Lease incentives relating to the agreement of a new or renewed operating lease are recognised as an integral part of the net consideration agreed for the use of the leased asset. Operating lease incentives received are initially recognised as a liability, are presented as trade and other payables, and are subsequently reduced through recognition in profit or loss as an integral part of the total lease expense (lease payments are allocated between rental expense and reduction of the liability) on a straight line basis over the period of the lease.

**(m) Taxation**

(i) Income tax

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

Current tax expense is the expected tax payable on the taxable income for the year, using tax rates for each jurisdiction, and any adjustment to tax payable in respect of previous financial periods. Deferred tax expense is the change in deferred tax assets and liabilities between the reporting periods.

Deferred tax assets and liabilities are recognised using the balance sheet method for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes, except in the following circumstances when no deferred tax asset or liability is recognised:

- temporary differences if they arose in a transaction, other than a business combination, that at the time of the transaction did not affect either accounting profit or taxable profit or loss;
- temporary differences between the carrying amount and tax bases of investments in subsidiaries where it is probable that the differences will not reverse in the foreseeable future; and
- temporary differences relating to goodwill that is not deductible for tax purposes.

The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at reporting date. Deferred tax assets are recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised.

(ii) Tax consolidation

The Parent and its Australian resident wholly-owned subsidiaries adopted the tax consolidation legislation with effect from 1 July 2002 and are therefore taxed as a single entity from that date. The Parent entity is the head entity within the tax-consolidated group.

**Note 1. Summary of significant accounting policies (continued)**

**(m) Taxation (continued)**

(ii) Tax consolidation (continued)

Current tax expense / income and deferred tax assets and liabilities arising from temporary differences of the members of the tax-consolidated group are recognised in the separate financial statements of the members of the tax-consolidated group using the 'separate taxpayer within group' approach by reference to the carrying amounts in the separate financial statements of each entity and the tax values applying under tax consolidation.

Any current tax liabilities (or assets) and deferred tax assets arising from unused tax losses of the subsidiaries are assumed by the head entity in the tax-consolidated group and are recognised as amounts receivable / (payable) from / (to) other entities in the tax-consolidated group in conjunction with any tax funding arrangement amounts (refer below). Any difference between these amounts is recognised by IAG as an equity contribution or distribution.

IAG recognises deferred tax assets arising from unused tax losses of the tax-consolidated group to the extent that it is probable that future taxable profits of the tax-consolidated group will be available against which the asset can be utilised.

*Nature of tax funding arrangements and tax sharing arrangements*
The head entity, in conjunction with members of the tax-consolidated group, has entered into a tax funding arrangement which sets out the funding obligations of members of the tax-consolidated group with respect to tax amounts. The tax funding arrangements require payments to / from the head entity equal to the current tax liability / (asset) assumed by the head entity and any tax loss deferred tax assets (associated with tax losses of the wholly-owned subsidiaries) assumed by the head entity. This results in the head entity recognising an intercompany receivable / (payable) equal in amount to the tax liability / (asset) assumed. The intercompany amount receivable / (payable) is at call.

Contributions to fund the current tax liabilities are payable as per the tax funding arrangement and reflect the timing of the head entity's obligation to make payments for tax liabilities to the relevant tax authorities.

The head entity, in conjunction with members of the tax-consolidated group, has also entered into a tax sharing agreement. The tax sharing agreement provides for the determination of the allocation of income tax liabilities between the entities of the tax-consolidated group should the head entity default on its tax payment obligations. No amounts have been recognised in the financial statements in respect of this agreement as payment of any amounts under the tax sharing agreement is considered remote.

(iii) Goods and services tax

Revenue, expenses and assets are recognised net of the amount of goods and services tax ("GST"), except where the amount of GST incurred is not recoverable from the Australian Taxation Office ("ATO"). In these circumstances the GST is recognised as part of the cost of acquisition of the asset or as part of an item of expense.

Receivables and payables are stated inclusive of GST. The net amount of GST recoverable from, or payable to, the ATO is included as part of other receivables and payables on the balance sheet. Cash flows are included in the cash flow statement on a gross basis. The GST components of cash flows arising from investing and financing activities, which are recoverable from, or payable to, the ATO are classified as operating cash flows.

**(n) Investments**

Investments comprise assets held to back insurance liabilities (also referred to as technical reserves) and assets that represent equity holders' funds. Segregated portfolios are maintained for those assets. All investments are managed and performance evaluated on a fair value basis for both external and internal reporting purposes in accordance with a documented risk management strategy.

All investments are designated as fair value through profit or loss upon initial recognition. They are initially recorded at fair value (being the cost of acquisition excluding transaction costs) and are subsequently remeasured to fair value at each reporting date. Changes in the fair value from the previous reporting date (or cost of acquisition excluding transaction costs if acquired during the financial period) are recognised as realised or unrealised investment gains or losses in profit or loss. Purchases and sales of investments are recognised on a trade date basis, being the date on which a commitment is made to purchase or sell the asset. Transaction costs for purchases of investments are expensed as incurred and presented in the income statement as investment expenses on assets backing insurance liabilities and corporate, administration and other expenses for investments that represent equity holders' funds. Investments are derecognised when the rights to receive future cash flows from the assets have expired, or have been transferred, and substantially all the risks and rewards of ownership have transferred.

**Note 1. Summary of significant accounting policies (continued)**

**(n) Investments (continued)**

For securities listed in an active market, fair value is determined by reference to published bid price quotations. For unlisted securities, and for securities listed in a market that is not active, fair value is determined using valuation techniques based on current economic conditions and with reference to observable market data. For trust securities this generally means using the redemption price provided by the trustee. The most common valuation technique used for other unlisted investments is reference to the fair values of recent arm's length transactions involving the same instruments or other instruments that are substantially the same. An alternative valuation technique that is used for a small number of investments is discounted cash flow analysis.

Investment revenue, comprising dividends, trust distributions and interest, is brought to account on an accruals basis. Revenue on investment in equity securities and property trusts is deemed to accrue on the date the dividends/distributions are declared, which for listed equity securities is deemed to be the ex-dividend date. Dividend revenue from Australian equities is received net of any franking credits.

*Prior to 1 July 2005 (refer to note 38 for further details)*
Prior to 1 July 2005, all investments were initially recorded at fair value (being the cost of acquisition including transaction costs) and were subsequently remeasured to net market value (fair value less anticipated disposal costs) at each reporting date. Changes in the net market value from the previous reporting date (or cost of acquisition, if acquired during the financial period) were recognised as unrealised investments gains or losses in profit or loss. This included all derivatives used in relation to investment activities. Market values were determined using last sale price information.

**(o) Investment in subsidiaries**

Investment in subsidiaries is initially recognised at cost (fair value of consideration provided plus directly attributable costs) and are subsequently carried in the Parent's financial statements at the lower of cost and recoverable amount. Costs incurred in investigating and evaluating an acquisition up to the point of formal commitment to an acquisition are expensed as incurred. Income from these investments, comprising dividends and trust distributions, are brought to account on an accruals basis. Dividend revenue is accrued on the date the dividends are declared.

**(p) Investment in joint ventures and associates**

Investment in joint ventures and associates is initially recognised at cost (fair value of consideration provided plus directly attributable costs) by the entity holding the ownership interest, including attributed goodwill, and is subsequently carried in the entity's financial statements at the lower of cost and recoverable amount.

**(q) Derivatives**

A variety of derivatives are used for the sole purpose of managing risk exposures. Derivatives are not held for speculative purposes.

Derivatives are initially recognised at fair value (generally the transaction price; the fair value of the consideration given or received) on the date a derivative contract is entered into and are subsequently remeasured to fair value at each reporting date. Fair value is generally determined using the current bid price for derivatives presented as assets and the current ask price for derivatives presented as liabilities. The method of recognising the resulting gain or loss depends on whether the derivative is designated as a hedging instrument, and if so, the nature of the item being hedged. Transaction costs for purchases of derivatives are expensed as incurred and presented in the income statement as investment expenses on assets backing insurance liabilities and corporate, administration and other expenses for assets representing equity holders' funds.

(i) Investment operations

All of the derivatives managed in conjunction with the investment operations are recognised on the balance sheet (presented together with the underlying investments) at fair value with movements in fair value being recognised as part of investment income in profit or loss. The fair value is determined by reference to current market quotes or generally accepted valuation principles. None of the derivatives are designated for hedge accounting. This matches the accounting for the derivatives with the accounting for the underlying investments.

**Note 1. Summary of significant accounting policies (continued)**

**(q) Derivatives (continued)**

(ii) Corporate treasury operations

Derivatives are used to hedge exposure to foreign currency and interest rate movements in relation to corporate treasury transactions, including borrowings. While there are a number of economic hedges in place, only a small number of these transactions have been selected for hedge accounting. Where hedge accounting is not applied the derivative and the hedged item are recognised and measured independently as if there was no hedging relationship with the derivative being recognised on the balance sheet at fair value with movements in fair value being recognised in profit or loss. The derivatives are classified as assets and presented as receivables when the fair value is positive, or as liabilities and presented as payables when the fair value is negative, except for cross currency swaps relating to borrowings, which are presented together with the borrowings.

The most commonly used derivative for which hedge accounting is not applied are forward foreign exchange contracts which are entered into to hedge foreign currency exposures recognised on the balance sheet. The forward foreign exchange contracts are recognised on the balance sheet at fair value being the net amounts receivable or payable under the contracts and the associated deferred gains or losses. When recognised, the net receivables or payables are translated using the foreign currency exchange rate current at reporting date.

(iii) Hedge accounting

Where derivatives are designated for hedge accounting, they are classified as either: (i) hedge of the change in fair value of recognised assets or liabilities or firm commitments (“fair value hedge”); (ii) hedge of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction (“cash flow hedge”); (iii) hedge of a net investment in a foreign operation (“net investment hedge”). Hedge accounting may be applied to derivatives designated as hedging instruments provided certain criteria are met. Certain transactions have been designated as either a cash flow hedge or a net investment hedge.

To qualify for hedge accounting, at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness). Actual effectiveness (retrospective effectiveness) in the range of 80 per cent to 125 per cent must also be demonstrated on an ongoing basis. At the inception of a hedging relationship, the relationship between the hedging instruments and hedged items is documented, as well as the risk management objective and strategy for undertaking the hedge.

*Cash flow hedge* - The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in reserves as part of equity. Any gain or loss relating to an ineffective portion is immediately recognised in profit or loss.

When the forecast transaction that is hedged results in the recognition of a financial asset or a financial liability, the associated gains and losses that had been deferred in equity are transferred into profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss. When the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the associated gains and losses that had been deferred in equity are transferred from equity and included in the initial measurement of the cost of the asset or liability.

More specifically, derivatives are used to hedge a forecast acquisition of a business only when the derivative is expected to reduce exposure to the risks being hedged, is designated prospectively so that it is clear when a forecast transaction has or has not occurred, and it is probable the forecast transaction will occur. Hedge accounting is applied where such hedges meet the hedge accounting requirements. Gains or losses on the derivative arising up to the date of the forecast transaction, together with any costs arising at the time of entering into the derivative, are deferred and included in the measurement of the transaction (typically cost of acquisition of a business). Any gains or losses on the derivative after the transaction date are recognised in profit or loss. If the transaction does not occur as anticipated, the costs are immediately expensed.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity until the forecast transaction is ultimately recognised in profit or loss. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to profit or loss.

*Net investment hedge* - Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in equity while the gain or loss relating to the ineffective portion is immediately recognised in profit or loss. Gains and losses accumulated in the equity reserve are recognised in profit or loss upon the disposal of the foreign operation.

*Prior to 1 July 2005 (refer to note 38 for further details)*
Prior to 1 July 2005 instruments subject to hedge accounting under AIFRS were accounted for on an accruals basis under Australian GAAP.

**Note 1. Summary of significant accounting policies (continued)**

**(r) Trade and other receivables**

Trade and other receivables are stated at the amounts to be received in the future and are presented net of any provision for impairment. The recoverability of debts is assessed on an ongoing basis and provision for impairment is made based on objective evidence and having regard to past default experience. The impairment charge is recognised in profit or loss. Debts which are known to be uncollectible are written off.

**(s) Property, plant and equipment**

Property, plant and equipment is initially recorded at cost which is the fair value of consideration provided plus incidental costs directly attributable to the acquisition (for land and buildings held as at 30 June 2004, the fair value at that date is used as the deemed cost as allowed upon first time adoption of AIFRS). The cost of plant and equipment that is located on certain leased premises is increased by the present value of the estimated future cost for dismantling and removing the items when the relevant alterations are made to the premises. All items of property, plant and equipment are carried at cost less accumulated depreciation and accumulated impairment charges. Items other than land are depreciated using the straight line method at rates based on the expected useful lives of the assets taking into account estimated residual values. Depreciation rates and residual values are reviewed annually and any changes are accounted for prospectively. The depreciation rates used currently for each class of asset are as follows:

- Buildings 2% - 5%
- Motor vehicles 12.5% - 20%
- Other plant and equipment 6.67% - 40%

The carrying amount of each class of property, plant and equipment is reviewed each reporting date by determining whether there is an indication that the carrying value of a class may be impaired. If any such indication exists, the item is tested for impairment by comparing the recoverable amount of the asset or its cash generating unit to the carrying value. An impairment charge is recognised whenever the carrying value exceeds the recoverable amount. Impairment charges are recognised in profit or loss and may be reversed where there has been an indication that the loss may no longer exist and / or a change in the estimates used to determine the recoverable amount.

The net gain or loss on disposal of items of property, plant and equipment is recognised in profit or loss and is calculated as the difference between the carrying amount of the asset at the time of disposal and the net proceeds on disposal including transaction costs and other expenses associated with the disposal.

**(t) Intangible assets**

(i) Acquired intangible assets

Acquired intangible assets are initially recorded at their cost at the date of acquisition being the fair value of the consideration provided plus incidental costs directly attributable to the acquisition. Intangible assets with finite useful lives are amortised on a straight line basis over the estimated useful lives of the assets being the period in which the related benefits are expected to be realised (shorter of legal duration and expected economic life). Amortisation rates and residual values are reviewed annually and any changes are accounted for prospectively. The amortisation rates used currently for each class of asset are as follows:

- Contractual arrangements 10% - 20%
- Other intangible assets 20%

The carrying amount of intangible assets with finite useful lives is reviewed each reporting date by determining whether there is an indication that the carrying value may be impaired. If any such indication exists, the item is tested for impairment by comparing the recoverable amount of the asset or its cash generating unit to the carrying value. Where the recoverable amount is determined by the value in use, the projected net cash flows are discounted using a pre-tax discount rate. For assets with indefinite useful lives, the recoverability of the carrying value of the assets is reviewed for impairment at each reporting date, or more frequently if events or changes in circumstances indicate that it might be impaired. An impairment charge is recognised whenever the carrying value exceeds the recoverable amount. Impairment charges are recognised in profit or loss and may be reversed where there has been a change in the estimates used to determine the recoverable amount.

**Note 1. Summary of significant accounting policies (continued)**

**(t) Intangible assets (continued)**

(ii) Software development expenditure

Software development expenditure that meets the criteria for recognition as an intangible asset is capitalised on the balance sheet and amortised over its expected useful life, subject to impairment testing. Costs incurred in researching and evaluating a project up to the point of formal commitment to a project are treated as research costs and are expensed as incurred. Only software development projects with total budgeted expenditure of more than $2 million are considered for capitalisation. Smaller projects and other costs are treated as maintenance costs, being an ongoing part of maintaining effective computer systems, and are expensed as incurred.

All such capitalised costs are deemed to have an expected useful life of 3 years unless it can be clearly demonstrated for a specific project that the net benefits are to be generated over a longer period. The capitalised costs are amortised on a straight line basis over the period following completion of a project or implementation of part of a project. The recoverability of the carrying amount of the asset is assessed in the same manner as for acquired intangible assets with finite useful lives.

**(u) Goodwill**

Business combinations are accounted for using the acquisition method. Business combinations occur when control is obtained over an entity or business. Goodwill represents the excess of the purchase consideration plus incidental costs over the fair value of the net identifiable assets and contingent liabilities acquired and is presented net of any impairment charges. If the cost of acquisition is less than the fair value of the net identifiable assets and contingent liabilities acquired, the difference is recognised immediately in profit. Goodwill arising on acquisitions dated prior to 1 July 2004 has been carried forward on the basis of its deemed cost being the net carrying amount as at 1 July 2004 measured in accordance with the accounting standards relevant at that time (refer to note 38 for further details).

Where settlement of any part of cash consideration is deferred, the amounts payable in the future are discounted to their present value at the date of exchange. The discount rate used is the incremental borrowing rate, being the rate at which a similar borrowing could be obtained from an independent financier under comparable terms and conditions.

Where the initial accounting for a business combination is determined only provisionally by the first reporting date after acquisition date, the business combination is accounted for using those provisional values. Any subsequent adjustments to those provisional values are recognised within twelve months of the acquisition date and are applied effective from the acquisition date.

Where a business combination is achieved in stages (commonly referred to as a step acquisition), each exchange transaction is treated separately, using the cost of the transaction and the fair value information at the date of each exchange transaction, to determine the amount of any goodwill associated with that transaction. Before qualifying as a business combination, a transaction may qualify as an investment in an associate (refer note 1(c)). With investments in joint ventures and associates, where control is not obtained, the goodwill is included in the carrying amount of the investment in the joint venture and associate, rather than being presented as a separate asset.

Goodwill is allocated to cash generating units (the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets) for the purpose of impairment testing, principally based on how goodwill is monitored by management. The recoverability of the carrying value of the goodwill allocated to each cash generating unit is tested for impairment at each reporting date, or more frequently if events or changes in circumstances indicate that it might be impaired, by determining the present value (using a pre-tax discount rate that reflects the current market assessments of the risks specific to the cash generating unit) of projected net cash flows based on the five year business plans approved by management. Net cash flows beyond the five year period are extrapolated based on growth rates relevant to the asset / business which are consistent with long-term industry averages. Where the carrying value exceeds the recoverable amount, an impairment charge is recognised in profit or loss and cannot subsequently be reversed.

At the date of disposal of a business, attributed goodwill is included in the share of net assets used in the calculation of the gain or loss on disposal.

Acquisitions and disposals (where control is retained) of minority interests are treated as transactions between equity holders. Therefore, any difference between the acquisition cost of the minority interest and the carrying amount of the minority interest is recognised as an increase or decrease in equity.

**Note 1. Summary of significant accounting policies (continued)**

### (v) Trade and other payables

Trade and other payables are carried at cost, which is the fair value of the consideration to be paid in the future for goods and services received.

### (w) Restructuring provision

A restructuring provision is recognised for the expected costs associated with restructuring where there is a detailed formal plan for restructure and a demonstrated commitment to that plan. The provision is based on the direct expenditure to be incurred which is both directly and necessarily caused by the restructuring, including termination benefits, decommissioning of information technology systems and exiting surplus premises, and does not include costs associated with on-going activities. The adequacy of the provision is reviewed regularly and adjusted if required. Revisions in the estimated amount of a restructuring provision are reported in the period in which the revision in the estimate occurs. The provision is discounted using a pre-tax discount rate where the effect of the time value of money is material.

### (x) Lease provision

Certain of the operating leases for property require that the land and / or building be returned to the lessor in its original condition, however, the related operating lease payments do not include an element for the cost this will involve. The present value of the estimated future cost for the plant and equipment to be removed and the premises to be returned to the lessor in its original condition are recognised as a lease provision when the relevant alterations are made to the premises. The costs are capitalised as part of the cost of plant and equipment and then depreciated over the useful lives of the assets (refer note 1(s)).

### (y) Onerous contracts provision

A provision is recognised for onerous contracts when the expected benefits to be derived from a contract are lower than the unavoidable cost of meeting the obligations under the contract.

### (z) Employee benefits

(i) Wages and salaries, annual leave and sick leave

Liabilities for wages and salaries (including bonuses), annual leave and sick leave are recognised at the nominal amounts unpaid at the reporting date using remuneration rates that are expected to be paid when these liabilities are settled, including on-costs. A liability for sick leave is considered to exist only when it is probable that sick leave taken in the future will be greater than entitlements that will accrue in the future.

(ii) Long service leave

A liability for long service leave is recognised as the present value of estimated future cash outflows to be made in respect of services provided by employees up to the reporting date. The estimated future cash outflows are discounted using interest rates on national government guaranteed securities which have terms to maturity that match, as closely as possible, the estimated future cash outflows. Factors which affect the estimated future cash outflows such as expected future salary increases, experience of employee departures and period of service, are incorporated in the measurement.

(iii) Share based incentive arrangements

Share based remuneration is provided in different forms to eligible employees and IAG directors. All of the arrangements are equity settled share based payments. The fair value at grant date (the date at which the employer and the employee have a shared understanding of the terms and conditions of the arrangement) is determined for each equity settled share based payment using a valuation model which excludes the impact of any non-market vesting conditions. This fair value does not change over the life of the instrument. At each reporting date during the vesting period (the period during which related employment services are provided), and upon the final vesting or expiry of the equity instruments, the total accumulated expense is revised based on the fair value at grant date and the latest estimate of the number of equity instruments that are expected to vest based on non-market vesting conditions only (vesting conditions other than employee turnover are excluded), and taking into account the expired portion of the vesting period. Changes in the total accumulated expense from the previous reporting date are recognised in profit or loss with a corresponding movement in an equity reserve. Upon exercise of the relevant instruments, the balance of the share based remuneration reserve relating to those instruments is transferred within equity.

**Note 1. Summary of significant accounting policies (continued)**

**(z) Employee benefits (continued)**

(iii) Share based incentive arrangements (continued)

The different treatment of market and non-market vesting conditions means that if an equity instrument does not vest because a participant ceases relevant employment then the accumulated expense charged in relation to that participant is reversed, but if an equity instrument does not vest only because a market condition is not met, the expense is not reversed (this is relevant only to the Performance Award Rights Plan).

*Arrangements granted prior to 7 November 2002 (refer to note 38 for further details)*
The AIFRS expense treatment has not been retrospectively applied to share based payments granted prior to 7 November 2002 and / or that vested prior to 1 January 2005 as permitted under the transitional provisions for first time adoption of AIFRS. This principally means that the new requirements have not been applied to the Performance Share Rights Plan.

To satisfy obligations under the various share based remuneration plans, shares are generally bought on market at or near grant date of the relevant arrangement and held in trust. Previously under Australian GAAP the cost of acquiring the shares was recorded as a prepayment and then expensed in full, generally over the period during which the employees provided related services.

(iv) Superannuation

Contributions are made to various superannuation plans, both defined contribution and defined benefit plans, in accordance with their governing rules and, for defined benefit superannuation plans, recommendations from their respective actuaries, which are designed to ensure that each plan's funding provides sufficient assets to meet its liabilities over the longer term.

For defined contribution plans, obligations for contributions are recognised in profit or loss as they become payable. For defined benefit plans, the net financial position of the plans is recognised on the balance sheet and the movement in the net financial position is recognised in profit or loss, except for actuarial gains and losses (experience adjustments and changes in actuarial assumptions), which are recognised directly in retained earnings.

**(aa) Provision for dividends**

Provision for dividends is made in respect of all types of share capital where the dividends are declared on or before the reporting date but have not yet been distributed at that date.

**(bb) Interest-bearing liabilities and finance costs**

Interest-bearing liabilities are initially recognised at fair value less transaction costs that are directly attributable to the transaction. After initial recognition the liabilities are carried at amortised cost using the effective interest method.

Finance costs include interest, which is accrued at the contracted rate and included in payables, amortisation of transaction costs which are capitalised, presented together with the borrowings, and amortised over the life of the borrowings or a shorter period if appropriate, and amortisation of discounts or premiums (the difference between the original proceeds, net of transaction costs, and the settlement or redemption value of borrowings) over the term of the liabilities. Where interest payments are hedged, they are recognised as finance costs net of any effect of the hedge.

*Prior to 1 July 2005 (refer to note 38 for further details)*
Prior to 1 July 2005, the reset preference shares, now presented as interest-bearing liabilities, were treated as equity and formed part of share capital. The transaction costs associated with the capital raising were recognised directly in equity as a reduction in the proceeds of the instruments. The distributions, now treated as interest, were treated as dividends and so recognised only when declared.

**Note 1. Summary of significant accounting policies (continued)**

**(cc) Foreign currency**

(i) Functional and presentation currency

Items included in the financial records of each of the entities within the Consolidated entity are measured using the currency of the primary economic environment in which the entity operates (the functional currency). For nearly all entities, this is the local currency of the country in which it operates. The financial statements are presented in Australian dollars, which is the functional and presentation currency of the Parent and the presentation currency of the Consolidated entity.

(ii) Translation of foreign currency transactions

Foreign currency transactions are translated into the functional currency for each of the entities within the Consolidated entity using the exchange rates prevailing at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at reporting date, are translated to Australian dollars using reporting date exchange rates. Resulting exchange differences are recognised in profit or loss except for those relating to foreign operations and hedging transactions as per (iii) and (iv) below.

(iii) Translation of the financial results of foreign operations

The financial position and performance of foreign operations with a functional currency other than Australian dollars are translated into the presentation currency for inclusion in the consolidated financial statements. The assets and liabilities are translated using reporting date exchange rates while equity items are translated using historical rates. Items from the income statement are translated using weighted average rates for the reporting period. Exchange differences arising from the translations are recorded directly in equity in the foreign currency translation reserve. Goodwill and fair value adjustments arising on the acquisition of a foreign operation are treated as assets and liabilities of the foreign operation and translated at the closing rate.

On the disposal of a foreign operation, the cumulative amount of the exchange differences deferred in the foreign currency translation reserve relating to that foreign operation is recognised in profit or loss.

(iv) Hedge transactions

Derivatives are used to hedge the foreign exchange risk relating to certain transactions. Refer to note 1(q)(iii) for details of the relevant accounting policies.

**(dd) Earnings per share**

(i) Basic earnings per share

Basic earnings per share is determined by dividing the profit or loss attributable to equity holders of the Parent, excluding any costs of servicing equity other than ordinary shares, by the weighted average number of shares of the Parent on issue during the reporting period, net of treasury shares held in trust.

(ii) Diluted earnings per share

Diluted earnings per share is determined by dividing the profit or loss attributable to equity holders of the Parent used in the calculation of basic earnings per share, adjusted for relevant costs associated with dilutive potential ordinary shares, by the weighted average number of ordinary shares and dilutive potential ordinary shares.

**(ee) Treasury shares held in trust**

Ordinary shares of IAG that are controlled for accounting purposes by share based remuneration trusts that are subsidiaries of the Consolidated entity, are presented on the balance sheet as treasury shares held in trust. The shares are measured at cost (total amount paid to acquire the shares including directly attributable costs), and are presented as a deduction from equity until they are otherwise dealt with. No gain or loss is recognised in profit or loss on the sale, cancellation or reissue of the shares. The shares are derecognised as treasury shares held in trust when the shares vest or are released to the participant.

**Note 1. Summary of significant accounting policies (continued)**

**(ff) Reset exchangeable securities**

Reset exchangeable securities ("RES") were initially measured at fair value (which was equivalent to the face value) less transaction costs incurred in issuing the securities. On the balance sheet, the RES liability is offset against the investments purchased ("Portfolio") from the proceeds of RES, as there is a legal right of set-off and it is the intention that the Portfolio and the RES liability would be settled simultaneously. Transaction costs are capitalised, presented together with interest-bearing liabilities, and are amortised over five years from the date of issue. Interest expense on the RES is brought to account on an accruals basis and payable quarterly subject to the terms of issue. The interest expense on the RES is offset against the interest income generated from the Portfolio in the income statement.

**Note 2. Critical accounting estimates and judgements**

In the process of applying the significant accounting policies, certain critical accounting estimates and assumptions are used, and certain judgements are made.

The estimates and related assumptions are based on experience and other factors that are considered to be reasonable, the results of which form the basis for judgements about the carrying values of assets and liabilities. Actual results may differ from these estimates. The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimates are revised, and the future periods if relevant.

The areas where the estimates and assumptions involve a high degree of judgment or complexity and are considered significant to the financial statements, listed together with reference to the notes to the financial statements where more information is provided, are:

- Insurance contracts related:
  - Claims, refer note 11;
  - Reinsurance and other recoveries on outstanding claims, refer note 12;
  - Liability adequacy test, refer note 14(b);

  There are other amounts relating to insurance contracts that are based on allocation methodologies supported by assumptions (eg deferred acquisition costs; which costs in the shared services model (refer note 4) are related to the acquisition of general insurance contracts and so eligible for deferral). The estimates relate to past events, do not incorporate forward looking considerations, and do not change from year to year.

- Other
  - Goodwill and intangible assets impairment testing, refer notes 19 and 20;
  - Share based remuneration, refer note 30; and
  - Defined benefit superannuation arrangements, refer note 31.

The accounting judgements made during the year that did not involve estimations, including determination of the existence of control when entities are not wholly-owned and the classification of leases as either operating or finance leases, are considered to have had no significant impact on the amounts recognised in the financial report (2005 – none).

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

| | PARENT | | CONSOLIDATED | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **$m** | $m | **$m** | $m |
| **Note 3. Analysis of income** | | | | |
| **(a) General insurance revenue** | | | | |
| Direct gross written premium | **-** | - | **6,434** | 6,674 |
| Movement in unearned premium liability | **-** | - | **102** | ( 112 ) |
| Direct premium revenue | **-** | - | **6,536** | 6,562 |
| Inwards reinsurance premium revenue | **-** | - | **1** | ( 1 ) |
| Premium revenue | **-** | - | **6,537** | 6,561 |
| Reinsurance and other recoveries revenue | **-** | - | **566** | 660 |
| Total general insurance revenue | **-** | - | **7,103** | 7,221 |
| **(b) Investment income** | | | | |
| Dividend revenue | **745** | 585 | **87** | 96 |
| Interest revenue | **-** | - | **375** | 394 |
| Trust revenue | **-** | - | **33** | 15 |
| Total investment revenue | **745** | 585 | **495** | 505 |
| Changes in net fair values of investments | | | | |
| - Realised net gains and (losses) | **1** | - | **162** | 205 |
| - Unrealised net gains and (losses) | **-** | - | **248** | 333 |
| Total investment income | **746** | 585 | **905** | 1,043 |
| Represented by: | | | | |
| Investment income on assets backing insurance liabilities | **-** | - | **329** | 525 |
| Investment income on equity holders’ funds | **746** | 585 | **576** | 518 |
| | **746** | 585 | **905** | 1,043 |
| **(c) Other income** | | | | |
| Fee based revenue | **-** | - | **218** | 178 |
| Other revenue | **3** | - | **-** | - |
| Net gain on disposal of property, plant and equipment | **-** | - | **-** | 1 |
| Total other income | **3** | - | **218** | 179 |
| **(d) Share of net profit of associate** | **-** | - | **2** | - |
| Total income | **749** | 585 | **8,228** | 8,443 |

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

| | PARENT | | CONSOLIDATED | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **$m** | $m | **$m** | $m |
| **Note 4. Analysis of expenses** | | | | |
| **(a) Expenses as presented in the income statement** | | | | |
| Reinsurance expense | **-** | - | **405** | 417 |
| Claims expense | **-** | - | **4,466** | 4,750 |
| Acquisition costs | **-** | - | **1,081** | 1,070 |
| Other underwriting expenses | **-** | - | **395** | 377 |
| Fire service levies | **-** | - | **223** | 177 |
| Investment expenses on assets backing insurance liabilities | **-** | - | **19** | 9 |
| Finance costs | **57** | - | **86** | 69 |
| Net income attributable to minority interests in unitholders' funds* | **-** | - | **20** | - |
| Corporate, administration and other expenses | **-** | - | **298** | 289 |
| Total expenses | **57** | - | **6,993** | 7,158 |

* This item has been treated differently in the current reporting period following the election to not restate comparatives for certain accounting standards as allowed upon first time adoption of AIFRS. Refer to note 38 for further details.

| | PARENT | | CONSOLIDATED | |
|---|---|---|---|---|
| **(b) Analysis of expenses by function** | | | | |
| General insurance business expenses | **-** | - | **6,570** | 6,791 |
| Corporate and administration expenses | **57** | - | **423** | 367 |
| Total expenses | **57** | - | **6,993** | 7,158 |

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

| | PARENT | | CONSOLIDATED | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **$m** | $m | **$m** | $m |
| **Note 4. Analysis of expenses (continued)** | | | | |
| **(c) Other items** | | | | |
| Disclosure of the following items is considered relevant in explaining the results for the year: | | | | |
| Insurance protection tax levied by the NSW State Government | **-** | - | **21** | 20 |
| Depreciation and amortisation | | | | |
| - Property, plant and equipment (refer note 18) | **-** | - | **47** | 43 |
| - Capitalised software development expenditure | **-** | - | **6** | - |
| - Acquired intangibles | **-** | - | **8** | 13 |
| | **-** | - | **61** | 56 |
| Impairment charges (note (i)) | | | | |
| - Trade and other receivables | **-** | - | **1** | 1 |
| | **-** | - | **1** | 1 |
| Employee benefits | | | | |
| - Defined contribution superannuation | **-** | - | **78** | 78 |
| - Defined benefit superannuation | **-** | - | **7** | 2 |
| - Share based remuneration | **-** | - | **19** | 7 |
| - Salaries and other employee benefits expense | **-** | - | **926** | 831 |
| | **-** | - | **1,030** | 918 |
| Transfers to provisions charged to profit or loss | | | | |
| - Restructuring provision | **-** | - | **11** | 12 |
| | **-** | - | **11** | 12 |
| Finance costs | | | | |
| - Reset preference share distributions paid/payable | **29** | - | **29** | - |
| - Subordinated term notes interest paid/payable | **-** | - | **53** | 54 |
| - Reset exchangeable securities | **-** | - | **-** | 12 |
| - Amortisation of capitalised transaction costs | **2** | - | **4** | 3 |
| - Loans from controlled entity/related bodies corporate | **26** | - | **-** | - |
| | **57** | - | **86** | 69 |
| Other | | | | |
| - Net loss on disposal of property, plant and equipment | **-** | - | **4** | - |
| - Operating lease payments | **-** | - | **182** | 191 |
| - Software research and development costs expensed | **-** | - | **26** | 38 |
| - Net foreign exchange losses / (gains) | **-** | - | **34** | 27 |
| - Liability adequacy test deficiency | **-** | - | **11** | - |

The IAG Group operates a shared services model with the use of dedicated units and entities to provide services throughout the IAG Group. The costs incurred by business units and entities directly, together with internal charges between them, are allocated to the various operating functions and so feed through to relevant lines in the income statement. For example, the Consolidated entity incurs expenses in meeting the superannuation contribution obligations for employees involved in a wide range of functions including sales and marketing, underwriting, and claims management. Hence the superannuation expense is allocated across the lines in the income statement based on the areas for which these employees provide services.

Note:
(i) There were no impairment charges for goodwill, intangible assets and property, plant and equipment for the year ended 30 June 2006 (2005 – none).

| | CONSOLIDATED | |
|---|---|---|
| | **2006** | 2005 |
| | **$000** | $000 |
| **Note 5. Remuneration of auditors** | | |
| **(a) KPMG Australia** | | |
| (i) Assurance services | | |
| Audit of the financial statements prepared for the parent and subsidiaries | **4,598** | 3,113 |
| Audit of statutory returns in accordance with regulatory requirements | **667** | 792 |
| Other assurance services | **1,702** | 2,447 |
| | **6,967** | 6,352 |
| (ii) Advisory services | | |
| Taxation services | **287** | 563 |
| Due diligence in relation to potential acquisitions outside Australia | **1,627** | 2,016 |
| Due diligence in relation to capital raising (RES transaction) | **-** | 332 |
| Due diligence and other services on other acquisitions, divestment and capital transactions | **-** | 442 |
| Other | **126** | 39 |
| | **2,040** | 3,392 |
| **(b) Overseas related practices of KPMG Australia** | | |
| (i) Assurance services | | |
| Audit of the financial statements prepared for subsidiaries | **574** | 498 |
| Audit of statutory returns in accordance with regulatory requirements | **4** | - |
| Other assurance services | **79** | 25 |
| | **657** | 523 |
| (ii) Advisory services | **83** | 39 |
| **Total remuneration of auditors** | **9,747** | 10,306 |

It is IAG Group policy that KPMG may provide assurance and other audit-related services that, while outside the scope of the statutory audit, are consistent with the role of auditor. These include regulatory and prudential reviews requested by a regulator such as the Australian Prudential Regulation Authority. KPMG may not provide services that are perceived to be materially in conflict with the role of auditor. It is IAG Group policy to contract KPMG on assignments additional to their statutory audit and assurance duties where KPMG's expertise and experience with the IAG Group are important. The total fees for such services cannot exceed the audit fees without the approval of the IAG Audit Committee and KPMG can be contracted only in relation to reviewing financial information and not in its preparation. The Board is of the opinion that audit independence was not impaired during the current financial year as a result of the provision of these services.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

| | PARENT | | CONSOLIDATED | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **$m** | $m | **$m** | $m |
| **Note 6. Income tax** | | | | |
| **(a) Income tax expense** | | | | |
| Current tax | **( 9 )** | ( 2 ) | **375** | 310 |
| Deferred tax | **( 1 )** | - | **( 10 )** | 51 |
| (Over) / under provided in prior years | **-** | - | **8** | ( 4 ) |
| Income tax (credit) / expense | **( 10 )** | ( 2 ) | **373** | 357 |
| Deferred income tax expense / (credit) included in income tax comprises: | | | | |
| (Increase) / decrease in deferred tax asset | **( 1 )** | - | **( 5 )** | ( 29 ) |
| Increase / (decrease) in deferred tax liability | **-** | - | **( 5 )** | 80 |
| | **( 1 )** | - | **( 10 )** | 51 |
| **(b) Income tax reconciliation** | | | | |
| The income tax for the financial year differs from the amount calculated on the profit before income tax. The differences are reconciled as follows: | | | | |
| Profit for the year before income tax | **692** | 585 | **1,235** | 1,285 |
| Income tax calculated at 30% (2005 – 30%) | **208** | 176 | **371** | 386 |
| Tax effect of permanent differences: | | | | |
| Rebateable dividends | **( 223 )** | ( 176 ) | **( 19 )** | ( 22 ) |
| Capital profits / (losses) not subject to income tax | **-** | - | **3** | ( 4 ) |
| Other non-deductible items | **9** | - | **13** | 3 |
| Other | **( 4 )** | ( 2 ) | **( 3 )** | ( 2 ) |
| Income tax (credit) / expense applicable to current year | **( 10 )** | ( 2 ) | **365** | 361 |
| Adjustment relating to prior year | **-** | - | **8** | - |
| Income tax (credit) / expense attributable to profit for the year before impact of tax consolidation | **( 10 )** | ( 2 ) | **373** | 361 |
| Effect of resetting tax values on entering tax consolidation | **-** | - | **-** | ( 4 ) |
| Income tax (credit) / expense attributable to profit for the year after impact of tax consolidation | **( 10 )** | ( 2 ) | **373** | 357 |

**(c) Tax consolidation**

Effective 1 July 2002, the Company became the head entity in a tax-consolidated group comprising the Company and all of its Australian wholly-owned subsidiaries and the requirements of the relevant accounting standards have been applied.

**Note 7. Segment reporting**

**(a) Primary reporting – business segments**

The Parent is a non-operating holding company operating only in Australia.

The Consolidated entity operated in the general insurance industry throughout the year. Revenue from the general insurance industry is derived from the underwriting of Australian personal, Australian commercial and international insurance businesses and these form separate reportable segments. The reportable segments comprise the following businesses (each insurance product is predominantly short-tail in duration except where noted):

- Australian personal insurance – The Australian personal insurance business develops and underwrites personal insurance products (through direct and indirect distribution channels), and manages claims and assessing services. Insurance products include motor vehicle, home and contents, compulsory third party (long-tail), consumer credit, and niche insurance products such as pleasure craft, veteran and classic car, boat, caravan, and travel insurance;
- Australian commercial insurance – The Australian commercial insurance business develops and underwrites insurance for businesses. Insurance products include commercial property, commercial motor and fleet motor, construction and engineering, farm, crop and livestock, home warranty, marine, public and product liability (long-tail), professional indemnity (long-tail), directors and officers (long-tail), and workers' compensation (long-tail);
- International insurance - comprises all direct insurance business underwritten outside Australia through foreign subsidiaries in New Zealand and Thailand and an associate in Malaysia, and the operations of the captive reinsurer;
- Corporate and investments – comprises other activities, including corporate services, investment management and investment of the Consolidated entity's equity holders' funds.

The net outstanding claims liability for each segment includes an allocation of the diversification benefit incorporated into the risk margin relating to the combination of the segments at the Consolidated entity level. Depreciation expense is allocated to different business segments as management fees from the Corporate segment and so all depreciation relating to property, plant and equipment is treated as part of the Corporate segment.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

**Note 7. Segment reporting (continued)**

**(a) Primary reporting – business segments (continued)**

| | Australian Personal insurance 2006 | Australian Commercial insurance 2006 | International insurance 2006 | Corporate and investments 2006 | Inter-segment elimination 2006 | Total 2006 |
|---|---|---|---|---|---|---|
| | $m | $m | $m | $m | $m | $m |
| External revenue | 4,340 | 2,071 | 1,167 | 650 | - | 8,228 |
| Intersegment revenue | - | - | 240 | - | ( 240 ) | - |
| Total revenue | 4,340 | 2,071 | 1,407 | 650 | ( 240 ) | 8,228 |
| Underwriting profit | 287 | 235 | 11 | - | - | 533 |
| Investment income net of investment fees – technical reserves | 193 | 81 | 36 | - | - | 310 |
| Insurance profit | 480 | 316 | 47 | - | - | 843 |
| Investment income net of investment fees – equity holders' funds | - | - | - | 537 | - | 537 |
| Share of net profit of associates | - | - | 2 | - | - | 2 |
| Other net operating result | - | 8 | ( 7 ) | ( 148 ) | - | ( 147 ) |
| Profit before income tax | 480 | 324 | 42 | 389 | - | 1,235 |
| Income tax expense | | | | | | ( 373 ) |
| Profit for the year | | | | | | 862 |
| Segment assets | 5,951 | 3,702 | 777 | 6,542 | - | 16,972 |
| Unallocated assets | | | | | | - |
| Total assets | | | | | | 16,972 |
| Segment liabilities | 5,951 | 3,702 | 777 | 2,871 | - | 13,301 |
| Unallocated liabilities | | | | | | - |
| Total liabilities | | | | | | 13,301 |
| Acquisitions of property, plant and equipment, intangibles and other non-current segment assets | - | - | - | 158 | - | 158 |
| Depreciation expense | 20 | 13 | 5 | 9 | - | 47 |
| Amortisation of acquired intangibles | - | - | - | 8 | - | 8 |
| Total depreciation and amortisation expense | 20 | 13 | 5 | 17 | - | 55 |
| Other non-cash expenses | 45 | 25 | 9 | 9 | - | 88 |

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

**Note 7. Segment reporting (continued)**

**(a) Primary reporting – business segments (continued)**

| | **Australian Personal insurance** 2005 | **Australian Commercial insurance** 2005 | **International insurance** 2005 | **Corporate and investments** 2005 | **Inter-segment elimination** 2005 | **Total** 2005 |
|---|---|---|---|---|---|---|
| | $m | $m | $m | $m | $m | $m |
| External revenue | 4,552 | 2,102 | 1,193 | 596 | - | 8,443 |
| Intersegment revenue | - | - | 267 | - | ( 267 ) | - |
| Total revenue | 4,552 | 2,102 | 1,460 | 596 | ( 267 ) | 8,443 |
| Underwriting profit | 271 | 33 | 126 | - | - | 430 |
| Investment income net of investment fees – technical reserves | 303 | 179 | 34 | - | - | 516 |
| Insurance profit | 574 | 212 | 160 | - | - | 946 |
| Investment income net of investment fees – equity holders' funds | - | - | - | 500 | - | 500 |
| Other net operating result | - | ( 14 ) | ( 5 ) | ( 142 ) | - | ( 161 ) |
| Profit before income tax | 574 | 198 | 155 | 358 | - | 1,285 |
| Income tax expense | | | | | | ( 357 ) |
| Profit for the year | | | | | | 928 |
| Segment assets | 5,992 | 3,755 | 679 | 6,676 | - | 17,102 |
| Unallocated assets | | | | | | - |
| Total assets | | | | | | 17,102 |
| Segment liabilities | 5,992 | 3,755 | 679 | 2,173 | - | 12,599 |
| Unallocated liabilities | | | | | | - |
| Total liabilities | | | | | | 12,599 |
| Acquisitions of property, plant and equipment, intangibles and other non-current segment assets | - | - | - | 109 | - | 109 |
| Depreciation expense | 17 | 11 | 8 | 7 | - | 43 |
| Amortisation of acquired intangibles | - | - | - | 13 | - | 13 |
| Total depreciation and amortisation expense | 17 | 11 | 8 | 20 | - | 56 |
| Other non-cash expenses | 73 | 73 | 9 | 5 | - | 160 |

**Note 7. Segment reporting (continued)**

**(b) Secondary reporting – geographical segments**

The Consolidated entity operates mainly in the Australian and New Zealand general insurance industry. In the Australian market the operations cover all states and territories. Australia and International (primarily New Zealand) markets are separate reportable geographical segments. There have been changes in the composition of the international geographic segment during the financial year (refer note 26).

| | **Australia** | | **International** | | **Inter-segment elimination** | | **Total** | |
|---|---|---|---|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 | **2006** | 2005 | **2006** | 2005 |
| | **$m** | $m | **$m** | $m | **$m** | $m | **$m** | $m |
| External revenue | **6,928** | 7,196 | **1,300** | 1,247 | **-** | - | **8,228** | 8,443 |
| Segment assets | **15,649** | 15,791 | **2,929** | 2,187 | **(1,606)** | ( 876) | **16,972** | 17,102 |
| Acquisitions of property, plant and equipment, intangibles and other non-current segment assets | **71** | 93 | **87** | 16 | **-** | - | **158** | 109 |

| | CONSOLIDATED 2006 cents | 2005 cents |
|---|---|---|
| **Note 8. Earnings per share** | | |
| **(a) Ordinary shares** | | |
| Basic earnings per ordinary share [i] | **47.87** | 49.31 |
| Diluted earnings per ordinary share | **47.59** | 49.00 |

[i] The basic earnings per ordinary share excludes the treasury shares held in trust from the denominator of the calculation, but includes earnings attributable to those shares in the numerator, to comply with AASB 133 *Earnings per Share*. If the amounts relating to those shares are excluded from both the numerator and denominator, the basic earnings per ordinary share for the year ended 30 June 2006 would be reduced to 47.60 cents (2005 – 49.07 cents).

| | 2006 $m | 2005 $m |
|---|---|---|
| (i) Reconciliation of earnings used in calculating earnings per share | | |
| Profit for the year | **862** | 928 |
| Profit attributable to minority interests | **( 103 )** | ( 117 ) |
| Profit attributable to equity holders of the Parent | **759** | 811 |
| Profit attributable to reset preference shares (refer note 9(d)) | **n/a** | ( 29 ) |
| Earnings used in calculating basic and diluted earnings per share | **759** | 782 |

| (ii) Reconciliation of weighted average number of ordinary shares used in calculating earnings per share | 2006 Number of shares millions | 2005 Number of shares millions |
|---|---|---|
| Ordinary shares on issue | **1,595** | 1,594 |
| Treasury shares held in trust | **( 9 )** | ( 9 ) |
| Weighted average number of ordinary shares used in the calculation of basic earnings per share | **1,586** | 1,585 |
| Weighted average number of dilutive potential ordinary shares relating to: | | |
| - Rights issued under the Performance Share Rights Plan (refer note 30) | **-** | 2 |
| - Unvested share based remuneration rights supported by treasury shares held in trust | **9** | 8 |
| Weighted average number of ordinary shares used in the calculation of diluted earnings per share | **1,595** | 1,595 |

The following matters are relevant to the determination of the weighted average number of ordinary shares:

- The reset preference shares are not considered to be dilutive potential ordinary shares even though they may convert into ordinary shares because the contingent conversion conditions were not met at the reporting date.
- The reset exchangeable securities (refer note 33(b)) are not considered to be dilutive potential ordinary shares because the contingent conversion conditions were not met at the reporting date.

**(b) Reset preference shares**

While for accounting purposes the reset preference shares are presented as debt from 1 July 2005 onwards, they were previously presented as equity under Australian GAAP (refer to note 38 for further details). When presented as equity, a separate earnings per share calculation was conducted for the reset preference shares and the distributions on the shares were deducted from the profit attributable to equity holders of the Parent prior to calculation of the earnings per share for ordinary shares. From 1 July 2005 onwards the distributions are treated as finance costs and so are included in profit for the year. When presented as equity, the reset preference shares had a basic earnings per share for the year ended 30 June 2005 of 533.09 cents based on distributions paid or payable for the year of $29 million and a weighted average number of reset preference shares outstanding during the period of 5.5 million shares.

| | Cents per share | Total amount | Payment date | Tax rate for franking credit tax rate | Percentage franked |
|---|---|---|---|---|---|
| | | $m | | | |
| **Note 9. Dividends** | | | | | |
| **(a) Ordinary shares** | | | | | |
| **Recognised in year ended 30 June 2006** | | | | | |
| **Special dividend** | **12.5** | **201** | **26 June 2006** | **30%** | **100%** |
| **2006 interim dividend** | **13.5** | **215** | **10 April 2006** | **30%** | **100%** |
| **2005 final dividend** | **14.5** | **231** | **17 October 2005** | **30%** | **100%** |
| | | **647** | | | |
| Recognised in year ended 30 June 2005 | | | | | |
| 2005 interim dividend | 12.0 | 191 | 18 April 2005 | 30% | 100% |
| 2004 final dividend | 14.0 | 222 | 18 October 2004 | 30% | 100% |
| | | 413 | | | |

It is standard practice to declare the dividend for a period after the relevant reporting date. In accordance with the relevant accounting policy (refer note 1(aa)) a dividend is not accrued for until it is declared and so the dividends for a period are generally recognised and measured in the financial reporting period following the period to which the dividend relates.

A special dividend was paid to shareholders during the year as a return of excess capital in line with the commitment to ensure capital is managed efficiently. The total special dividend is presented inclusive of transaction costs of $1.3 million.

**(b) Dividend reinvestment**

A Dividend Reinvestment Plan (“DRP”) is operated which allows equity holders to elect to receive their dividend entitlement in the form of IAG shares. The price of DRP shares is the average share market price, less a discount if any (determined by the Directors) calculated over the pricing period (which is at least five trading days) as determined by the Directors for each dividend payment date. The price of DRP shares in 2006 includes no discount (2005 – no discount). The 29.5 million shares allocated to equity holders participating in the DRP for the year ended 30 June 2006 were purchased on-market (2005 – 20.0 million shares). This included 8.7 million shares relating to the special dividend.

**(c) Dividend not recognised at reporting date**

In addition to the above dividends, the following dividend was declared after the reporting date but before finalisation of this financial report and has not been recognised in this financial report.

| | Cents per share | Total amount | Expected payment date | Tax rate for franking credit | Percentage franked |
|---|---|---|---|---|---|
| | | $m | | | |
| **2006 final dividend – ordinary shares** | **16.0** | **255** | **9 October 2006** | **30%** | **100%** |

The dividend was declared on 25 August 2006. The last date for the receipt of an election notice for participation in the dividend reinvestment plan in relation to this final dividend is 6 September 2006. The DRP will operate using shares acquired on-market with no discount applied.

| | Distribution percentage per annum | Total amount | Payment date | Percentage franked |
|---|---|---|---|---|
| **Note 9. Dividends (continued)** | | **$m** | | |
| **(d) Reset preference shares** | | | | |
| **Recognised in year ended 30 June 2006** | ***n/a** | ***n/a** | ***n/a** | ***n/a** |
| Recognised in year ended 30 June 2005 | | | | |
| First issue June 2002 - IAGPA | 5.80% | 20 | 15 June 2005 and 15 December 2004 | 100% |
| Second issue June 2003 - IAGPB | 4.51% | 9 | 15 June 2005 and 15 December 2004 | 100% |
| | | 29 | | |

* This item has been treated differently in the current reporting period following the election to not restate comparatives for certain accounting standards as allowed upon first time adoption of AIFRS. Refer to note 38 for further details.

All of the distributions paid in relation to the reset preference shares for the current annual reporting period and the previous annual reporting period were fully franked at 30%.

**(e) Restrictions that may limit the payment of dividends**

There are presently no restrictions on the payment of dividends by the Parent other than:

- The payment of dividends generally being limited to profits subject to ongoing solvency obligations; and
- No dividends can be paid and no returns of capital can be made on ordinary shares, if distributions are not paid on the reset preference shares, unless certain actions are taken by IAG. For further details refer to note 23.

There are presently no restrictions on the payment of dividends from subsidiaries to the Parent other than:

- The payment of dividends generally being limited to profits subject to ongoing solvency obligations of the subsidiary; and
- For certain subsidiaries, statutory reserve and regulatory minimum capital requirements, in particular, the Australian Prudential Regulation Authority has advised Australian general insurers that a general insurer under its supervision must obtain approval from it before declaring a dividend if the general insurer has incurred a loss, or proposes to pay dividends which exceed the level of profits earned in the current period.

The impact to these requirements caused by the payment of dividends is monitored. Payments of dividends from overseas subsidiaries may attract withholding taxes which have not been provided for in this financial report.

| | PARENT | | CONSOLIDATED | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **$m** | $m | **$m** | $m |
| **(f) Dividend franking account** | | | | |
| The amount of franking credits available for the subsequent annual reporting period are: | | | | |
| Franking account balance at reporting date at 30% | **452** | 343 | **483** | 354 |
| Franking credits to arise from payment of income tax payable | **83** | 165 | **103** | 205 |
| Franking debits to arise from receipt of income tax refundable | **( 19 )** | ( 20 ) | **( 20 )** | ( 20 ) |
| Franking credits to arise from receipt of dividends receivable | **3** | 3 | **4** | 4 |
| Franking credits available for future reporting periods | **519** | 491 | **570** | 543 |
| Franking account impact of dividends declared before issuance of financial report but not recognised at reporting date | **( 109 )** | ( 99 ) | **( 109 )** | ( 99 ) |
| Franking credits available for subsequent financial years based on a tax rate of 30% | **410** | 392 | **461** | 444 |

The balance of the franking account arises from:
- franked income received or recognised as a receivable at the reporting date;
- income tax paid, after adjusting for any franking credits which will arise from the payment of income tax provided for in the financial statements; and
- franking debits from the payment of dividends recognised as a liability at the reporting date.

The consolidated amounts include franking credits that would be available to the Parent if distributable profits of non-wholly owned subsidiaries were paid as dividends.

**Note 10. Insurance contracts risk management**

A key risk from operating in the general insurance industry is the exposure to insurance risk arising from underwriting general insurance contracts. The insurance contracts transfer risk to the insurer by indemnifying the policyholders against adverse affects arising from the occurrence of specified uncertain future events. The risk is that the actual amount of claims to be paid in relation to contracts will be different to those estimated at the time a product was designed and priced. The Consolidated entity is exposed to this risk because the price for a contract must be set before the losses relating to the product are known. Hence the insurance business involves inherent uncertainty. The Consolidated entity also faces other risks relating to the conduct of the general insurance business including financial risks (refer principally to note 35) and capital risks (refer principally to note 36).

A fundamental part of the overall risk management strategy is the effective governance and management of the risks that impact the amount, timing and uncertainty of cash flows arising from insurance contracts.

**(a) Risk management objectives and policies for mitigating insurance risk**

The insurance activities primarily involve the underwriting of risks and the management of claims. A disciplined approach to risk management is adopted in accordance with IAG Group protocols rather than a premium volume or market share orientated approach. It is believed this approach provides the greatest long term likelihood of being able to meet the objectives of all stakeholders; including policyholders, lenders and equity holders.

The risk management activities can be broadly separated into underwriting (acceptance and pricing of risk), claims management, reserving (including investment in data capabilities), and investment management. The objective of these risk management functions is to enhance the longer term financial performance of the overall insurance operations. The policies for the management of risk are applied consistently across the IAG Group with certain allowances made for non-Australian jurisdictions.

The key policies in place to mitigate risks arising from underwriting insurance contracts include the following:

- Acceptance of risk – The IAG Group Underwriting and Pricing Policy Committee establishes, reviews and monitors the underwriting and pricing standards and strategies. The underwriting of large numbers of uncorrelated individual risks, across a range of classes of insurance businesses, in different geographical segments reduces the variability in overall claims experience. Limiting exposure to long-tail classes of business (where the settlement of claims typically takes longer than one year) to a target of 20% of the business as measured by gross written premiums, limits risk. Maximum limits are set for the acceptance of risk both on an individual contract basis and for classes of business and specific risk groupings. Management information systems are maintained that provide up-to-date, reliable data on the risks to which the business is exposed at any point in time. Efforts are made, including plain language policy terms, to ensure there is no misalignment between what policyholders perceive will be paid when a policy is initially entered and what is actually paid when a claim is made;
- Pricing - Statistical models are used which combine historical and projected data to calculate premiums and monitor claims patterns for each class of business. The data used includes historical pricing and claims analysis for each class of business as well as current developments in the respective markets and classes of business. All data used is subject to rigorous verification and reconciliation processes. The models incorporate consideration of market conditions;
- Reinsurance - The use of reinsurance to limit exposure to large single claims and accumulation of claims that arise from the same event or the accumulation of similar events. This includes the monitoring of reinsurers' credit risk to control exposure to reinsurance counterparty default (refer note 12);
- Claims management – initial claim determination is managed by claims officers with the requisite degree of experience and competence with the assistance, where appropriate, of a loss adjustor or other party with specialist knowledge. It is IAG Group policy to respond and settle claims quickly whenever possible and to pay claims fairly, based on policyholders full entitlement in line with community and regulator expectations;
- Investment management - assets and liabilities are managed so as to effectively match the expected pattern of claims payments with the assets that are held to back insurance liabilities;
- Risk reduction - Reducing the frequency and severity of a claim in the first place by investing in community risk reduction programmes such as fire prevention strategies, crime prevention programmes and motor vehicle safety initiatives.

**Note 10. Insurance contracts risk management (continued)**

**(b) Terms and conditions of insurance contracts**

The terms and conditions attaching to insurance contracts affect the level of insurance risk accepted. The majority of direct insurance contracts written are entered into on a standard form basis. Insurance contracts are generally entered into on an annual basis and at the time of entering into a contract all terms and conditions are negotiable or, in the case of renewals, renegotiable. Non-standard and long term policies may only be written if expressly approved by a relevant delegated authority. There are no special terms and conditions in any non standard contracts that would have a material impact on the financial report. Insurance contracts written in all jurisdictions are subject to substantially the same terms and conditions. There are no embedded derivatives that are separately recognised from a host insurance contract.

**(c) Concentrations of insurance risk**

The exposure to concentrations of insurance risk is mitigated by a portfolio diversified into many classes of business across different countries. A high level indication of the spread of insurance risk may be obtained from the segment reporting note.

Concentration risk is particularly relevant in the case of natural disasters and other catastrophes which generally result in a concentration of affected policyholders over and above the norm and which constitutes the largest individual potential financial loss. Each year, the Consolidated entity sets its tolerance for concentration risk. Various models are used to estimate the impact of different potential natural disasters and other catastrophes. The tolerance for concentration risk is used to determine the maximum event retention which is the maximum net exposure to insurance risk determined appropriate for any single event with a given probability. While it is desirable to limit the net exposure, it is reduced to only the maximum event retention limit because the cost of purchasing reinsurance cover to reduce the net exposure further is not capital efficient.

Specific processes for monitoring identified key concentrations are set out below:

| Risk | Source of concentration | Risk management measures |
|---|---|---|
| An accumulation of risks arising from a natural peril | Insured property concentrations | Accumulation risk modelling, reinsurance protection |
| A large property loss | Fire or collapse affecting one building or a group of adjacent buildings | Maximum acceptance limits, property risk grading, reinsurance protection |
| Multiple liability retentions being involved in the same event | Response by a multitude of policies to the one event | Purchase of reinsurance clash protection |

As an example of the impact of a potential catastrophe on the Consolidated entity, the exposure to an earthquake in Sydney with associated claims costs of $3.5 billion would be limited to an estimated $200 million.

For concentrations of risk relating to the reinsurance contracts refer to note 12(e).

**(d) Credit risk**

Financial assets or liabilities arising from insurance contracts are presented on the balance sheet at the amount that best represents the maximum credit risk exposure at reporting date.

The credit risk relating to insurance contracts relates primarily to:

- Premium receivable which is due from individual policyholders and intermediaries (brokers, agents and business partners). The brokers and agents collect premium from policyholders and remit the monies to the insurer in accordance with contractual arrangements being generally within 90 days for brokers and 30-60 days for agents. The recoverability of premium receivable is assessed and provision is made for impairment based on objective evidence and having regard to past default experience. Concentrations of credit risk are considered low due to the large number of customers/corporate partners comprising the customer base and their dispersion across different industries and geographies. The premium receivable is presented on the balance sheet net of a provision for impairment of $41 million (2005 - $37 million).
- Reinsurance recoveries receivable which are discussed further in note 12.

Additional information about credit risk is disclosed in note 35.

**Note 10. Insurance contracts risk management (continued)**

**(e) Interest rate risk**

The underwriting of general insurance contracts creates exposure to the risk that interest rate movements may materially impact the value of the outstanding claims liability. Movements in interest rates impact the determination of the liability through the selection of discount rates. Discounting the liability is in effect allowing for future investment earnings on the assets held to back the insurance liabilities. The funds held to pay outstanding claims are invested principally in fixed interest securities matched to the settlement durations of the outstanding claims. Movements in market interest rates affect the value of the fixed interest securities. Hence movements in interest rates should have minimal impact on the insurance profit for a year due to movements in investment income on assets backing insurance liabilities offsetting the impact of movements in discount rates on the claims liabilities.

**(f) Reinsurance risk**

Refer to note 11(f) and note 12(d) and (e).

**(g) Operational risk**

Operational risk is the risk of financial loss (including lost opportunities) resulting from external events and / or inadequate or failed internal processes, people and systems to perform as required. The IAG Group Risk Management Strategy includes consideration of operational risk. Operational risk is identified and assessed on an ongoing basis and the capital management strategy includes consideration of operational risk. Management and staff are responsible for identifying, assessing and managing operational risks in accordance with their roles and responsibilities. The IAG Group has an internal audit function which monitors processes and procedures surrounding operational risk.

| | CONSOLIDATED 2006 | 2005 |
|---|---|---|
| **Note 11. Claims** | **$m** | $m |
| **(a) Claims expense, net** | | |
| Direct business | **3,899** | 4,088 |
| Inwards reinsurance business | **1** | 2 |
| Net claims expense | **3,900** | 4,090 |

**(b) Claims development**

(i) Net claims expense recognised in the income statement

Given the uncertainty in establishing the outstanding claims liability, it is likely that the final outcome will be different from the original liability established. Claims development refers to the financial adjustment in the current period relating to claims incurred in previous periods because of new and more up to date information that has become available and to reflect changes in inflation and discount assumptions. The information is presented on an accident year basis (claims are related to the period in which the insured event occurred and not the period in which the policy was underwritten).

| | CONSOLIDATED 2006 | | | 2005 | | |
|---|---|---|---|---|---|---|
| | **Current year** | **Prior years** | **Total** | Current year | Prior years | Total |
| | **$m** | **$m** | **$m** | $m | $m | $m |
| Direct business | | | | | | |
| Gross claims - undiscounted | **5,261** | **( 763)** | **4,498** | 5,114 | ( 236 ) | 4,878 |
| Discount | **( 277)** | **243** | **( 34)** | ( 247 ) | 118 | ( 129 ) |
| Gross claims - discounted | **4,984** | **( 520)** | **4,464** | 4,867 | ( 118 ) | 4,749 |
| Reinsurance and other recoveries - undiscounted | **( 645)** | **127** | **( 518)** | ( 609 ) | ( 168 ) | ( 777 ) |
| Discount | **24** | **( 71)** | **( 47)** | 19 | 97 | 116 |
| Reinsurance and other recoveries - discounted | **( 621)** | **56** | **( 565)** | ( 590 ) | ( 71 ) | ( 661 ) |
| Net claims expense | **4,363** | **( 464)** | **3,899** | 4,277 | ( 189 ) | 4,088 |

Current year claims relate to claim events that occurred in the current financial year. Prior year claims relate to a reassessment of the claim events that occurred in all previous financial periods. A major component of the prior year movement is the release of risk margins in respect of claims payments during the year (largely offset by inclusion of risk margins in respect of current year claims). Other factors contributing to the prior year claims development in the current financial year are releases in commercial liability portfolios and a reduction in the probability of adequacy used in determining the outstanding claims liability at reporting date (refer note 11(f)).

The table above disclosing the net claims expense recognised in the income statement (table A) and the table on the next page in note 11(b)(ii) disclosing the net outstanding claims liability recognised on the balance sheet (table B) both relate to claims development but present information in different formats and so are not directly reconcilable. Key differences between the tables relate to the inclusion in the prior year columns in table A of items that in table B are included in the reconciliation section of the table and not the development section. The key items are:

- Claims handling expenses;
- Development on claims for accident years 2001 and prior; and
- Development on claims from acquisitions which relates to accident years prior to the year of acquisition.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

**Note 11. Claims (continued)**

**(b) Claims development (continued)**

(ii) Net outstanding claims liability recognised on the balance sheet

The following table shows the development of the estimated net undiscounted outstanding claims liability relative to the current estimate of ultimate claims costs for the five most recent accident years as estimated at each reporting date. The table also shows a reconciliation of the net discounted liability for the five most recent accident years to the gross outstanding claims liability on the balance sheet. The development section of the table includes only direct business because the financial impact of the inwards reinsurance business, which is in run-off, is not significant.

| | Accident year | | | | | |
|---|---|---|---|---|---|---|
| | **2002** | **2003** | **2004** | **2005** | **2006** | **Total** |
| **Net ultimate claims cost estimate** | **$m** | **$m** | **$m** | **$m** | **$m** | **$m** |
| Development | | | | | | |
| At end of accident year | **2,313** | **3,677** | **3,881** | **4,024** | **4,105** | |
| One year later | **2,215** | **3,360** | **3,521** | **3,743** | | |
| Two years later | **2,137** | **3,249** | **3,493** | | | |
| Three years later | **2,087** | **3,163** | | | | |
| Four years later | **2,051** | | | | | |
| Current estimate of net ultimate claims cost | **2,051** | **3,163** | **3,493** | **3,743** | **4,105** | |
| Cumulative payments | **( 1,744)** | **( 2,614)** | **( 2,720)** | **( 2,683)** | **( 2,010)** | |
| Net undiscounted outstanding claims liability for the five most recent accident years | **307** | **549** | **773** | **1,060** | **2,094** | **4,783** |
| Discount to present value | **( 41)** | **( 82)** | **( 122)** | **( 176)** | **( 246)** | **( 667)** |
| Net discounted outstanding claims liability for the five most recent accident years | **266** | **467** | **651** | **884** | **1,848** | **4,116** |
| Reconciliation | | | | | | |
| Claims handling expense (inclusive of risk margin) | | | | | | **461** |
| Net discounted outstanding claims for accident years 2001 and prior | | | | | | **379** |
| Net outstanding claims liability for acquired subsidiaries for accident years prior to acquisition | | | | | | **667** |
| Net outstanding claims liability for Thailand based insurance entities | | | | | | **31** |
| Net outstanding claims liability for inwards reinsurance | | | | | | **76** |
| **Net outstanding claims liability** | | | | | | **5,730** |
| Gross outstanding claims liability on the balance sheet | | | | | | **6,916** |
| Reinsurance and other recoveries on outstanding claims liabilities | | | | | | **(908)** |
| GST recoverable on net outstanding claims liability | | | | | | **(278)** |
| **Net outstanding claims liability** | | | | | | **5,730** |

Favourable development of claims provisions has given rise to the release of risk margins, and in some cases central estimates, as the ultimate claims costs were settled or became more certain.

Conditions and trends that have affected the development of the liabilities in the past may, or may not, occur in the future, and accordingly, conclusion about future results may not necessarily be derived from the information presented in the tables above.

**Note 11. Claims (continued)**

**(b) Claims development (continued)**

(ii) Net outstanding claims liability recognised on the balance sheet (continued)

Short-tail claims are normally reported soon after the incident and are generally settled within months following the reported incident. Hence any development on short-tail claims is normally limited to the year the incident occurred and the following year. For long-tail classes of business it can be several years before a claim is reported and settled, hence the original estimation involves greater uncertainty and so inherently there is more likely to be greater disparity between the original and current estimates. It is for these long-tail classes of business that the development of the outstanding claims liability generally occurs over a number of years.

Where an entity or business has been acquired that includes outstanding claims liabilities, the claims costs for the acquired businesses are included in the claims development table from and including the year of acquisition. Development on the liabilities of such acquired businesses relating to accident years prior to the year of acquisition is included in the reconciliation section of the table.

The Consolidated entity conducts general insurance business in local currencies in foreign countries. The gross outstanding claims liability for international operations includes contracts written in New Zealand dollars and Thai Baht. The translation of the outstanding claims liabilities denominated in foreign currencies into Australian dollars over a number of reporting dates, includes exchange rate movements that have no reflection on the development of the measurement of the underlying claims. The amounts included in the development section of the tables have been determined using constant exchange rates being the rates as at 30 June 2006.

| | **CONSOLIDATED** | |
|---|---|---|
| | **2006** | 2005 |
| | **$m** | $m |
| **(c) Composition of outstanding claims liability – gross, discounted** | | |
| Expected future payments for claims incurred | | |
| - Central estimate | **5,228** | 5,045 |
| - Claims handling costs | **380** | 380 |
| - Risk margin | **1,308** | 1,415 |
| Outstanding claims liability | **6,916** | 6,840 |

The outstanding claims liability includes $4,547 million (2005 - $4,465 million) which is expected to be settled after more than twelve months from reporting date. The net outstanding claims liability at the financial reporting date relating to the inwards reinsurance business which is in run-off and for which commutation opportunities are being pursued was $76 million (2005 - $86 million).

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

| | CONSOLIDATED | |
|---|---|---|
| | **2006** | 2005 |
| **Note 11. Claims (continued)** | **$m** | $m |
| **(d) Reconciliation of movements in outstanding claims liability** | | |
| Outstanding claims liability at the beginning of the financial year – gross, discounted | **6,840** | 6,327 |
| Reinsurance and other recoveries receivable on outstanding claims at the beginning of the financial year (refer note 12(a)) | **( 883)** | ( 745) |
| GST recoverable on net outstanding claims liability at beginning of the financial year | **( 298)** | ( 267) |
| Net outstanding claims liability at the beginning of the year | **5,659** | 5,315 |
| Risk margin at the beginning of the year | **( 1,149)** | ( 1,052) |
| Net central estimate at the beginning of the year | **4,510** | 4,263 |
| Claims incurred in the current year | **4,660** | 4,487 |
| Reinsurance and other recoveries in the current year | **( 581)** | ( 544) |
| Claims cost paid | **( 4,423)** | ( 4,179) |
| Reinsurance and other recoveries received | **589** | 452 |
| Unwind of the discount | **189** | 176 |
| Development on prior year net central estimate | **( 184)** | ( 211) |
| Movement in discounting | **( 87)** | 66 |
| Movement in foreign currency exchange rates | **( 17)** | - |
| Net movement for acquired Thailand businesses | **32** | - |
| Net central estimate at the end of the year | **4,688** | 4,510 |
| Risk margin at the end of the year | **1,042** | 1,149 |
| **Net outstanding claims liability at the end of the year** | **5,730** | 5,659 |
| Reinsurance and other recoveries receivable on outstanding claims at the end of the financial year (refer note 12(a)) | **908** | 883 |
| GST recoverable on net outstanding claims liability at end of the financial year | **278** | 298 |
| Outstanding claims liability at the end of the financial year – gross, discounted | **6,916** | 6,840 |

| | | |
|---|---|---|
| **(e) Discounting of net outstanding claims liability** | | |
| Net outstanding claims liability – undiscounted | **7,020** | 6,770 |
| Discount to present value | **( 1,290)** | ( 1,111) |
| **Net outstanding claims liability – discounted** | **5,730** | 5,659 |

**Note 11. Claims (continued)**

**(f) Central estimate and risk margin**

(i) Reporting date values

As at 30 June 2006, the percentage risk margin applied to the present value of expected future payments for claims incurred net of expected recoveries on outstanding claims liability and expected input tax credit is 22.2% (2005 – 25.5%), representing a probability of adequacy of 90.0% (2005 – 92.5%).

The high level of professional judgement applied by actuaries in calculating the outstanding claims liability, and hence the probability of adequacy of the liability, means that for a certain probability of adequacy, different risk margins may be applied for similar risks, which is important in considering the overall reserving strength of an insurer.

(ii) Process

The estimation of the outstanding claims liability is based on a variety of actuarial techniques that analyse experience, trends and other relevant factors. The claims estimation process commences with the actuarial projection of the future payments relating to claims incurred at the reporting date. The expected future payments include those in relation to claims reported but not yet paid or not yet paid in full, claims incurred but not enough reported ("IBNER"), claims incurred but not reported ("IBNR") and the anticipated direct and indirect claims handling costs.

The estimation process involves using the Consolidated entity's specific data, relevant industry data and more general economic data. Each class of business is usually examined separately and the process involves consideration of a large number of factors including the risks to which the business is exposed at a point in time, claim frequencies and average claim sizes, historical trends in the incidence and development of claims reported and finalised, legal, social and economic factors that may impact upon each class of business as well as the key actuarial assumptions set out in note 11(g), and the impact of reinsurance and other recoveries (refer note 12).

Different actuarial valuation models are used for different claims types with the results then being aggregated. This aggregation of results enhances the valuation process by allowing the use of the model best suited to particular claims types. The selection of the appropriate model takes into account the characteristics of a class of business and the extent of development of each past accident period.

The different components of the outstanding claims liability are subject to different levels of uncertainty. The estimation of the cost of claims reported but not yet paid or not yet paid in full is made on a case-by-case basis by claims personnel having regard to the facts and circumstances of the claim as reported, any information available from assessors and information on the cost of settling claims with similar characteristics in previous periods. A further amount, which may be a reduction, is included for IBNER on the basis of past experience with the accuracy of initial claims estimates. With IBNR, the estimation is generally subject to a greater degree of uncertainty than the estimation of the cost of settling claims already notified, as no information is currently available about the claim. IBNR claims may often not be apparent to the insured until many years after the events giving rise to the claim have occurred. In calculating the estimated cost of unpaid claims a variety of estimating techniques are used, generally based on statistical analysis of historical experience, which assumes that the development pattern of the current claims will be consistent with past experience. Allowance is made, however, for changes or uncertainties which may create distortions in the underlying statistics or which might cause the cost of unsettled claims to increase or reduce when compared with the cost of previously settled claims.

**Note 11. Claims (continued)**

**(f) Central estimate and risk margin (continued)**

(ii) Process (continued)

Large claims impacting each relevant business class are generally assessed separately, being measured on a case by case basis or projected separately in order to allow for the possible distortive effect of the development and incidence of these large claims. For new products the growing experience with the development of claims is closely monitored.

Reserves are not established for catastrophes in advance of such events and so these events may cause volatility in the results for a period and in the levels of the outstanding claims liability, subject to the effects of reinsurance recoveries.

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.

Over 99.9% of the outstanding claims liability is reviewed at least annually by external actuaries from organisations which are independent of both the IAG Group and the external auditor.

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 than the actuarial central estimate of the liability. The risk margin added to the central estimate increases the probability that the net outstanding claims liability will ultimately prove to be adequate.

Risk margins are held to allow for uncertainty surrounding the outstanding claims liability estimation process. Potential uncertainties include those relating to the actuarial models and assumptions, the quality of the underlying data used in the models, general statistical uncertainty, the general insurance environment, scope for and experience of political intervention (particularly for long-tail classes) and the impact of legislative reform. Uncertainty from the above sources is examined for each class of business and expressed as a volatility of the net central estimate. The volatility for each class is derived after consideration of stochastic modelling and benchmarking to industry analysis.

The long-tail classes of business generally have the highest volatilities of the insurance classes as the longer average time for claims to be reported and settled allows more time for sources of uncertainty to emerge. Short-tail classes generally have lower levels of volatility.

The risk margin required to provide a given probability of adequacy for two or more classes of business or for two or more geographic locations combined is likely to be less than the sum of the risk margins for the individual classes. This reflects the benefit of diversification in general insurance. Two key components of the valuation methodology are the selection of coefficients of variation (CoV) for each class of business and the correlation factors between each pair of classes of business. The CoV is a measure of the volatility of a class of business and is generally greater for long tail classes when compared to short tail classes because of the increased uncertainty relating to the longer time until settlement of claims. The correlation factors are a measure of the correlation between pairs of business classes and measure the strength of the relationship of movements in that pair of class liabilities. The higher the correlation between two classes of business, the more likely it is that a negative outcome in one class will correspond to a negative outcome in the other class. The correlations adopted are normally derived from industry analysis, historical experience and the judgement of experienced and qualified actuaries.

The risk margin is set taking into account the correlations assessed between the outstanding claims liabilities arising from the various forms of business underwritten by the different entities within the Consolidated entity. The Approved Actuary estimates the overall risk margin on a diversified basis, taking into account the diversification benefit arising from combining all classes of business within the Consolidated entity. The assumptions regarding uncertainty for each class are applied to the net central estimates, and the results are aggregated. The aggregated central estimate plus the risk margin calculated on a diversified basis forms the outstanding claims liability. The policy is for the risk margin to be set so as to provide an overall probability of adequacy for the outstanding claims liability of 90% or greater which has been determined having regard to the inherent uncertainty in the central estimate and the prevailing market environment.

**Note 11. Claims (continued)**

**(g) Actuarial assumptions**

The following key actuarial assumptions were used in the measurement of outstanding claims and recoveries, where appropriate, at reporting date:

| | CONSOLIDATED FOR 2006 | | | |
|---|---|---|---|---|
| | Australian personal insurance | Australian commercial insurance | New Zealand insurance | Reinsurance captive |
| Weighted average terms to settlement | 2.8 years | 5.9 years | 0.4 years | 1.8 years |
| Inflation rate | 3.3% - 4.3% | 3.5% - 4.3% | 3.1% | 4.3% |
| Superimposed inflation rate | 2.0% - 5.0% | 2.5% - 8.0% | 4.0% | - |
| Discount rate | 5.5% - 5.9% | 5.8% - 5.9% | * 5.5% - 6.8% | 5.7% - 5.8% |
| Claims handling expense ratio | 7.6% | 6.3% | 5.7% | 1.9% |

* In accordance with New Zealand Government bond yields ranging from 6.8% in the next year to 5.5% from year seven onwards.

**(h) Processes used to determine the assumptions**

The process for establishing the outstanding claims liability involves extensive consultation with internal and external actuaries, claims managers, underwriters and other senior management. One of the key elements of the valuation processes is rigorous data verification and reconciliation.

A description of the key assumptions and the processes used to determine those assumptions is provided below:

- Weighted average term to settlement - The weighted average term to settlement relates to the expected payment pattern for claims. The payment pattern is important in considering the timing of future cash outflows and hence discounting and in managing the assets backing insurance liabilities to support the outflows. The future cashflow pattern is estimated separately for each class of business based on historic settlement patterns and estimated future settlement patterns. The weighted average term to settlement, while not itself an assumption, provides a summary indication of the future cashflow pattern.

- Inflation rate – Insurance costs are subject to inflationary pressures. Economic inflation assumptions are set by reference to current economic indicators. For example, for the motor and property classes, claims costs are related to the inflationary pressures of the materials and goods insured as well as labour costs to effect repairs.

- Superimposed inflation rate - Superimposed inflation occurs due to non-economic effects such as court settlements increasing at a faster rate than wages or CPI inflation and from social and environmental pressures. Where appropriate, the effect of superimposed inflation is made either in the underlying model for the class of business, for example where the past pattern of development in claims cost are used to estimate future claim cost development factors, or by including a specific superimposed inflation rate assumption designed to allow for all other claims inflation not modelled. The level of superimposed inflation is estimated after considering both the superimposed inflation present in the portfolio and industry superimposed inflation trends.

- Discount rate – Because the outstanding claims liability 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 government securities.

- Claims handling expense ratio – It is known that costs will be incurred in the future in the management of claims to finalisation that have been incurred up to the reporting date. An estimate of these costs is incorporated into the outstanding claims liability using the claims handling expense ratio. The ratio incorporates assumptions about the future costs to be incurred based on past experience with such costs for each class of business.

**Note 11. Claims (continued)**

**(i) The effect of changes in assumptions**

(i) General impact of changes

Sensitivity analyses are conducted to quantify the exposure to changes in the key underlying variables. The valuations included in the reported results are calculated using certain assumptions about these variables as disclosed above. The movement in any key variable will impact the financial position and performance for a period. The information below describes how a change in each assumption will affect claims liabilities and provides an analysis of the sensitivity of the net outstanding claims liability to changes in these assumptions.

- Weighted average term to settlement - A decrease in the average term to settlement would reflect claims being paid sooner than anticipated and so increase the claims expense.
- Inflation and superimposed inflation rates - Expected future payments are inflated to take account of inflationary increases. An increase or decrease in the assumed levels of inflation would have a corresponding impact on claims expense, with particular reference to long-tail business. The inflation rate sensitivity is provided as an indicator of the impact of inflation on the portfolio, whether it be from economic inflation, inflation implied from the use of the past pattern of development in claims cost in the valuation method or inflation related to a specific superimposed inflation rate specified.
- Discount rate - The outstanding claims liability is calculated by reference to expected future payments. These payments are discounted to adjust for the time value of money. An increase or decrease in the assumed discount rate will have an opposing impact on total claims expense.
- Claims handling expense ratio - An increase in the ratio reflects an increase in the estimate for the internal costs of administering claims which will increase the outstanding claims liability.

(ii) Sensitivity analysis of changes

The impact of changes in key outstanding claims variables are summarised below. Each change has been calculated in isolation of the other changes and each change shows the relevant impact assuming that there is no change to:

- Any of the other variables – This is considered unlikely as, for example, an increase in interest rates is normally accompanied by an increase in the rate of inflation.
- The probability of adequacy – The directors and management have set an internal target for the probability of adequacy for the outstanding claims liability. It is likely that if, for example, the central estimate was to increase by 5%, at least part of the increase would result in a decrease in the probability of adequacy rather than being reflected wholly in the net outstanding claims liability as inferred below.

An economic assumption may be relevant to only a part of a business segment and so a large change in the assumption may have only a small financial impact on the business segment.

**Note 11. Claims (continued)**

**(i) The effect of changes in assumptions (continued)**

The impact on the net outstanding claims liability for each of the key assumptions:

| | | CONSOLIDATED FOR 2006 | | | |
|---|---|---|---|---|---|
| **Variable** | **Movement in variable** | **Australian personal insurance** | **Australian commercial insurance** | **New Zealand insurance** | **Reinsurance captive** |
| | | **$m** | **$m** | **$m** | **$m** |
| Weighted average term to settlement | +10% | (47) | (60) | - | (2) |
| | -10% | 46 | 61 | - | 2 |
| Inflation rate | +1.0% | 77 | 76 | 1 | 4 |
| | -1.0% | (75) | (66) | (1) | (4) |
| Discount rate | +1.0% | (73) | (75) | (1) | (4) |
| | -1.0% | 77 | 85 | 1 | 4 |
| Claims handling expense ratio | +1.0% | 31 | 21 | 2 | 2 |
| | -1.0% | (31) | (21) | (2) | (2) |

The movements in the net outstanding claims liability would have an opposing net impact on the profit or loss before tax for a year.

| | CONSOLIDATED | |
|---|---|---|
| | **2006** | 2005 |
| | **$m** | $m |
| **Note 12. Reinsurance and other recoveries on outstanding claims** | | |
| **(a) Reinsurance and other recoveries receivable on outstanding claims** | | |
| Reinsurance recoveries receivable on outstanding claims | **598** | 599 |
| Other recoveries receivable on outstanding claims | **310** | 284 |
| Reinsurance and other recoveries receivable on outstanding claims | **908** | 883 |

The carrying value of reinsurance and other recoveries receivable on outstanding claims includes $597 million (2005 - $576 million) which is expected to be settled after more than twelve months from reporting date. Because of the nature of the amount being an estimate, the credit risk is incorporated into the estimate rather than being presented separately as a provision for impairment.

**(b) Actuarial assumptions**

Reinsurance and other recoveries on outstanding claims are computed using actuarial assumptions and methods similar to that used for outstanding claims (refer note 11(f)). The outstanding claims liability is calculated gross of any reinsurance recoveries and a separate estimate is then made of the amounts that are expected to be recoverable from reinsurers based upon the gross provisions. Estimates of potential reinsurance recoveries are made on an individual claim basis for reported claims. The recoverability of these assets is assessed on a periodic basis to ensure that the balance is reflective of the amounts that will ultimately be received.

**(c) The effect of changes in assumptions**

The effect of changes in assumptions on the net outstanding claims liability, which incorporates the reinsurance and other recoveries receivable on outstanding claims, is disclosed in note 11(i).

**(d) Risk management**

The Board and senior management of the IAG Group have developed, implemented and maintain a Reinsurance Management Strategy (“REMS”) which is in accordance with the prudential standards issued by the Australian Prudential Regulation Authority (“APRA”). The REMS is updated annually and approved by the Board.

The REMS identifies the IAG Group’s policies and procedures, processes and controls that comprise its risk management and control systems relating to reinsurance. Annually, the Board certifies to APRA that adequate strategies have been put in place to monitor those risks, that systems are in place to ensure compliance with legislative and prudential requirements, and that the Board has satisfied itself as to compliance with the REMS.

**(e) Reinsurance programme**

Risks underwritten are reinsured in order to limit exposure to losses, stabilise earnings, protect capital resources and ensure efficient control and spread of the risks underwritten. Each subsidiary that is an insurer has its own reinsurance programme and determines its own risk limits. To facilitate the reinsurance process and to create economies of scale, the IAG Group has established a captive reinsurance company, IAG Re Limited (“IAG Re”), incorporated in the Republic of Ireland, which acts as the reinsurer for the IAG Group by being the main buyer of the IAG Group’s outwards reinsurance programme. The operations of IAG Re are intended to manage reinsurance and earnings volatility and the IAG Group’s exposure to catastrophe risk. IAG Re retains a portion of the intercompany business it assumes and retrocedes (passes on) the remainder to external reinsurers.

While a large portion of the business ceded by the Consolidated entity’s subsidiaries is reinsured with IAG Re, individual business units do purchase additional reinsurance protection outside the IAG Group. This generally relates to facultative reinsurance covers and selected treaty reinsurance arrangements for the Australian commercial insurance operations. IAG Re helps to facilitate these arrangements.

**Note 12. Reinsurance and other recoveries on outstanding claims (continued)**

**(e) Reinsurance programme (continued)**

IAG Re purchases reinsurance on behalf of IAG Group entities to cover a maximum return period of at least APRA's minimum of 1:250 year event on a single site basis but is authorised to elect to purchase covers up to 1:250 year event on a whole of portfolio basis. Dynamic Financial Analysis modeling is used to determine the optimal level to which reinsurance should be purchased for capital efficiency, compared with the cost and benefits of covers available in the market.

The external reinsurance programmes consist of a combination of the following reinsurance protection:

- A Group Catastrophe cover which is placed in line with the strategy of buying to the level of a 1:250 year event on a modified whole of portfolio basis. The catastrophe programme is negotiated on an annual basis. Covers purchased are dynamic; the maximum event retention (MER) changes as total requirements change and as the reinsurance purchase strategy evolves.
- An Aggregate cover is also purchased alongside the catastrophe cover. This is designed to protect the IAG Group from certain attritional losses as well as providing subsequent event covers.
- A Surplus cover, which provides "per risk" protection for IAG Commercial Property and Engineering business in Australia and New Zealand.
- Excess of loss reinsurance for all casualty portfolios including CTP, Public Liability and Workers' Compensation.

Reinsurance arrangements mitigate insurance risk but potentially expose the IAG Group to credit risk. Reinsurance is placed with companies based on an evaluation of the financial strength of the reinsurers, terms of coverage, and price. The IAG Group has clearly defined credit policies for the approval and management of credit risk in relation to reinsurers. The Consolidated entity monitors the financial condition of its reinsurers on an ongoing basis and periodically reviews the reinsurers' ability to fulfill its obligations to the Consolidated entity under respective existing and future reinsurance contracts.

It is IAG Group policy to deal with reinsurers with credit ratings of at least Standard & Poor's "A-" (or other rating agency equivalent) without collateralisation. For some newly acquired businesses a transition period is used for implementation of this policy. Where the credit rating of a reinsurer falls below the threshold level during the period of risk, there exists a contractual right to replace the counterparty. Some of the reinsurance protection is purchased on a 'collateralised' basis, where reinsurers have deposited funds equivalent to their participation in a trust fund. The level and quality of reinsurance protection is an important element in understanding the financial strength of an insurer. There is limited value in purchasing reinsurance protection from a reinsurer when that reinsurer may be unable to meet its payment obligations upon submission of a claim. The counterparty credit profile of the reinsurance catastrophe programme currently stands with 75% of the limit for the 2006 programme with parties rated by Standard & Poor's as "AA" or better.

Having reinsurance protection with strong reinsurers also benefits the Consolidated entity in its regulatory capital calculations. The risk charges vary with the grade of the reinsurers such that higher credit quality reinsurance counterparties incur lower APRA regulatory capital charges.

There are no significant concentrations of credit risk for reinsurance recoveries receivable. Reinsurance contracts are entered into with a number of reinsurers from different countries each of which has a high independent credit rating. The use of reinsurance as part of the overall risk management strategy, and the level of reinsurance cover entered into with particular reinsurers are sufficiently diversified so as to avoid a concentration charge in the regulatory capital calculation (refer note 36).

*Changes during the year*
The catastrophe event limit cover purchased was maintained at $3.5 billion. However, with effect from 1 January 2006, the maximum event retention (MER) for a first event was increased from $100 million to $200 million, dropping to $175 million for a second event. The decision to increase the retained single event loss was made as the cost of the coverage available in the reinsurance market was such that the transaction proved to be capital inefficient compared with retaining the risk against the Consolidated entity's capital.

| | CONSOLIDATED 2006 | 2005 |
|---|---|---|
| | **$m** | $m |
| **Note 13. Deferred acquisition costs** | | |
| Reconciliation of movements for the financial year | | |
| Deferred acquisition costs at the beginning of the financial year | **621** | 558 |
| Acquisition costs deferred during the year | **1,051** | 1,133 |
| Amortisation charged to profit for the year | **( 1,081 )** | ( 1,070 ) |
| Deferred acquisition costs at the end of the financial year | **591** | 621 |

The carrying value of deferred acquisition costs includes $46 million (2005 - $33 million) which is expected to be amortised after more than twelve months from reporting date.

## Note 14. Unearned premium liability

### (a) Reconciliation of movements for the financial year

| | 2006 | 2005 |
|---|---|---|
| Unearned premium liability at the beginning of the financial year | **3,586** | 3,472 |
| Deferral of premiums on contracts written in the financial year | **3,402** | 3,500 |
| Earning of premiums written in previous years | **( 3,485 )** | ( 3,386 ) |
| Unearned premium liability at the end of the financial year | **3,503** | 3,586 |

The carrying value of unearned premium liability includes $146 million (2005 - $101 million) which is expected to be earned after more than twelve months from reporting date.

### (b) Liability adequacy test

The liability adequacy test has been conducted using the premium liabilities methodology for reporting to APRA (refer note 36), adjusted as appropriate, for each portfolio of contracts, being Australian personal insurance operations, Australian commercial insurance operations, the IAG New Zealand operations, the reinsurance captive, and other geographical locations separately.

The conduct of the liability adequacy test as at 30 June 2006 identified a surplus for each portfolio of contracts except for the reinsurance captive portfolio of contracts for which a deficiency was recognised (1 July 2005 – a surplus for all portfolios). The deficiency has been recognised through the recognition of an unexpired risk liability.

The deficiency for the reinsurance captive portfolio of contracts of $11 million represents the amount by which the present value of the expected future cash flows relating to future claims of $202 million (which is inclusive of risk margin and is net of related reinsurance recoveries of $201 million) exceeds the unearned premium liability of $313 million less the related deferred reinsurance expense of $122 million. The test is based on prospective information and so is heavily dependent on assumptions and judgements.

For the purposes of the liability adequacy test, the present value of expected future cash flows for future claims including the risk margin for the Consolidated entity of $2,513 million (1 July 2005 - 2,567 million) comprises the discounted central estimate of $2,280 million (1 July 2005 - $2,323 million), and a risk margin of $233 million (1 July 2005 - $244 million).

The risk margin included in the Consolidated entity's expected future cash flows for future claims as a percentage of the central estimate is 10.2% (1 July 2005 – 10.5%) which was determined via a process similar to that described in note 11(f) allowing also for diversification between the outstanding claims liability and the premium liabilities to give a probability of adequacy of 75%. The probability of adequacy applied in the test is different to the probability of adequacy adopted in determining the outstanding claims liability. No specific guidance exists for the risk margin to be used in determining the adequacy of premium liabilities. The 75% basis is considered appropriate having regard to the purpose and nature of the test, the use of the 75% basis as a regulatory benchmark in Australia, and consistency with developing market practice.

| | CONSOLIDATED 2006 | CONSOLIDATED 2005 |
|---|---|---|
| | **$m** | $m |
| **Note 15. Investments** | | |
| Listed | | |
| *Money market securities* | | |
| - Australian government and semi-government | **1,893** | 2,698 |
| - Foreign government and institutions | **867** | 181 |
| - Financial institutions and corporate | **151** | 159 |
| *Equity and trust securities* | | |
| - Australian | **1,961** | 2,381 |
| - International | **597** | 527 |
| | **5,469** | 5,946 |
| Unlisted | | |
| *Money market securities* | | |
| - Financial institutions and corporate | **4,152** | 4,215 |
| *Equity and trust securities* | | |
| - Australian | **160** | 129 |
| - International | **148** | 80 |
| | **4,460** | 4,424 |
| | **9,929** | 10,370 |

The carrying value of investments includes $7,037 million (2005 - $7,501 million) which is expected to be settled after more than twelve months from reporting date. None of the investments have been pledged as collateral (2005 – none).

| | PARENT 2006 | PARENT 2005 | CONSOLIDATED 2006 | CONSOLIDATED 2005 |
|---|---|---|---|---|
| | **$m** | $m | **$m** | $m |
| **Note 16. Trade and other receivables** | | | | |
| Reinsurance and other recoveries on paid claims | **-** | - | **140** | 178 |
| Provision for impairment | **-** | - | **( 8 )** | ( 8 ) |
| | **-** | - | **132** | 170 |
| Other trade debtors | **-** | - | **31** | 35 |
| Provision for impairment | **-** | - | **( 11 )** | ( 10 ) |
| | **-** | - | **20** | 25 |
| Premium funding loans secured on policies (net of unearned interest) | - | - | **127** | 130 |
| Provision for impairment | - | - | **( 2 )** | ( 2 ) |
| | - | - | **125** | 128 |
| GST recoverable on gross outstanding claims liability | **-** | - | **284** | 300 |
| Investment income receivable | **-** | - | **94** | 99 |
| Investment transactions not yet settled at reporting date | **-** | - | **12** | 11 |
| Corporate treasury derivatives receivable | **-** | - | **-** | 3 |
| Other debtors | **1** | - | **97** | 91 |
| | **1** | - | **764** | 827 |

Trade and other receivables are non-interest bearing and are normally settled between 30 days and 12 months. The balance has not been discounted because the effect of the time value of money is not material. The net carrying amount of receivables is a reasonable approximation of the fair value of the assets because of the short term nature of the assets. A portion of the trade and other receivables balance is owed by related parties, which are considered to be fully recoverable.

| | PARENT | | CONSOLIDATED | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **$m** | $m | **$m** | $m |
| **Note 17. Deferred tax assets and liabilities** | | | | |
| **(a) Deferred tax assets** | | | | |
| (i) The balance comprises temporary differences attributable to: | | | | |
| *Amounts recognised in profit for the financial year* | | | | |
| Property, plant and equipment | **-** | - | **48** | 63 |
| Employee benefits | **-** | - | **65** | 54 |
| Defined benefit superannuation plans | **-** | - | **7** | 8 |
| Insurance provisions | **-** | - | **146** | 138 |
| Investments | **-** | - | **15** | 11 |
| Provisions | **-** | - | **2** | 2 |
| Other | **1** | - | **2** | 1 |
| | **1** | - | **285** | 277 |
| *Amounts recognised directly in equity* | | | | |
| Hedges | **-** | - | **5** | - |
| Defined benefit superannuation plans | **-** | - | **( 9 )** | - |
| | **1** | - | **281** | 277 |
| Set-off of deferred tax liabilities | **-** | - | **( 122 )** | ( 146 ) |
| | **1** | - | **159** | 131 |
| (ii) Movements | | | | |
| Balance at the beginning of the financial year | **-** | - | **277** | 263 |
| Adjustment at 1 July 2005 (refer note 38) | **-** | - | **2** | - |
| | **-** | - | **279** | 263 |
| Credited / (charged) to profit or loss | **1** | - | **5** | 29 |
| Credited / (charged) to equity | **-** | - | **( 5 )** | - |
| Acquisitions | **-** | - | **8** | - |
| Transfers | **-** | - | **( 5 )** | ( 3 ) |
| Adjustments relating to prior year | **-** | - | **( 1 )** | ( 12 ) |
| Balance at the end of the financial year | **1** | - | **281** | 277 |

(iii) Tax losses

The Consolidated entity has not brought to account any tax losses (2005 – $Nil). Included in deferred tax assets is $Nil relating to tax losses which the directors believe will probably be realised.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

| | PARENT | | CONSOLIDATED | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **$m** | $m | **$m** | $m |
| **Note 17. Deferred tax assets and liabilities (continued)** | | | | |
| **(b) Deferred tax liabilities** | | | | |
| (i) The balance comprises temporary differences attributable to: | | | | |
| *Amounts recognised in profit for the financial year* | | | | |
| Investments | **-** | - | **116** | 137 |
| Other provisions | **-** | - | **42** | 33 |
| | **-** | - | **158** | 170 |
| *Amounts recognised directly in equity* | | | | |
| Hedges | **-** | - | **4** | - |
| | **-** | - | **162** | 170 |
| Set-off against deferred tax assets | **-** | - | **( 122 )** | ( 146 ) |
| | **-** | - | **40** | 24 |
| (ii) Movements | | | | |
| Balance at the beginning of the financial year | **-** | - | **170** | 98 |
| Charged / (Credited) to profit or loss | **-** | - | **( 5 )** | 80 |
| Credited to equity | **-** | - | **4** | - |
| Foreign exchange differences | **-** | - | **( 2 )** | - |
| Transfers | **-** | - | **( 5 )** | ( 3 ) |
| Adjustments relating to prior year | **-** | - | **-** | ( 5 ) |
| Balance at the end of the financial year | **-** | - | **162** | 170 |

| | CONSOLIDATED | | | |
|---|---|---|---|---|
| | **Land and buildings** | **Motor vehicles** | **Other plant and equipment** | **Total** |
| | **$m** | **$m** | **$m** | **$m** |
| **Note 18. Property, plant and equipment** | | | | |
| **2006** | | | | |
| **(a) Composition** | | | | |
| Cost* | **70** | **71** | **336** | **477** |
| Accumulated depreciation* | **( 5 )** | **( 23 )** | **( 192 )** | **( 220 )** |
| Accumulated impairment charges | **-** | **-** | **-** | **-** |
| Balance at the end of the financial year | **65** | **48** | **144** | **257** |

* Additions through business combinations are presented on a gross basis.

| | | | | |
|---|---|---|---|---|
| **(b) Reconciliation of movements for the financial year** | | | | |
| Balance at the beginning of the financial year | **60** | **51** | **148** | **259** |
| Additions | **-** | **20** | **35** | **55** |
| Additions through business combinations | **6** | **1** | **3** | **10** |
| Disposals | **-** | **( 11 )** | **( 8 )** | **( 19 )** |
| Net foreign exchange differences | **-** | **-** | **( 1 )** | **( 1 )** |
| Depreciation | **( 1 )** | **( 13 )** | **( 33 )** | **( 47 )** |
| Balance at the end of the financial year | **65** | **48** | **144** | **257** |
| 2005 | | | | |
| **(c) Composition of comparatives** | | | | |
| Cost | 61 | 70 | 319 | 450 |
| Accumulated depreciation | ( 1 ) | ( 19 ) | ( 171 ) | ( 191 ) |
| Accumulated impairment charges | - | - | - | - |
| Balance at the end of the financial year | 60 | 51 | 148 | 259 |

The net carrying amount of all classes of property, plant and equipment is considered a reasonable approximation of the fair value of the assets in the context of the financial statements. For property, this assessment included consideration of valuations prepared as at the reporting date by Mr Scott Fullarton FAPI of Scott Fullarton Valuations Pty Limited.

There were no impairment indicators present for each class of property, plant and equipment at the reporting date or noted during the year (2005 - none). There are no items of property, plant and equipment pledged as security for liabilities. The depreciation expense amounts are allocated across various lines in the income statement.

The net carrying amount of the lease provision capitalised in other plant and equipment was $7 million as at 30 June 2006 (2005 - $10 million).

| | CONSOLIDATED | | | |
|---|---|---|---|---|
| | Software development expenditure | Contractual arrangements | Other | Total |
| | $m | $m | $m | $m |
| **Note 19. Intangible assets** | | | | |
| **2006** | | | | |
| **(a) Composition** | | | | |
| Cost | **58** | **109** | **2** | **169** |
| Accumulated depreciation | **( 6 )** | **( 105 )** | **( 1 )** | **( 112 )** |
| Accumulated impairment charges | **-** | **-** | **-** | **-** |
| Balance at the end of the financial year | **52** | **4** | **1** | **57** |
| **(b) Reconciliation of movements for the financial year** | | | | |
| Balance at the beginning of the financial year | **24** | **6** | **1** | **31** |
| Additions acquired and developed | **34** | **-** | **1** | **35** |
| Additions through business combinations | **-** | **5** | **-** | **5** |
| Amortisation | **( 6 )** | **( 7 )** | **( 1 )** | **( 14 )** |
| Balance at the end of the financial year | **52** | **4** | **1** | **57** |
| 2005 | | | | |
| **(c) Composition of comparatives** | | | | |
| Cost | 24 | 104 | 1 | 129 |
| Accumulated depreciation | - | ( 98 ) | - | ( 98 ) |
| Accumulated impairment charges | - | - | - | - |
| Balance at the end of the financial year | 24 | 6 | 1 | 31 |

All of the intangible assets have been acquired other than the capitalised software development expenditure intangible asset. All of the intangible assets have finite useful lives. The amortisation of the capitalised software development expenditure is included in the claims expense, acquisition costs, other underwriting expenses, and corporate, administration and other expenses lines in the income statement. The amortisation of other intangible assets forms part of corporate, administration and other expenses in the income statement.

There were no impairment indicators present for each class of intangible asset at the reporting date or noted during the year (2005 - none). The capitalisation of the software development expenditure involves the exercise of judgement in determining whether the costs incurred will be recovered through the probable generation of future economic benefits from the internal use of the asset. This process is supported by the preparation of detailed business cases and subsequent review processes that are required to approve a greater than $2 million project including a detailed business case. Reasonable variations in the exercise of this judgement would not have a material impact on the amounts recognised.

There are a number of other intangible assets that are controlled but which are not presented on the balance sheet because they do not meet the recognition criteria. These are both acquired and internally generated intangible assets. These include brands, information technology systems, and distribution channels.

| | CONSOLIDATED | |
|---|---|---|
| | **2006** | 2005 |
| | **$m** | $m |

## Note 20. Goodwill

### (a) Composition

| | **2006 $m** | 2005 $m |
|---|---|---|
| Goodwill | **1,505** | 1,452 |
| Net cumulative foreign exchange movements | **( 19 )** | 11 |
| Accumulated impairment charges | **-** | - |
| | **1,486** | 1,463 |

### (b) Reconciliation of movements for the financial year

| | **2006 $m** | 2005 $m |
|---|---|---|
| Goodwill at the beginning of the financial year | **1,463** | 1,455 |
| Additional goodwill amounts arising from business combinations | **53** | 8 |
| Net foreign exchange movements during the financial year | **( 30 )** | - |
| Goodwill at the end of the financial year | **1,486** | 1,463 |

### (c) Allocation to cash generating units

| | **2006 $m** | 2005 $m |
|---|---|---|
| Australian personal insurance operations | **418** | 418 |
| Australian commercial insurance operations | **724** | 724 |
| New Zealand insurance operations | **294** | 321 |
| Other cash generating units | **50** | - |
| | **1,486** | 1,463 |

The goodwill relating to certain acquisitions outside Australia is denominated in currencies other than Australian dollars and so is subject to foreign exchange rate movements.

There was no impairment recognised during the year (2005 – $Nil). The impairment testing of the goodwill involves the use of accounting estimates and assumptions. The recoverable amount of each cash generating unit is determined on the basis of value in use calculations. The value in use is calculated using a discounted cash flow methodology covering a five year period with an appropriate terminal value at the end of year five, less net assets, for each of the key business units within a cash generating unit.

The following describes the key assumptions on which management has based its cash flow projections to undertake impairment testing of goodwill:

- Cash flow forecasts - Cash flow forecasts are based on five year business plans presented to and approved by the Board.
- Terminal value - Terminal value is calculated using a perpetuity growth formula based on the cash flow forecast for year five, discount rate (after tax), and terminal growth rate.
- Terminal growth rates - Terminal growth rates are based on past performance and management's expectations for future performance in each segment and country.
- Discount rate - Discount rates used reflect the risk free rate, an appropriate beta and equity risk premium (after tax) in each segment and country, risk adjusted where applicable. Discount rates used are pre-tax.

The cash flow projections derived values for the cash generating units that were in excess of the carrying value of goodwill. Reasonably possible changes in the key assumptions on which the recoverable amounts are based would not cause the respective recoverable amounts for each cash generating unit to fall short of the carrying amounts at 30 June 2006.

| | PARENT | | CONSOLIDATED | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **$m** | $m | **$m** | $m |

**Note 21. Trade and other payables**

| | PARENT 2006 $m | PARENT 2005 $m | CONSOLIDATED 2006 $m | CONSOLIDATED 2005 $m |
|---|---|---|---|---|
| Trade creditors | | | | |
| Commissions payable | **-** | - | **116** | 111 |
| Stamp duty payable | **-** | - | **69** | 67 |
| GST payable on premium receivable | **-** | - | **62** | 58 |
| Other | **-** | - | **179** | 186 |
| | **-** | - | **426** | 422 |
| Other payables | | | | |
| Investment creditors | **-** | - | **40** | 14 |
| Interest payable on interest-bearing liabilities | **1** | - | **8** | 8 |
| Other | **1** | 1 | **186** | 194 |
| Loan from former related party (i) | **-** | - | **83** | 83 |
| | **2** | 1 | **743** | 721 |

Trade and other payables are unsecured, non interest-bearing and are normally settled within 30 days. The balance has not been discounted because the effect of the time value of money is not material. The carrying amount of payables is a reasonable approximation of the fair value of the liabilities because of the short-term nature of the liabilities.

(i) The loan from former related party relates to an entity that was previously a subsidiary and is now in liquidation. The loan is expected to be settled in conjunction with the final distribution from that entity by the liquidator.

**Note 22. Restructuring provision**

**(a) Composition**

| | CONSOLIDATED 2006 $m | CONSOLIDATED 2005 $m |
|---|---|---|
| Restructuring of customer-facing outlets | **6** | 1 |
| Other restructuring projects | **4** | 10 |
| Balance at the end of the financial year | **10** | 11 |

**(b) Reconciliation of movements for the financial year**

| | CONSOLIDATED 2006 $m | CONSOLIDATED 2005 $m |
|---|---|---|
| Balance at the beginning of the financial year | **11** | 29 |
| Additions during the financial year | **11** | 12 |
| Settled during the financial year | **( 12 )** | ( 30 ) |
| Balance at the end of the financial year | **10** | 11 |

All of the provision outstanding at the reporting date is expected to be settled within twelve months (2005 – $11 million).

## Note 23. Interest-bearing liabilities

### (a) Composition

| | Notes | PARENT 2006 $m | PARENT 2005 $m | CONSOLIDATED 2006 $m | CONSOLIDATED 2005 $m |
|---|---|---|---|---|---|
| Unsecured | | | | | |
| NZ senior term notes | (c)(i) | **-** | - | **41** | 91 |
| Subordinated term notes | (c)(ii) | **-** | - | **299** | 299 |
| US subordinated term notes | (c)(iii) | **-** | - | **323** | 315 |
| Derivatives related to US subordinated term notes | (c)(iii) | **-** | - | **95** | 88 |
| Reset preference shares | (c)(iv) | **550** | - | **550** | - |
| Perpetual subordinated loan | (c)(v) | **-** | - | **2** | 2 |
| Less: capitalised transaction costs | | **( 3 )** | - | **( 14 )** | ( 16 ) |
| | | **547** | - | **1,296** | 779 |

The carrying value of interest-bearing liabilities (gross, without deducting transaction costs) includes $1,310 million (2005 - $749 million) for the Consolidated entity and $550 million (2005 - $Nil) for the Parent, which is expected to be settled after more than twelve months from reporting date. Other than the reset preference shares, the liabilities are unable to be traded in markets in a standardised form.

### (b) Reconciliation of movements for the financial year

| | PARENT 2006 $m | PARENT 2005 $m | CONSOLIDATED 2006 $m | CONSOLIDATED 2005 $m |
|---|---|---|---|---|
| Balance at the end of the previous financial year | **-** | - | **779** | 786 |
| AIFRS transition adjustments | | | | |
| - Reclassification of reset preference shares * | **550** | - | **550** | - |
| - Reclassification of capitalised transaction costs * | **( 11 )** | - | **( 11 )** | - |
| - Cumulative amortisation of capitalised transaction costs* | **6** | - | **6** | - |
| - Fair value transition adjustment for cash flow hedge* | **-** | - | **7** | - |
| Balance at the beginning of the financial year | **545** | - | **1,331** | 786 |
| Foreign exchange movement on US subordinated term notes | **-** | - | **8** | ( 30 ) |
| Foreign exchange movement on cash flow hedge | **-** | - | **( 8 )** | 32 |
| Other fair value movement on cash flow hedge | **-** | - | **7** | - |
| Repayment of tranche of NZ senior term notes | **-** | - | **( 46 )** | - |
| Foreign exchange movement on NZ senior term notes | **-** | - | **( 4 )** | - |
| Transaction costs capitalised during the financial year | **-** | - | **-** | ( 12 ) |
| Amortisation of capitalised transaction costs | **2** | - | **7** | 3 |
| Other foreign exchange movements | **-** | - | **1** | - |
| Balance at the end of the financial year | **547** | - | **1,296** | 779 |

* These reconciliation adjustments arose from the election to not restate comparatives for certain accounting standards as allowed upon first time adoption of AIFRS. Refer to note 38 for further details.

The transaction costs capitalised during the year to 30 June 2005 of $12 million relate to the issuance of the reset exchangeable securities which are held off balance sheet and so not included in interest-bearing liabilities (refer note 1(ff) for further details).

**Note 23. Interest-bearing liabilities (continued)**

**(c) Significant terms and conditions**

(i) The NZ senior term notes were issued through IAG (NZ) Holdings Limited's medium-term note programme. NZ$100 million of notes were issued at a discount, with NZ$50 million that matured and was fully repaid in August 2005 and NZ$50 million to mature in August 2008. They are fixed rate notes (7.25% payable semi-annually) with the principal and interest flows denominated in New Zealand dollars. Amounts are translated into the equivalent Australian dollars using the reporting date exchange rate. The primary difference between the Australian dollar equivalent of the face value of the notes at inception and the carrying value is due to foreign exchange rate movements.

(ii) The subordinated term notes have a face value of $300 million and were issued at a discount through Insurance Australia Limited's debt issuance programme with $250 million at a fixed rate and $50 million at a floating rate. The notes mature in November 2012, however, they may be redeemed at par at the issuer's option from November 2007 onwards, subject to the approval of APRA. If the notes are not redeemed in November 2007, all notes become floating rate notes with an interest rate of the three month Bank Bill Swap Rate plus a margin of 1.58% per annum. The notes qualify as Lower Tier 2 capital for the purposes of Insurance Australia Limited's APRA regulatory capital position.

(iii) The US subordinated term notes have a face value of US$240 million and were issued at par by NRMA Insurance Funding 2003 Limited (a wholly-owned subsidiary of Insurance Australia Limited). They are fixed rate notes (5.19% payable semi-annually) with the principal and interest flows denominated in US dollars, which are hedged with cross currency swaps and interest rate swaps. Cash flow hedge accounting is applied for this hedge arrangement (refer note 35 for further information). The notes mature in April 2015, however, they may be redeemed at par at the issuer's option from April 2010 onwards, subject to the approval of APRA. If the notes are not redeemed in April 2010, all notes become floating rate notes with an interest rate of the three month London Inter-Bank Offer Rate plus a margin of 2.04% per annum. The notes qualify as Lower Tier 2 capital for the purposes of Insurance Australia Limited's APRA regulatory capital position.

(iv) The reset preference shares ("RPS") are a hybrid security with characteristics of both debt and equity. The securities were issued in two tranches referred to as IAGPA (issued June 2002) and IAGPB (issued June 2003) with the first reset date for each tranche being 15 June 2007 and 15 June 2008 respectively. IAG may, prior to any reset date, make changes to certain terms (such as the next reset date, the market rate, the margin and the frequency and timing of the dividend payment dates) which will apply from the day after the relevant reset date. The RPS rank in priority to ordinary shares for the payment of dividends and in the event of a winding up. In a winding up, all RPS will rank equally for return of capital behind all other creditors of IAG, and ahead of ordinary shares. The RPS do not carry voting rights at general meetings, except in limited circumstances.

The RPS entitle the holder to a preferred, but not cumulative, distribution (currently 5.8% per annum for IAGPA and 4.51% per annum for IAGPB). The distributions are payable semi-annually in arrears on 15 December and 15 June and are able to be franked. The distributions are expected to be fully franked and if a distribution is unfranked or partially franked, the distribution will be increased to compensate for the unfranked component. Because of the hybrid nature of the securities, distributions on the RPS are not the same as interest payments and may not always be paid, as there are a number of conditions that must be met before a distribution can be paid. If distributions are not paid on the RPS, no dividends can be paid and no returns of capital can be made on ordinary shares unless IAG takes certain actions.

The RPS may be exchanged by IAG or the holder on a reset date, by the holder upon a specified trigger event (such as change in control of IAG by a takeover bid), or by IAG on a tax event (such as a more than insignificant increase in taxation costs), regulatory event (such as not all of the RPS being entitled to be treated as Tier 1 capital for regulatory reporting purposes) or following certain takeovers or schemes of arrangements. While the holder may initiate an exchange, IAG is able to select the method of exchange being either conversion into ordinary shares, arranging for a third party to acquire the shares for their face value, or to redeem, buy-back or cancel the shares (subject to APRA approval). The RPS convert into ordinary shares that would rank equally in all respects with all other ordinary shares. All conversions into ordinary shares, other than a holder requesting conversion on a reset date, will receive a discount of 2.5% of the ordinary share price used in calculating the number of ordinary shares to be issued on conversion.

(v) The perpetual subordinated loan is between Mutual Community General Insurance Proprietary Limited, a non-wholly owned subsidiary, and the minority interest equity holder in that company. The loan bears a fixed rate of interest.

**Note 23. Interest-bearing liabilities (continued)**

**(d) Financing arrangements**

| | | CONSOLIDATED | | | |
|---|---|---|---|---|---|
| | | **Facilities drawn at reporting date** | | **Facilities available** | |
| | | **2006** | 2005 | **2006** | 2005 |
| | | **$m** | $m | **$m** | $m |
| Standby letter of credit facility | (i) | **67** | 2 | **74** | 7 |
| Standby facility | (ii) | **-** | - | **30** | 30 |
| Debt issuance programme | (iii) | **299** | 299 | **750** | 750 |
| NZ medium-term note programme | (iv) | **41** | 91 | **41** | 91 |

Various entities within the Consolidated entity have facilities outstanding with external service providers, mostly banks, providing short term financing arrangements for specific situations including standby letters of credit, and guarantees for lease guarantees and performance bonds.

Notes:
(i) The standby letter of credit facilities are denominated in US dollars and are translated into equivalent Australian dollars using the reporting date exchange rate.

(ii) The standby facility is for liquidity support in the event that Insurance Australia Limited is unable to refinance maturing obligations under the debt issuance programme due to a market disturbance. Interest on this standby facility when drawn down is charged at a margin over the bank bill rate.

(iii) Insurance Australia Limited has a $750 million debt issuance programme. Standard & Poor's has assigned its "AA" long-term and "A-1+" short-term ratings to the programme's senior obligations and "AA-" to its subordinated notes. Insurance Australia Limited is rated "AA" for its insurer financial strength and counterparty credit ratings.

(iv) IAG (NZ) Holdings Limited has a NZ$50 million medium-term note programme (2005 - NZ$100 million). Standard & Poor's has assigned a "AA" long-term rating to the guaranteed and unsubordinated series of wholesale notes issued under the programme. The programme is guaranteed by Insurance Australia Limited. This programme is denominated in New Zealand dollars and is translated into equivalent Australian dollars using the reporting date exchange rate. Exchange rate movements are recognised in the foreign currency translation reserve.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

| | PARENT / CONSOLIDATED | | | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **Number of shares million** | Number of shares million | **$m** | $m |
| **Note 24. Reconciliation of total equity** | | | | |
| **(a) Share capital** | | | | |
| Ordinary shares | | | | |
| Balance at the beginning of the financial year | **1,594** | 1,591 | **3,263** | 3,263 |
| Shares issued under Performance Share Rights Plan | **1** | 3 | **-** | - |
| Balance at the end of the financial year | **1,595** | 1,594 | **3,263** | 3,263 |
| Reset preference shares | | | | |
| Balance at the end of the previous financial year | **6** | 6 | **539** | 539 |
| AIFRS transition adjustments at 1 July 2005 | | | | |
| - Reclassification of reset preference shares [(e)(i)] | **( 6 )** | - | **( 550 )** | - |
| - Reclassification of capitalised transaction costs [(e)(i)] | **-** | - | **11** | - |
| Balance at the beginning and end of the financial year | **-** | 6 | **-** | 539 |
| Total share capital at the end of the financial year | **1,595** | 1,600 | **3,263** | 3,802 |

| | PARENT | | CONSOLIDATED | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| | **$m** | $m | **$m** | $m |
| **(a) Share capital** (refer above) | **3,263** | 3,802 | **3,263** | 3,802 |
| **(b) Treasury shares held in trust** | | | | |
| Balance at the beginning of the financial year | **-** | - | **( 34 )** | ( 21 ) |
| Acquisition of shares | **-** | - | **( 19 )** | ( 13 ) |
| Shares vested and/or released to participants | **-** | - | **13** | -* |
| Balance at the end of the financial year | **-** | - | **( 40 )** | ( 34 ) |
| **(c) Reserves** | | | | |
| *Foreign currency translation reserve* | - | - | | |
| Balance at the beginning of the financial year | - | - | **( 6 )** | ( 5 ) |
| Net exchange difference on translation of foreign operations | - | - | **( 18 )** | ( 1 ) |
| Hedge of net investment in a subsidiary | - | - | **9** | - |
| Balance at the end of the financial year | - | - | **( 15 )** | ( 6 ) |
| *Share based remuneration reserve* | | | | |
| Balance at the beginning of the financial year | **-** | - | **13** | 5 |
| Charged to profit for the year | **-** | - | **19** | 8 |
| Transfers from the reserve upon vesting of rights/shares | **-** | - | **( 13 )** | - |
| Balance at the end of the financial year | **-** | - | **19** | 13 |

* Rounds to zero.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

| | PARENT | | CONSOLIDATED | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| **Note 24. Reconciliation of total equity (continued)** | **$m** | $m | **$m** | $m |
| **(c) Reserves (continued)** | | | | |
| *Hedging reserve* | | | | |
| Balance at the end of the previous financial year | **-** | - | **-** | - |
| AIFRS transition adjustments at 1 July 2005 | | | | |
| - Recognition of cash flow hedges, net of tax [(e)(i)] | **-** | - | **( 5 )** | - |
| Balance at the beginning of the financial year | **-** | - | **( 5 )** | - |
| Net movements in fair value of derivatives forming hedge | **-** | - | **1** | - |
| Net movements in fair value recycled to profit | **-** | - | **( 8 )** | - |
| Net tax impact on movements | **-** | - | **2** | - |
| Balance at the end of the financial year | **-** | - | **( 10 )** | - |
| *Other reserve* | | | | |
| Balance at the beginning of the financial year | **-** | - | **-** | - |
| Additions during the year | **-** | - | **-*** | - |
| Balance at the end of the financial year | **-** | - | **-*** | - |
| Total reserves | **-** | - | **( 6 )** | 7 |
| **(d) Retained earnings** | | | | |
| Balance at the end of previous financial year | **638** | 493 | **142** | ( 227) |
| Net total AIFRS transition adjustments (refer to note 38) | **( 7 )** | - | **( 5 )** | - |
| Adjustment for Safety Insurance at 1 July 2005 | **-** | - | **5** | - |
| Balance at the beginning of the financial year | **631** | 493 | **142** | ( 227 ) |
| **Profit attributable to equity holders of the Parent** | **702** | 587 | **759** | 811 |
| Actuarial gains / (losses) on defined benefit plans, net of tax | **-** | - | **21** | -* |
| Vesting of share based remuneration | **-** | - | **( 1 )** | - |
| Dividends declared and paid [(e)(ii)] | **( 647 )** | ( 442 ) | **( 647 )** | ( 442 ) |
| Balance at the end of the financial year | **686** | 638 | **274** | 142 |
| **Parent interest** | **3,949** | 4,440 | **3,491** | 3,917 |
| **(e) Minority interests** | | | | |
| Balance at the end of previous financial year | **-** | - | **586** | 689 |
| AIFRS transition adjustments | | | | |
| - Reclassification of minority interests in unitholders' funds [(e)(i)] | - | - | **( 421 )** | - |
| - Net impact of other AIFRS transition adjustments | - | - | **( 1 )** | - |
| Balance at the beginning of the financial year | **-** | - | **164** | 689 |
| Profit attributable to minority interests | **-** | - | **103** | 117 |
| Distributions to minority interests | **-** | - | **( 89 )** | ( 120 ) |
| Other movements in unitholders' funds | **-** | - | **-** | ( 100 ) |
| Business combination | **-** | - | **2** | - |
| Balance at the end of the financial year | **-** | - | **180** | 586 |
| Minority interests comprising: | | | | |
| - Share capital | **-** | - | **126** | 124 |
| - Retained earnings | **-** | - | **54** | 41 |
| - Foreign currency translation reserve | **-** | - | **-*** | - |
| - Unitholders' funds | **-** | - | **-** | 421 |
| **Minority interests** | **-** | - | **180** | 586 |
| **Total equity** | **3,949** | 4,440 | **3,671** | 4,503 |

* Rounds to zero.

**Note 24. Reconciliation of total equity (continued)**

(i) These reconciliation adjustments arose from the election to not restate comparatives for certain accounting standards as allowed upon first time adoption of AIFRS. Refer to note 38 for further details.

(ii) Prior to 1 July 2005 the distributions on reset preference shares were included as dividends. From 1 July 2005 onwards the distributions are treated as finance costs and in this reconciliation are included in profit attributable to equity holders of the Parent. Refer to note 38 for further details. Refer to note 23 for further details regarding the instruments.

**(f) Notes to sections (a) to (e) above**

(i) Share capital

All ordinary shares on issue are fully paid and have no par value (the concepts of authorised capital and par value have been abolished under Australian law). Ordinary shares entitle the holder to a vote at a general meeting of the Company and to participate in the dividends and the proceeds on winding up the Company in proportion to the number of, and amounts paid on, the shares held. Dividends, if declared, are subject to there being distributable profits available and not breaching APRA capital adequacy requirements. Reset preference shares rank before ordinary shares in the event of the Parent being wound up and distributions on reset preference shares are paid in priority to any dividends on ordinary shares.

(ii) Treasury shares held in trust

Share based remuneration is provided in different forms to eligible employees and directors. To satisfy obligations under the various share based remuneration plans, shares are generally bought on-market at or near grant date of the relevant arrangement and held in trust. Upon consolidation of the trusts, the shares held are recognised as treasury shares held in trust, as described in note 1(ee). The balance of treasury shares held in trust at a reporting date represents the cumulative cost of acquiring IAG shares that have not yet been distributed to employees as share based remuneration.

(iii) Nature and purpose of reserves

*Foreign currency translation reserve*
The foreign currency translation reserve records the foreign currency differences arising from the translation of the financial position and performance of subsidiaries that have a functional currency other than Australian dollars.

*Hedging reserve*
The hedging reserve is used to record gains or losses on derivatives that form part of hedging relationships which have been designated as cash flows hedges or net investment hedges, as described in note 1(q).

*Share based remuneration reserve*
The share based remuneration reserve is used to recognise the fair value at grant date of equity-settled share based remuneration provided to employees and directors over the vesting period, as described in note 1(z).

*Other reserve*
Some of the overseas subsidiaries are required for various regulatory and legal purposes to set aside reserves from their retained earnings. These reserves are not able to be used in the normal course of business.

(iv) Minority interests

Minority interests represent the proportion of equity holders' equity that is attributable to minority shareholders. Minority interests relates to Insurance Manufacturers of Australia Pty Limited (Australia), World Class Accident Repairs (Cheltenham North) Pty Limited (Australia), Mutual Community General Insurance Proprietary Limited (Australia), Mike Henry Travel Insurance Limited (New Zealand), NHCT Limited (Thailand), and Safety Insurance Public Company Limited (Thailand). Prior to 1 July 2005, minority interests also related to IAG Asset Management Cash Management Trust, IAG Asset Management Private Equity Trust, and IAG Asset Management Fund of Hedge Fund, however the third party interest in those trusts is now presented as a liability on the balance sheet. The change in treatment arose from the election to not restate comparatives for certain accounting standards as allowed upon first time adoption of AIFRS. Refer to note 38 for further details.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

| | PARENT | | CONSOLIDATED | |
|---|---|---|---|---|
| | **2006** | 2005 | **2006** | 2005 |
| **Note 25. Notes to the cash flow statements** | **$m** | $m | **$m** | $m |
| **(a) Composition** | | | | |
| Cash and cash equivalents | **1** | 1 | **718** | 456 |

Cash and cash equivalents comprises cash at bank and on hand and short term deposits. The net carrying amount of cash and cash equivalents is equivalent to the fair value of the assets because of the negligible credit risk and frequent repricing. There are no cash balances held that are not available for use in normal operations.

The carrying amount of the cash and cash equivalents presented on the balance sheet is the same as that used for the purposes of the cash flow statements as there are no bank overdrafts used which are repayable upon demand.

**(b) Reconciliation of profit for the year to net cash flows from operating activities**

| | PARENT 2006 $m | PARENT 2005 $m | CONSOLIDATED 2006 $m | CONSOLIDATED 2005 $m |
|---|---|---|---|---|
| Profit for the year | **702** | 587 | **862** | 928 |
| Depreciation of property, plant and equipment | **-** | - | **47** | 35 |
| Amortisation of intangibles | **-** | - | **8** | 13 |
| Realised gains on disposal of investments | **-** | - | **( 148 )** | ( 221 ) |
| Unrealised gains on revaluation of investments | **-** | - | **( 295 )** | ( 344 ) |
| Loss on disposal of property, plant and equipment | **-** | - | **4** | - |
| Foreign exchange (gains) and losses | **-** | - | **34** | 27 |
| Provision for impairment | **-** | - | **1** | 1 |
| Other | **2** | - | **31** | ( 21 ) |
| Decrease / (increase) in operating assets: | | | | |
| Premium and other receivables | **58** | ( 73 ) | **155** | ( 252 ) |
| Prepayments and deferred levies and expenses | **-** | - | **( 4 )** | ( 67 ) |
| Deferred tax assets | **( 1 )** | 7 | **( 18 )** | ( 86 ) |
| Increase / (decrease) in operating liabilities: | | | | |
| Trade and other payables | **12** | ( 140 ) | **( 77 )** | 74 |
| Provisions | **-** | - | **( 9 )** | 78 |
| Current tax liabilities | **( 77 )** | ( 3 ) | **( 117 )** | ( 29 ) |
| Deferred tax liabilities | **-** | 53 | **16** | 160 |
| Outstanding claims liability | **-** | - | **43** | 511 |
| Unearned premium liability | **-** | - | **( 146 )** | 114 |
| Net cash flows from operating activities | **696** | 431 | **387** | 921 |

**(c) Significant non-cash transactions relating to financing and investing transactions**

There were no financing or investing transactions during the year which have had a material effect on the assets and liabilities that did not involve cash flows.

**Note 26. Acquisitions and disposals of businesses**

There were no acquisitions or disposals of businesses by the Parent during the year (2005 – none). The following acquisitions and disposals of businesses relate to the Consolidated entity.

**2006**

**(a) Acquisition of subsidiaries**

(i) Acquisition of a Thailand based general insurance business

The Consolidated entity acquired all of the ordinary shares in IAG Insurance (Thailand) Ltd ("IAG Thailand") (formerly Royal and Sun Insurance Alliance (Thailand) Ltd) effective 4 July 2005. This subsidiary is involved in general insurance underwriting in Thailand.

The key changes made to bring the financial report of IAG Thailand prepared in accordance with Thai GAAP in line with the significant accounting policies of the Consolidated entity related to an analysis of all insurance products on offer to confirm the status as insurance contracts, the measurement of all investments at fair value through profit or loss, and the alignment of reserving policies. After those adjustments were made, there were no significant fair value adjustments required.

(ii) Acquisition of a further interest in a Thailand based listed general insurance business

On 10 February 2006, an additional 16.7% interest was acquired in Safety Insurance Public Company Limited ("Safety Insurance") taking the then 21.6% shareholding to 38.3%. A general tender offer to all Safety Insurance shareholders was subsequently lodged at the end of February 2006. The tender closed on the 27 March 2006 with the Consolidated entity holding 96.09% of the voting share capital. The entity has been deemed to be a subsidiary from 31 March 2006.

Safety Insurance, which has been listed on the Stock Exchange of Thailand since 1977, is Thailand's 7th largest general insurer and 6th largest motor insurer and currently generates approximately A$100 million in gross written premium per annum. Providing predominantly motor insurance, as well as fire, marine and other general insurance, Safety Insurance distributes its products through insurance agents and brokers, as well as selling direct to customers.

The key changes made to bring the financial report of Safety Insurance prepared in accordance with Thai GAAP to comply with the significant accounting policies of the Consolidated entity related to an analysis of all insurance products on offer to confirm the status as insurance contracts, the measurement of all investments at fair value through profit or loss, and the alignment of reserving policies. After those adjustments were made, there were no significant fair value adjustments required.

(iii) Acquisition of a specialist New Zealand underwriter

On 3 May 2006 IAG New Zealand Limited acquired a 51% share of Driveright Limited, a specialist underwriter of mechanical breakdown insurance in New Zealand, with a contractual obligation, subject to certain criteria being satisfied, to acquire the remaining 49% on or before 31 August 2008.

**Note 26. Acquisitions and disposals of businesses (continued)**

**(a) Acquisition of subsidiaries (continued)**

| | CONSOLIDATED | | |
|---|---|---|---|
| Details of the 2006 acquisitions of subsidiaries are as follows: | **Driveright** | **Safety Insurance** | **IAG Insurance (Thailand)** |
| | **$m** | **$m** | **$m** |
| Purchase price: | | | |
| Cash paid | **4** | **68** | **34** |
| Costs directly associated with acquisition | **-** | **2** | **2** |
| Total purchase consideration | **4** | **70** | **36** |
| Fair value of net identifiable assets acquired: | | | |
| Cash and cash equivalents | **2** | **10** | **6** |
| Investments | **-** | **107** | **18** |
| Receivables | **-** | **30** | **22** |
| Deferred acquisition costs | **-** | **-** | **1** |
| Property, plant and equipment | **-** | **9** | **1** |
| Deferred tax assets | **-** | **8** | **-** |
| Payables | **( 1)** | **( 19)** | **( 18)** |
| Current tax liabilities | **-** | **( 3)** | **( 1)** |
| Unearned premium liability | **-** | **( 58)** | **( 5)** |
| Outstanding claims liability | **-** | **( 30)** | **( 14)** |
| Less: minority interests | **-** | **( 2)** | **-** |
| Less: transfer of associate to subsidiary | **-** | **( 11)** | **-** |
| Net identifiable assets acquired during the financial year | **1** | **41** | **10** |
| Goodwill* | **3** | **29** | **21** |
| Intangible | **-** | **-** | **5** |
| | **3** | **29** | **26** |

* The goodwill on Safety Insurance includes the goodwill amount on the first acquisition in 1998 (which rounded to zero).

The goodwill is attributable to the synergies expected to arise after the acquisition. The fair value of assets and liabilities are based on discounted cash flow models. No restructuring provisions were created. In addition to the intangible assets recognised and disclosed in the table above, there are other intangible benefits that have been acquired as part of the transactions. These benefits have not been recognised separately from goodwill because they were not separately recognisable and/or were not able to be reliably measured.

The net cash flow in relation to the acquisitions is as follows:

| | | | |
|---|---|---|---|
| Cash consideration paid | **4** | **70** | **36** |
| Cash balance acquired | **( 2)** | **( 10)** | **( 6)** |
| Net outflow of cash | **2** | **60** | **30** |

Contribution from the acquired businesses (from date of acquisition):

| | | | |
|---|---|---|---|
| Income | **-** | **28** | **37** |
| Profit before income tax | **-** | **1** | **1** |

The gross written premium and profit of the Consolidated entity for the year ended 30 June 2006 would have been higher by $63 million and $3 million respectively, had the subsidiaries acquired during the year been consolidated from the beginning of the financial year.

**Note 26. Acquisitions and disposals of businesses (continued)**

**(a) Acquisition of subsidiaries (continued)**

2005
During the year ended 30 June 2005 the consolidated entity made the following acquisitions:
- Mike Henry Travel Insurance Limited: 50.1% acquired on 6 July 2004 for $4 million with a contractual obligation to purchase remaining equity on or before 1 July 2006;
- Clipper Club Underwriters Limited: 100% acquired on 1 January 2005 for $1 million; and
- National Auto Club Underwriters Agency (NZ) Limited: 100% acquired on 1 January 2005 for $6 million.

The total outlay for these acquisitions in 2005 (net of cash acquired) was $7 million. As these acquisitions are not significant to the Consolidated entity no further disclosure is provided.

**(b) Other acquisitions**

(i) Acquisition of an interest in a Malaysian based composite insurance business

On 31 March 2006, the Consolidated entity acquired a 30% strategic stake in AmAssurance Berhad, a Malaysian based general and life insurer. Based on the annual report for the year ended 31 March 2006 prepared under Malaysian generally accepted accounting principles, AmAssurance Berhad had gross assets of RM1,783 million (approximately A$653 million). The general insurance operations generate an annual gross written premium of RM438 million (approximately A$161 million).

(ii) Lloyd's managing agency and specialist Asian syndicate

In June 2006, the Consolidated entity agreed to acquire a newly-formed Lloyd's managing agency and specialist Asian syndicate to support the development and management of its expanding Asian business. The businesses operate as Alba Group Pte Limited (Alba) and have been newly established. The syndicate has access to all markets in which Lloyd's is licensed. The terms of the acquisition are confidential but neither the purchase price nor the capital required in the first two years from completion is material to the Consolidated entity. A letter of credit was issued in support of the Consolidated entity's participation. The terms of the acquisition are subject to final regulatory approval from the relevant regulatory authorities in Singapore and the United Kingdom.

**(c) Disposals of subsidiaries**

During the year the Consolidated entity disposed of New Zealand Car Parts Limited. As this disposal was not significant to the consolidated entity no further disclosure is provided.

There were no disposals of businesses by the Consolidated entity during the year ended 30 June 2005.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

## Note 27. Details of subsidiaries

The following entities constitute the Consolidated entity:

| | Notes | Country of incorporation/ formation | Extent of beneficial interest if not 100% | |
|---|---|---|---|---|
| | | | **2006** | 2005 |
| **Ultimate parent** | | | **%** | % |
| Insurance Australia Group Limited | | Australia | **n/a** | n/a |
| **Subsidiaries** | | | | |
| *Australian general insurance operations* | | | | |
| Insurance Australia Limited | | Australia | | |
| NRMA Personal Lines Holdings Pty Limited | | Australia | | |
| Insurance Manufacturers of Australia Pty Limited | | Australia | **70.00** | 70.00 |
| World Class Accident Repairs (Cheltenham North) Pty Limited | | Australia | **70.00** | 70.00 |
| CGU Insurance Australia Limited | | Australia | | |
| CGU Insurance Limited | | Australia | | |
| Swann Insurance (Aust) Pty Ltd | | Australia | | |
| Mutual Community General Insurance Proprietary Limited | | Australia | **51.00** | 51.00 |
| NZI Insurance Australia Limited | | Australia | | |
| Sitrof Australia Limited | | Australia | | |
| CGU-VACC Insurance Limited | | Australia | | |
| CGU Workers Compensation (NSW) Limited | | Australia | | |
| CGU Workers Compensation (VIC) Limited | | Australia | | |
| CGU Workers Compensation (SA) Limited | | Australia | | |
| CGU Premium Funding Pty Ltd | | Australia | | |
| *International operations* | | | | |
| IAG International Pty Limited | | Australia | | |
| IAG (NZ) Holdings Limited | C | New Zealand | | |
| IAG New Zealand Limited | C,F | New Zealand | | |
| Mike Henry Travel Insurance Limited | C | New Zealand | **50.10** | 50.10 |
| National Auto Club Underwriters Agency (NZ) Limited | C | New Zealand | | |
| Clipper Club Underwriters Limited | C | New Zealand | | |
| Driveright Limited | B | New Zealand | **51.00** | - |
| New Zealand Insurance Limited | C | New Zealand | | |
| State Insurance Limited | C | New Zealand | | |
| Direct Insurance Services Limited | C | New Zealand | | |
| Swann Insurance (NZ) Limited | C | New Zealand | | |
| IAG (NZ) Share Plan Nominee Limited | C | New Zealand | | |
| The IAG New Zealand Limited Employee Share Plan | C,E | New Zealand | | |
| The IAG Performance Awards Rights Plan for Executives in New Zealand | C,E | New Zealand | | |
| NZI Staff Superannuation Fund Nominees Limited | C | New Zealand | | |
| Belves Investments Limited | C | New Zealand | | |
| IAG Re Limited | C | Ireland | | |
| IAG (Asia) General Pte Ltd | C | Singapore | | - |
| IAG (Asia) Services Pte Ltd | C | Singapore | | - |
| IAG (Asia) Holdings Pte Ltd | C | Singapore | | - |
| NHCT Limited | (ii), C | Thailand | **49.00** | 49.00 |
| IAG Insurance (Thailand) Ltd | (iii), C,D | Thailand | | |
| Safety Insurance Public Company Limited | (iv), B,D | Thailand | **96.09** | 21.60 |
| IAG Re Labuan (L) Berhad | C | Malaysia | | |
| Beijing Continental Automobile Association Limited | C,D | China | | |
| IAG China (Mauritius) | C | Mauritius | | - |
| China Investments (Mauritius) | C | Mauritius | | - |
| *Investment operations* | | | | |
| IAG Asset Management Limited | | Australia | | |
| IAG Nominees Pty Limited | | Australia | | |
| IAG Portfolio Limited | | Australia | | |
| IAG Asset Management Cash Management Trust | (i) | Australia | **62.30** | 72.54 |
| IAG Asset Management Private Equity Trust | (i) | Australia | **83.18** | 82.85 |
| IAG Asset Management Fund of Hedge Funds | (i) | Australia | | |

**Note 27. Details of subsidiaries (continued)**

| | Notes | Country of incorporation / formation | Extent of beneficial interest if not 100% 2006 | 2005 |
|---|---|---|---|---|
| | | | **%** | % |
| **Subsidiaries (continued)** | | | | |
| *Corporate operations* | | | | |
| NRMA Information Services Pty Limited | | Australia | | |
| NRMA Insurance Funding 2003 Limited | | Australia | | |
| IAG Finance (New Zealand) Limited | | Australia | | |
| Insurance Australia Group Services Pty Limited | | Australia | | |
| IAG & NRMA Superannuation Pty Limited | A | Australia | | |
| IAG Share Plan Nominee Pty Limited | A | Australia | | |
| The IAG Share and Performance Award Rights Plan Trust | E | Australia | | |
| ACN 007 078 140 Pty Limited | A | Australia | | |
| *Subsidiaries that commenced deregistration after the year ended 30 June 2006* | | | | |
| Sitrof Life Holdings Limited | | Australia | | |
| Sitrof Superannuation Pty Ltd | | Australia | | |
| *Subsidiaries that commenced deregistration during the year ended 30 June 2006* | | | | |
| SWAPL Pty Limited | A | Australia | | |
| *Entities de-registered during the year ended 30 June 2006* | | | | |
| ACN 069 065 158 Pty Limited | A | Australia | - | |
| *Entities disposed of during the year ended 30 June 2006* | | | | |
| New Zealand Car Parts Limited | C | New Zealand | - | |

General notes relating to a number of subsidiaries

A Small proprietary companies that are not required to prepare, and have not prepared, audited financial statements.
B Audited by accounting firms not affiliated with KPMG.
C Audited by overseas KPMG firms.
D All subsidiaries have a 30 June financial year end, except these companies which have a 31 December year end. These entities have been consolidated using financial information as at 30 June.
E These entities have been deemed to be controlled for the first time under AIFRS. Refer note 38.
F All subsidiaries have only ordinary shares on issue except this entity also has perpetual preference shares on issue.

The following special conditions exist with respect to certain subsidiaries

(i) As at the reporting date, the Consolidated entity has a majority holding, is the Responsible Entity for, and has the capacity to control, IAG Asset Management Cash Management Trust, IAG Asset Management Private Equity Trust and IAG Asset Management Fund of Hedge Funds.

(ii) IAG International Pty Limited owns 49% of the share capital of NHCT Limited and has a majority voting right and the right to appoint the board of directors of NHCT Limited. Therefore, NHCT Limited is considered a subsidiary of IAG International Pty Limited. The remaining 51% is held by Allessi Capital Co., Ltd, a company registered in Thailand.

(iii) IAG International Pty Limited owns 25% directly in IAG Insurance (Thailand) Ltd and is able to govern the financial and operating policies of the company through a further 75% interest held indirectly through its holding in NHCT Limited.

(iv) During the year, a controlling interest was acquired in Safety Insurance Public Company Limited. For the comparative period, a strategic investment was held in the company of 21.6% of the issued capital carrying voting rights.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

## Note 28. Details of joint ventures and associates

### (a) Interests in the joint ventures and associates

| | Notes | Reporting date | Country of formation | Carrying value 2006 | Principal activity | Ownership interest 2006 | Ownership interest 2005 |
|---|---|---|---|---|---|---|---|
| | | | | $m | | % | % |
| Joint venture | | | | | | | |
| NTI Limited | (i), A,C | 31 December | Australia | **2** | Managing co-insurance arrangement | **50.00** | 50.00 |
| Associates | | | | | | | |
| AmAssurance Berhad | C | 31 March | Malaysia | **71** | Insurance underwriting | **30.00** | - |
| First Rescue and Emergency (NZ) Limited | A,C | 31 March | New Zealand | **1** | Roadside assistance | **50.00** | 50.00 |
| Loyalty New Zealand Limited | A,C | 31 March | New Zealand | **-*** | Loyalty programme | **25.00** | 25.00 |
| Sureplan NZ Limited | A,C | 31 March | New Zealand | **-*** | Fleet risk management | **30.00** | 30.00 |
| AR Hub Pty Ltd | A,B | 30 June | Australia | **-*** | Software development | **33.33** | 33.33 |
| | | | | **74** | | | |

*Amounts round to zero.

General notes relating to a number of joint ventures and associates

A Investment is measured at cost in the Consolidated entity due to materiality.
B Small proprietary companies that are not required to prepare, and have not prepared, audited financial statements.
C Audited by accounting firms not affiliated with KPMG.

None of the associates are listed on a stock exchange. Those entities that are equity accounted and that do not have a 30 June financial year end are equity accounted for using financial information for the year to 30 June which includes, at least in part, unaudited management results.

The following special conditions exist with respect to the joint venture

(i) CGU Insurance Limited, a subsidiary of the Consolidated entity, has a 50% interest in NTI Limited, the principal activity of which is to facilitate a co-insurance arrangement of commercial motor vehicle business. The Consolidated entity's portion of the results of the co-insurance arrangement is recorded directly in its accounting records.

| | CONSOLIDATED 2006 | CONSOLIDATED 2005 |
|---|---|---|
| | **$m** | $m |
| **(b) Reconciliation of movements in investment in joint ventures and associates for the financial year** | | |
| Balance at the beginning of the financial year | **8** | 8 |
| Adjustment for Safety Insurance at 1 July 2005 | **5** | - |
| Balance at the beginning of the financial year | **13** | 8 |
| Investment in associate acquired during the financial year | **73** | - |
| Share of associate's net profit | **2** | - |
| Associate transferred to subsidiary | **( 11 )** | - |
| Foreign currency exchange movements | **( 3 )** | - |
| Balance at the end of the financial year | **74** | 8 |

| | CONSOLIDATED | |
|---|---|---|
| | **2006** | 2005 |
| **Note 28. Details of joint ventures and associates (continued)** | **$m** | $m |
| **(c) Share of associate's profit for the financial year** | | |
| Profit before and after income tax | **2** | - |

The following disclosures relate only to the investment in AmAssurance, as all other investments in joint ventures and associates are not significant.

**(d) Summarised financial information of associate**

These disclosures relate only to the investment in AmAssurance, as all other investments in joint ventures and associates are not significant.

| | 2006 | 2005 |
|---|---|---|
| Assets | **653** | - |
| Liabilities | **590** | - |
| Revenue * | **317** | - |
| Profit * | **14** | - |

* These amounts are for the year ended 31 March 2006, being the financial year of AmAssurance, and not the period during which the entity was an associate. These amounts have been extracted from the audited financial report of AmAssurance.

**(e) Commitments and contingent liabilities**

There are no capital or other commitments or contingent liabilities arising from the investment in AmAssurance that are significant to the Consolidated entity.

| | Notes | CONSOLIDATED 2006 | 2005 |
|---|---|---|---|
| | | **$m** | $m |
| **Note 29. Employee benefits** | | | |
| **(a) Employee benefits provision** | | | |
| Annual leave | | **75** | 70 |
| Long service leave | | **56** | 49 |
| Cash based incentive arrangements | | **72** | 74 |
| Defined benefit pensions (i) | | **11** | 13 |
| Defined benefit superannuation plans (ii) | 31 | **( 7 )** | 23 |
| | | **207** | 229 |

(i) There is one defined benefit pension arrangement in Australia with a discounted liability as at 30 June 2006 of $8 million (2005 - $9 million) involving 86 participants (2005 – 93), and one defined benefit pension arrangement in New Zealand with a discounted liability as at 30 June 2006 of $3 million (2005 - $4 million) involving 52 participants (2005 - 55). These liabilities are met from the general assets of the relevant entities rather than assets being set aside in trust. Further details are not disclosed, as the financial impact of these arrangements is not significant to the Consolidated entity.

(ii) The 30 June 2006 amount for defined benefit superannuation plans represents an asset that should be presented separately on the balance sheet but is included here to align with the presentation of the comparative as the amount is not significant.

The carrying value of employee benefits includes $38 million (2005 - $67 million) which is expected to be settled after more than twelve months from reporting date.

**(b) Employee numbers**

The Consolidated entity had 12,093 employees on full time equivalent basis as at 30 June 2006 (2005 - 11,502).

**(c) Cash based incentive arrangements**

(i) Short-term incentive plan

The short-term incentive plan continued in operation during the year ended 30 June 2006. Eligible employees have the capacity to earn a proportion of their base pay (generally up to 10%, 15%, 20%, 30% or 45%) depending on an employee's role and responsibilities, as a cash incentive annually. The incentive payments are determined based on a range of corporate, divisional and individual measures and goals.

Employees, with maximum incentives of 20% and over, may elect to receive up to a maximum of 50% of their short-term incentive plan benefit in the form of IAG shares rather than cash through the related bonus equity share plan. The plan facilitates the voluntary election to receive part of a bonus in the form of IAG shares and does not represent an additional remuneration benefit to the employee. The acquisition of the shares is funded by the participating employee's remuneration. There are no vesting conditions attached to the shares provided, there are limited forfeiture conditions, and they carry full dividend entitlements and voting rights from the time of allocation. The shares are purchased on market and held in trust subject to a restriction period for tax purposes of between one and ten years (nominated by the participating employee) or until such time as the participating employee ceases relevant employment, whichever is earlier, after which they are released to the employee.

(ii) IMA long-term incentive scheme

A long-term incentive is provided to relevant Insurance Manufacturers of Australia Pty Limited ("IMA") personnel split evenly between two components. One component comprises an equity settled share based payment through the performance award rights plan (refer note 30(a)). The other component is a cash based incentive arrangement involving a hurdle relating to compound growth in the IMA underwriting result. Each participant may elect to receive the cash based incentive payment, if any, in the form of cash, superannuation contributions, or a combination of these.

**Note 30. Share based remuneration**

The provision of share based remuneration creates a link between shareholder value creation, financial performance and rewarding employees. Share based remuneration encourages employee share ownership, links employee reward to the performance of the IAG Group and assists with retention of key personnel. This type of remuneration aims to focus performance so that over the longer term shareholder value will increase.

The obligations under share based payment arrangements are covered by the on-market purchase of IAG ordinary shares which are held in trust. The shares are purchased on or near grant date at the prevailing market price. The arrangements are managed using in-house trusts, one for Australia and two for New Zealand, which are controlled for accounting purposes and so are subsidiaries of the Consolidated entity. The trustee for each trust is a subsidiary of the Consolidated entity. The trusts are administered by an external company.

The number of shares purchased to cover each tranche is determined by the trustee based on independent actuarial advice. The trusts allow for excess shares purchased in relation to one plan to be used to meet obligations of the other plans at the trustee's discretion. The trusts held 9,399,771 shares as at 30 June 2006 (2005 – 9,090,114 shares) representing 0.59% (2005 - 0.57%) of the share capital. This includes shares that are not controlled for accounting purposes and so not recognised as treasury shares.

Trading in IAG shares that are awarded under the share based remuneration arrangements is covered by the same restrictions that apply to all forms of share ownership by employees. These restrictions limit an employee trading in IAG shares where they are in a position to be aware, or are aware, of price sensitive information.

Share based remuneration is provided through three different plans each of which have different purposes and different rules. A further plan, the Performance Share Rights Plan (refer below), closed for further new rights issues during the year ended 30 June 2003, and had an insignificant impact on the current financial year. The share based remuneration expense amounts are included in the claims expense, other underwriting expenses, and corporate, administration and other expenses lines in the income statement.

**(a) Performance award rights ("PARs") plan**

The PARs Plan continued in operation during the year ended 30 June 2006. There are effectively two plans in operation, one for Australia and one for New Zealand, however the structure of the plans is the same. The rights are granted for nil consideration, are non-transferable, and can be settled only with existing IAG shares. Where the rights vest (the holder becomes entitled to exercise the right), the plan entitles participating employees to acquire one IAG ordinary share for each right. The exercise price for all rights is a nominal value of $1 per tranche of rights exercised. Holders do not receive dividends and do not have voting rights until the rights are exercised. IAG shares are bought on-market and held in trust to satisfy future exercise of the rights.

**Note 30. Share based arrangements (continued)**

**(a) Performance award rights ("PARs") plan (continued)**

The rights may vest between three and five years (the performance period) from base date (calculation date selected for each tranche) subject to the satisfaction of two vesting conditions. The first vesting condition is not market related and requires the participant to continue in relevant employment. The second vesting condition is a market related performance hurdle based on a comparison of IAG's total shareholder return ("TSR", the measure of return on an investment in IAG ordinary shares) with the TSR of a peer group of companies in the S&P/ASX 100 index. The peer group includes insurers and non-insurers because the IAG Group competes for investment funds with a range of large listed companies across many industries. For the performance hurdle, a tiered vesting scale is applied, such that the percentage of allocated rights that vest increases proportionately as IAG's TSR performance increases from the 50th percentile to the 75th percentile of the peer group. Below the 50th percentile no rights vest while at or above the 75th percentile all of the rights vest. Testing for the satisfaction of the performance hurdle generally occurs quarterly during the performance period.

There are additional circumstances in which the rights may vest such as a takeover of IAG. If either of the vesting conditions is not met then the rights lapse. The rights also lapse where the holder chooses to forego the rights, and all rights expire ten years from grant date where they have not previously lapsed or been exercised.

The following information relates to rights issued under the PARs Plan:

| Grant date | Fair value at grant date | Rights on issue at beginning of year | Rights granted during year | Rights exercised during year | Rights lapsed during year | Number of rights at end of year On issue | Exercisable |
|---|---|---|---|---|---|---|---|
| 24/12/2002 | $1.870 | 3,820,592 | - | 1,602,050 | 29,928 | 2,188,614 | 523,047 |
| 22/09/2003 | $2.840 | 4,008,978 | - | - | 95,509 | 3,913,469 | - |
| 10/12/2003 | $2.764 | 400,000 | - | - | - | 400,000 | - |
| 26/03/2004 | $3.287 | 948,758 | - | - | 6,972 | 941,786 | - |
| 17/09/2004 | $2.715 | 4,238,000 | - | - | 112,000 | 4,126,000 | - |
| 30/11/2004 | $2.718 | 905,500 | - | - | - | 905,500 | - |
| 30/03/2005 | $3.269 | 41,000 | - | - | - | 41,000 | - |
| 19/09/2005 | $3.187 | - | 4,561,500 | - | 61,500 | 4,500,000 | - |
| 30/11/2005 | $2.596 | - | 705,500 | - | 12,500 | 693,000 | - |
| 22/03/2006 | $3.145 | - | 189,000 | | - | 189,000 | - |
| | | 14,362,828 | 5,456,000 | 1,602,050 | 318,409 | 17,898,369 | 523,047 |

The fair value of the rights is calculated as at the grant date using the Monte Carlo valuation methodology. The valuations take into account the probability of achieving the market related performance hurdle. For those rights granted during the year to 30 June 2006, the following significant factors and assumptions were used:

| | | | |
|---|---|---|---|
| Grant date | 19/09/2005 | 30/11/2005 | 22/03/06 |
| Share price on grant date ($) | $5.42 | $5.25 | $5.43 |
| Exercise price ($) | $1 per tranche exercised | $1 per tranche exercised | $1 per tranche exercised |
| Risk free interest rate (%) | 5.63% | 5.84% | 5.74% |
| Expected share price volatility (%) | 25% | 25% | 25% |
| Expected dividend yield (%) | 4.98% | 5.14% | 5.16% |
| Expected life of rights (years) | 3.962 years | 3.884 years | 3.518 years |

Some of the assumptions, including expected share price volatility, are based on historical data which is not necessarily indicative of future trends. Reasonable changes in these assumptions would not have a material impact on the amounts recognised in the financial statements.

**Note 30. Share based arrangements (continued)**

**(b) Performance share rights ("PSRs") plan**

The PSRs plan was in operation from December 2000 and closed for further new rights issues during the year ended 30 June 2003. The following information relates to rights issued under the PSRs Plan:

| Grant date | Fair value at grant date | Rights on issue at beginning of year | Rights exercised during year | Rights lapsed during year | Number of rights at end of year On issue | Number of rights at end of year Exercisable |
|---|---|---|---|---|---|---|
| 21/12/2000 | $1.70 | - | - | - | - | - |
| 30/04/2001 | $1.67 | 336,600 | 211,600 | 20,000 | 105,000 | 105,000 |
| 02/08/2001 | $2.14 | 113,200 | 65,700 | - | 47,500 | 47,500 |
| 22/10/2001 | $1.84 | - | - | - | - | - |
| 13/12/2001 | $2.30 | 60,000 | 60,000 | - | - | - |
| 05/03/2002 | $2.68 | 306,017 | 306,017 | - | - | - |
| 15/07/2002 | $2.28 | 102,222 | 102,222 | - | - | - |
| | | 918,039 | 745,539 | 20,000 | 152,500 | 152,500 |

Further details are not disclosed because the PSRs plan is a closed plan and the financial impact of this plan is not significant.

**(c) Non-executive directors' share plan**

The non-executive director's share plan continued in operation during the year ended 30 June 2006. Non-executive Directors are required to receive at least 20%, but not in excess of 90%, of their annual base fee (at the time shares are allocated) in IAG shares, rather than in cash. Annual share allocations are generally made effective from 1 December each year. The shares vest on a pro-rata daily basis with limited forfeiture conditions and the participant is entitled to dividends and other shareholder rights during the vesting period. The on-market share price at grant date is used as the fair value of the equity instruments granted which for those granted during the current reporting period was $5.17. The shares are purchased on market and held in trust subject to a restriction period, for tax purposes, of between one and ten years. The number of shares purchased is determined by the amount of the base fee each Director is to receive in IAG shares, the weighted average market price of the shares at the date of allocation, and the trustee's discretion to use excess shares from another plan.

Further details are not disclosed as the financial impact of this plan is not significant.

**(d) Employee share plans**

There are employee share plan arrangements in place for both Australian and New Zealand employees. The employee share plans involve the granting of shares (sometimes restricted shares which are subject to a holding lock) to a substantial percentage of employees in both Australia and New Zealand, arranged through different trusts with different terms and conditions. New tranches were awarded for Australia and New Zealand in November 2005, with the previous arrangements having grant dates of 19 March 2001 for Australia and 11 October 2002 for New Zealand.

(i) Australia

During the year to 30 June 2006, a grant of 1,472,064 shares was made to 7,872 employees in Australia (187 shares to each participant). The grant date was 18 November 2005. Participation in the plan was open to employees that were not directors, that were not participants in the PARs Plan, that had completed at least twelve months service on a date set prior to the allocation date, and that remained in relevant employment on the allocation date being 18 November 2005.

The offer was predicated on exceeding a performance target based on IAG's total shareholder return for the 12 months to 30 June 2005. Eligible employees who accepted the offer received an allocation of IAG shares to the equivalent value of $1,000 based on the volume weighted average price at which IAG shares traded on the Australian stock exchange for the week up to and including the allocation date. The tranche was designed to comply with the conditions set out in the Australian tax legislation which gives permanent employees the opportunity to acquire up to $1,000 worth of shares at their tax market value in any one financial year as tax-exempt remuneration. Although the number of shares paid to each employee is determined by a cash amount, the payment is made in shares and is therefore treated as an equity settled share based payment.

**Note 30. Share based arrangements (continued)**

**(d) Employee share plans (continued)**

(i) Australia (continued)

The shares were granted for nil consideration. Shares granted under the plan vested immediately but remain held in trust on behalf of the participants subject to a restriction period of the earlier of three years from the allocation date or cessation of employment. The participants are entitled to dividends, which are paid directly to the participants, and other shareholder rights during the restriction period. The cost of acquiring the shares on-market in the days leading up to the grant was used as a proxy for the grant date fair value of the equity instruments.

Shares subscribed under this plan were purchased on-market. The full cost of purchasing the shares on-market of $8 million (including brokerage) was recognised as an expense in the year to 30 June 2006.

*Previous tranche*
Under the previous tranche of the employee share plan for Australian employees, eligible employees received an allocation of IAG shares to the value of 5% of their total salary for no consideration. The grant date for the tranche was 19 March 2001. The restricted shares were subject to a two year vesting period which ended on 19 March 2003 and a further three year restriction period which ended on 19 March 2006. Shares were purchased in 2001 to support the tranche. All of the remaining shares were transferred from the plan during the current financial year upon expiry of the restriction period. There is no expense for this tranche relevant to the year ended 30 June 2006 (2005 – $Nil) with previous expense allocations being based on an allocation of the cost to acquire the shares. The tranche will have no financial impact on future financial reporting periods.

(ii) New Zealand

During the year to 30 June 2006, a grant of 287,232 shares was made to 1,536 employees in New Zealand (187 shares to each participant). The grant date was 18 November 2005. The general terms of the offer are the same as the Australian tranche however because of the different taxation laws, the New Zealand tranche is subject to a 3 year vesting period. There remained in the plan 177,307 shares from the previous tranche which were able to be used for the current tranche and so only an additional 109,925 shares were purchased for the current tranche.

Employees that cease relevant employment before completion of the vesting period forfeit any rights to the shares. Under certain circumstances such as retirement, death or permanent disability, the vesting period may be waived. Forfeited shares may be reallocated as part of a future approved offer or disposed of at the discretion of the trustee. Dividends received on forfeited shares may, at the trustee's discretion, be used to defray costs of administering the plan. Participants are entitled to dividends and full voting rights during the vesting period.

*Previous tranche*
Under the previous tranche of the employee share plan for New Zealand employees, eligible employees received an allocation of IAG shares to the value of NZ$1,500, for nominal consideration of NZ$1. The grant date for the tranche was 11 October 2002. The shares were subject to a three year vesting period which ended on 11 October 2005 and no subsequent restriction period. Shares were purchased in 2002 to support the tranche. The final shares for the tranche that vested were transferred from the plan during the current financial year with the remaining shares being used for the new tranche. The expense incurred for this tranche relevant to the year ended 30 June 2006 was $Nil (2005 - $0.5 million) based on an allocation of the cost to acquire the shares. The tranche will have no financial impact on future financial reporting periods.

**Note 31. Superannuation**

Contributions are made to a number of superannuation plans both in Australia and New Zealand. The majority of employees are defined contribution members with fewer than 8% (2005 – 9%) of employees participating on a defined benefit basis. Entry to defined benefit plans is closed and so all new employees are provided with defined contribution arrangements. The plans provide benefits for members or their dependants in the form of lump sum or pension payments generally upon ceasing relevant employment.

The superannuation expense for the year is included in the claims expense, other underwriting expenses, and corporate, administration and other expenses lines in the income statement.

**(a) Defined contribution superannuation arrangements**

Contributions to the plans are made in accordance with the governing rules of each plan together with the Australian Superannuation Guarantee legislation and, for some plans, obligations under industry awards. The contributions are generally based on a percentage of employees' salaries.

The Consolidated entity contributed $78 million to the IAG & NRMA Superannuation Plan ("the Plan") for defined contribution members during the year (2005 - $10 million, the Plan was on contribution holiday for 11 months of the year as the governing rules of the Plan allow any surplus to be used to meet the contributions that would otherwise have been payable for both the defined benefit and defined contribution members of the Plan) and there were no employer contributions payable at the end of the year for those members (2005 - $Nil).

The Consolidated entity is not exposed to risks or rewards of the defined contribution arrangements and has no obligations beyond the payment of contributions.

**(b) Defined benefit superannuation arrangements**

Employees who are entitled to defined benefit superannuation arrangements are members of one of three superannuation plans each of which are funded plans. The defined benefit sections of those plans are closed to new members and so membership is reducing over time. Contributions to the plans are made in accordance with the governing rules of each plan and the contribution recommendations of an independent actuary. In contrast to defined contribution superannuation arrangements, the future cost of the defined benefit plans is not known with certainty in advance. The benefits received for defined benefit members are generally based on length of service and final average salary together with the member's own contributions (if any). The net positions of the plans are recognised on the balance sheet of the Consolidated entity.

Two of the plans are in New Zealand (the NZI Superannuation Fund and the IAG New Zealand Limited Staff Pension Scheme) with 23 defined benefit members as at 30 June 2006 (2005 - 32) with a combined surplus of $2.6 million (2005 - $2.4 million). These New Zealand defined benefit superannuation arrangements are not disclosed in more detail as the financial impact of these arrangements is not significant to the Consolidated entity.

All Australian employees with defined benefit superannuation arrangements are members of the Plan. The Plan had 881 defined benefit members as at 30 June 2006 (2005 – 980). The Consolidated entity has contributed to the Plan during the year in accordance with the recommendations of the actuary and has contributed $7 million for defined benefit members (2005 - $1 million, contribution holiday for 11 months of the year). There were no employer contributions payable at the end of the year (2005 – $Nil).

There are two subsidiaries in the Consolidated entity, being Insurance Australia Group Services Pty Ltd and Insurance Manufacturers of Australia Pty Limited, with employees that are defined benefit members of the Plan. While separate records are maintained for the liabilities relating to each member, there is effectively a sharing of the risks associated with the assets of the Plan. For the measurement of the net financial position of the Plan for recognition on the balance sheets of the employers sponsors, the assets of the Plan are allocated between the employers in proportion to the actuarial reserves for each entity.

**Note 31. Superannuation (continued)**

**(b) Defined benefit superannuation arrangements (continued)**

The following information relates only to the part of the Plan for employees of the Consolidated entity that are entitled to defined benefit superannuation arrangements. Actuarial valuations are performed at each reporting date by Guy Holley, BEc FIAA of Mercer Human Resource Consulting. The financial information disclosed below has been prepared in accordance with AASB 119 *Employee benefits*, except where otherwise stated:

| | **2006** | | 2005 | |
|---|---|---|---|---|
| | Number | **$m** | Number | $m |
| Number of defined benefit members | **881** | | 980 | |
| Fair value of net assets | | **191** | | 178 |
| Present value of defined benefit obligation * | | **( 186 )** | | ( 203 ) |
| Defined benefit surplus / (deficit) | | **5** | | ( 25 ) |

* Inclusive of contribution tax liability or asset

The calculation of the net financial position of the Plan under AASB 119 is different to the calculation used for determination of the funding position of the Plan (refer (ix)). While the majority of the underlying assumptions are the same, the contributions made to the Plan in accordance with the recommendations of the actuary, and in compliance with the terms of the Trust Deed, are not based on the AASB 119 net financial position. The key difference is the discount rate used. An employer can meet all of its superannuation contribution obligations and still have to recognise a liability for a net financial deficit under AASB 119.

| | **2006** | 2005 |
|---|---|---|
| | **$m** | $m |
| (i) Reconciliation of the movement in the present value of the defined benefit obligation | | |
| Defined benefit obligation at the beginning of the financial year | **200** | 189 |
| Current service cost | **9** | 9 |
| Interest cost | **8** | 10 |
| Contributions by plan participants | **2** | 1 |
| Actuarial (gains) and losses | **( 14 )** | 7 |
| Benefits paid | **( 18 )** | ( 16 ) |
| Defined benefit obligation at the end of the financial year | **187** | 200 |
| (ii) Reconciliation of the movement in the fair value of assets | | |
| Fair value of assets at the beginning of the financial year | **178** | 235 |
| Expected return on plan assets | **12** | 16 |
| Actuarial gains and (losses) | **10** | 19 |
| Contributions by employers | **7** | 1 |
| Contributions by plan participants | **2** | 1 |
| Benefits paid | **( 18 )** | ( 16 ) |
| Use of surplus to fund defined contribution members | **-** | ( 78 ) |
| Fair value of assets at the end of the financial year | **191** | 178 |

| | **2006** | 2005 |
|---|---|---|
| | **$m** | $m |
| **Note 31. Superannuation (continued)** | | |
| **(b) Defined benefit superannuation arrangements (continued)** | | |
| (iii) Reconciliation of the present value of the defined benefit obligation and the fair value of the net assets to the assets and liabilities recognised on the balance sheet | | |
| Fair value of net assets | **191** | 178 |
| Present value of funded defined benefit obligation (net discount rate) | **( 187 )** | ( 200 ) |
| Net defined benefit asset / (liability) | **4** | ( 22 ) |
| Contribution tax asset / (liability) | **1** | ( 3 ) |
| Net asset / (liability) recognised on the balance sheet | **5** | ( 25 ) |
| (iv) Items recognised from reporting date valuation | | |
| Current service cost | **8** | 9 |
| Interest cost (net of tax) | **9** | 10 |
| Expected return on plan assets | **( 12 )** | ( 16 ) |
| Actuarial (gains) and losses | **( 29 )** | - |
| Defined benefit expense | **( 24 )** | 3 |
| Accumulation contributions – employer * | **-** | 59 |
| Accumulation contributions – salary sacrifice * | **-** | 12 |
| Insurance costs and expenses (Accumulation Plan) * | **-** | 7 |
| Total net amount recognised from reporting date valuation | **( 24 )** | 81 |

* The governing rules of the Plan allow any surplus to be used to meet the contributions that would otherwise have been payable for both the defined benefit and defined contribution members of the Plan.

| | Allocation percentage | |
|---|---|---|
| | **2006** | 2005 |
| (v) Plan assets | **%** | % |
| The percentage invested in each asset class at reporting date: | | |
| Australian shares | **37.1** | 34.8 |
| Overseas shares | **25.4** | 25.1 |
| Listed property trusts | **10.2** | 10.0 |
| Fixed interest | **24.6** | 24.6 |
| Cash | **2.7** | 5.5 |

The assets of the Plan are managed by the IAG Group. The assets of the Plan do not include any shares issued by the Consolidated entity nor any property or other assets used by the Consolidated entity.

To determine the expected rate of return on assets, the actuary has considered the expected future investment returns for each major asset class net of investment tax and investment fees. These estimated returns for each asset class have been used to calculate the expected rate of return on the assets supporting the defined benefits based on the Plan's target asset allocation and allowing for correlations of the investment returns between asset classes. The actual return on Plan assets for the year ended 30 June 2006 was 15.6% (2005 – 11.9%).

**Note 31. Superannuation (continued)**

**(b) Defined benefit superannuation arrangements (continued)**

(vi) Actuarial assumptions

Assumptions used in the determination of the financial position of the Plan are reviewed annually and determined in conjunction with the independent actuaries to the Plan. The principal actuarial assumptions used in determining the financial position of the Plan include:

| | **2006** | 2005 |
|---|---|---|
| | **%** | % |
| Discount rate (gross) / (net) * | **5.1 / 4.3** | 5.9 / 5.0 |
| Expected rate of return on plan assets supporting pension liabilities | **7.4** | 7.4 |
| Expected rate of return on other plan assets | **6.9** | 6.9 |
| Expected future salary increases | **4.0** | 4.0 |
| Future pension increases – adult / child | **2.5 / 0.0** | 2.5 / 0.0 |

* The discount rate has been determined by reference to the market yields on government bonds.

(vii) Sensitivity of measurement to actuarial assumptions

The superannuation arrangements are by nature long term. The majority of the assumptions reflect this and are not changed to reflect short term variations in factors. The discount rate required to be applied must reflect the market yields on government bonds and so is subject to change if those yields change. A one percent reduction in the discount rate would result in a $17 million increase in the present value of the defined benefit obligation of the Plan and result in the net financial surplus becoming a $20 million deficit.

(viii) Historical information

The experience adjustments are as follows:

| | **2006** | | 2005 | |
|---|---|---|---|---|
| | **$m** | **%** | $m | % |
| Plan liabilities | **6** | **3.3** | 6 | 3.2 |
| Plan assets | **10** | **5.4** | 19 | 10.7 |

The experience adjustments are based on the actuarial gain or loss after removing the impact of any change in assumptions.

**Note 31. Superannuation (continued)**

**(b) Defined benefit superannuation arrangements (continued)**

(ix) Funding obligations

The financial information disclosed below has been determined in accordance with AAS25 *Financial Reporting by Superannuation Plans*, using the Attained Age Actuarial Funding method.

| | **2006** | 2005 |
|---|---|---|
| | **$m** | $m |
| Net market value of plan assets | **190** | 177 |
| Present value of accrued benefits | **( 161 )** | ( 161 ) |
| Defined benefit surplus / (deficit) | **29** | 16 |
| Vested benefits | **151** | 150 |

| | **2006** | 2005 |
|---|---|---|
| | **%** | % |
| Contribution recommendation current at the end of the financial year | **15.3** | 15.3 |
| It is estimated that the employer contributions to the Plan for defined benefit members for the year to 30 June 2007 will be $7 million. | | |
| The principal actuarial assumptions used in determining the financial position of the Plan in accordance with AAS 25 and the funding recommendation include: | | |
| Expected investment returns – pension assets / other assets | **7.5 / 7.0** | 7.5 / 7.0 |
| Expected future salary increases | **4.0** | 4.0 |
| Future pension increases – adult / child | **2.5 / 0.0** | 2.5 / 0.0 |

The accrued benefits are determined on the basis of the present value of expected future payments that arise from membership up to the measurement date. The accrued benefits are determined by reference to expected future salary levels and are discounted by using a market-based, risk-adjusted discount rate. Vested benefits are the benefits which would be payable to members if they all voluntarily resigned as at the reporting date.

Assumptions used in the determination of the financial position of the Plan are reviewed annually and determined in conjunction with the independent actuary to the Plan. Changes in financial and/or demographic assumptions, or changes in the relevant regulatory environment, could significantly impact the financial position of the Plan. The financial position of the Plan is calculated at a specific point in time, however the superannuation arrangements are by nature long term. Short term variations between long term actuarial assumptions and actual experience will cause the net funding status of the Plan to change without impacting on the long term viability of the Plan.

The contribution recommendation uses a different actuarial methodology and a different discount rate assumption to that used in determining the financial position for measurement on the balance sheet of the employer sponsor. In determining the contribution recommendation, the actuarial valuation method focuses on the funding of benefits for current members, irrespective of whether they stem from past or future membership, whereas, for financial reporting purposes, the present value of expected future benefit payments does not include benefits that have not yet accrued. The difference in methodologies used for determining the employer contributions and the measurement of the asset/liability recognised on the balance sheet mean that a liability may be recognised even where the employer has met all of the superannuation contribution obligations.

| | CONSOLIDATED | |
|---|---|---|
| | **2006** | 2005 |
| | **$m** | $m |
| **Note 32. Commitments** | | |
| Commitments are not recorded on the balance sheet but are disclosed here at their face value. | | |
| **(a) Capital commitments** | | |
| Property | | |
| - due within 1 year | **3** | 5 |
| **(b) Operating lease commitments** | | |
| Property | | |
| - due within 1 year | **81** | 89 |
| - due within 1 to 2 years | **65** | 85 |
| - due within 2 to 5 years | **56** | 112 |
| - due after 5 years | **24** | 21 |
| Plant and equipment | | |
| - due within 1 year | **12** | 34 |
| - due within 1 to 2 years | **7** | 24 |
| - due within 2 to 5 years | **5** | 7 |
| | **250** | 372 |

Certain property, motor vehicles and computer equipment are leased under non-cancellable operating leases. Most leases are subject to annual reviews with increases subject to a set percentage or based on either movements in consumer price indices or operating criteria. Where appropriate, a right of renewal has been incorporated into the lease agreements at which time all terms and conditions may be renegotiated. There are no options to purchase the relevant assets on expiry of the lease. The operating lease commitments for property are to an extent offset by the receipt of sub-lease income of approximately $6 million per year from non-cancellable subleases.

| | | |
|---|---|---|
| **(c) Software licence and rental commitments** | | |
| - due within 1 year | **39** | 41 |
| - due within 1 to 2 years | **3** | 26 |
| - due within 2 to 5 years | **1** | 3 |
| | **43** | 70 |
| **(d) Other commitments** | | |
| - due within 1 year | **9** | 4 |
| - due within 1 to 2 years | **9** | 2 |
| - due within 2 to 5 years | **6** | 2 |
| | **24** | 8 |

**Note 33. Contingencies**

Contingent liabilities are not recognised on the balance sheet but are disclosed here, unless the possibility of settlement is remote, in which case no disclosure is made. If settlement becomes probable, a provision is recognised. The best estimate of the settlement amount is used in measuring a contingent liability for disclosure.

**(a) Contingent liabilities**

In the normal course of business, transactions are entered into that may generate a range of contingent liabilities. These include:

(i) litigation arising out of insurance policies;

(ii) various types of investment contracts including forward foreign exchange contracts, financial futures, interest rate swaps, exchange traded options, forward rate agreements and other underwriting subscription contracts, usually as part of the management of the Consolidated entity's investment portfolios (refer note 35 for details regarding the exposures);

(iii) undertakings for maintenance of net worth and liquidity support to subsidiaries in the Consolidated entity. It is normal practice to provide wholly-owned subsidiaries with support and assistance as may be appropriate with a view to enabling them to meet their obligations and to maintain their good standing. Such undertakings constitute a statement of present intent only and are not intended to give rise to any binding legal obligation; and

(iv) guarantees for performance obligations, including a letter of credit issued in support of the Consolidated entity's participation in Lloyd's of London (refer 26(b)).

The Directors do not believe there are any other potential material exposures to the Consolidated entity and know of no event that would require it to satisfy the guarantees or take action under a support agreement.

**(b) Reset exchangeable securities**

In respect of the issue of reset exchangeable securities ("RES") by a wholly-owned subsidiary, IAG Finance (New Zealand) Limited ("IAGF NZ"):

(i) IAGF NZ has granted to Permanent Trustee Company Limited ("Trustee"), the trustee of the RES, a fixed charge over its right, title and interest in the payments to it under the Portfolio Management Agreement and certain intragroup receivables. IAG Portfolio Limited, a wholly-owned subsidiary of IAG, has granted to the Trustee a mortgage over IAG Portfolio Limited's portfolio of investments ("Portfolio") and a floating charge over its rights, property and undertaking as security to the RES holders.

(ii) Insurance Australia Limited has put in place an interest rate floor with IAG Portfolio Limited in the event the bank bill rate applicable to the calculation of the interest rate payable on the RES falls below a specified rate. This will enable IAG Portfolio Limited to generate sufficient income to allow IAGF NZ to make part or full interest payments on the RES.

(iii) In the event of an interest payment on the RES being unfranked, IAG must pay an amount into IAG Portfolio Limited to fund a gross-up of the interest payment on the RES.

(iv) IAG may exchange some or all of the RES for preference shares issued by IAG at any time. This exchange right is considered an embedded derivative within the RES and is recognised at fair value on the balance sheet. The exchange right has been assessed as having a fair value of nil at 30 June 2006.

(v) IAGF NZ may, in relation to the RES, change their terms, redeem them for cash or convert them into ordinary shares issued by IAG on any reset date. The next reset date is 15 March 2010.

(vi) IAGF NZ may, in relation to the RES, redeem them for cash or convert them into ordinary shares issued by IAG, if a tax event, regulatory event or acquisition event, as defined in the RES terms, occurs.

(vii) RES holders may redeem the RES on any reset date or if a trigger event, as defined in the RES terms, occurs.

(viii) IAG has an obligation to pay all costs, charges and expenses in managing the Portfolio including costs of the trustee and custodian.

(ix) IAG and other members of the IAG Group may be entitled to any surplus in the Portfolio from excess income from the Portfolio after the payment of aggregate interest payments on the RES or from excess net assets of the Portfolio after the payment of aggregate redemption amounts on the RES.

**Note 33. Contingencies (continued)**

**(c) Fiduciary activities**

The Consolidated entity's fiduciary activities consist of investment management and other fiduciary activities conducted as manager, custodian or trustee for a number of investments and trusts. The funds managed on behalf of third parties which are not included in the Consolidated entity's balance sheet had a fair value as at 30 June 2006 of $1,969 million (2005 - $2,920 million). This does not include the investment by third parties in the IAG Asset Management Wholesale Trusts presented as minority interests in unitholders' funds on the balance sheet. The Consolidated entity is exposed to operational risk relating to managing these funds on behalf of third parties.

**Note 34. Related party disclosures**

**(a) Controlling entities**

The ultimate parent entity in the Consolidated entity is Insurance Australia Group Limited which is incorporated in Australia.

**(b) Subsidiaries**

The Consolidated entity consists of Insurance Australia Group Limited and its subsidiaries (information in relation to ownership interests is provided in note 27). The IAG Group operates a shared services model with the use of dedicated units (such as head office finance providing accounting and processing services to operational entities) and entities (such as an entity that provides employee services, a technology company that provides software development services, and a reinsurance captive providing reinsurance services). All such intragroup transactions are charged to the relevant entities on either normal commercial terms and conditions, a direct and actual cost recovery basis or time allocation basis. Certain entities are economically dependent on other entities in the IAG Group. There are also loans between entities in the Consolidated entity. Only the transactions between the Parent and the wholly-owned subsidiaries are disclosed here because all other transactions that have occurred among entities within the Consolidated entity have been eliminated for consolidation purposes.

Aggregate amounts included in the determination for the Parent of profit before income tax for the year that resulted from transactions with related parties within the wholly-owned group were as follows:

| | **PARENT** | |
|---|---|---|
| | **2006** | 2005 |
| | **$m** | $m |
| Dividend revenue | **746** | 585 |
| Interest expense | **26** | - |

Aggregate amounts receivable from, and payable to, related parties in the wholly-owned group were as follows:

| | | |
|---|---|---|
| Amounts receivable | **160** | 215 |
| Amounts payable | **84** | 73 |
| Loans receivable | **-** | 5 |
| Loans payable | **313** | 184 |

The loans receivable and payable are either interest bearing or non-interest bearing and are repayable on demand.

While the Parent does not transact directly with all subsidiaries, the Parent does however generally receive dividends from all subsidiaries even if indirectly through other subsidiaries. Details of the tax sharing and tax funding agreements are disclosed in note 1(m)(ii).

Other notes:
(i) Insurance Manufacturers of Australia Pty Limited ("IMA")

Both IMA and a subsidiary in the wholly-owned group have employees that are defined benefit members of the IAG & NRMA Superannuation Plan (refer note 31). While separate records are maintained for the liabilities relating to each member, there is effectively a sharing of the risks associated with the assets of the plan.

(ii) Transactions with IAG Asset Management Wholesale Trusts

IAG Asset Management Wholesale Trusts (some of which are disclosed as non-wholly owned subsidiaries in note 27), were established to enable higher investment yields for smaller investment portfolios. All entities within the IAG Group can invest in the trusts in accordance with their investment mandates. All investments in these trusts are on normal commercial terms and conditions.

The IAG & NRMA Superannuation Plan, the net financial position of which is recognised on the balance sheet, has a significant holding in some of the IAG Asset Management Wholesale Trusts. All transactions between the Plan and the trusts are on normal commercial terms and conditions.

**Note 34. Related party disclosures (continued)**

**(b) Subsidiaries (continued)**

(iii) Other

Both the amount of the transactions and the outstanding balances at reporting date relating to transactions between the Parent and other subsidiaries are not significant and no further information is disclosed.

**(c) Joint ventures and associates**

Details of interests in joint ventures and associates are disclosed in note 28.

During the course of the financial year, transactions with associates were conducted on normal terms and conditions. Both the amount of the transactions and the outstanding balances at reporting date are not significant and no further information is provided.

**(d) Key management personnel**

(i) Details of compensation

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity. It is important to note that the Company's Non-executive Directors are specifically required to be included as key management personnel in accordance with Accounting Standard AASB124 *Related Party Disclosures*. However, the Non-executive Directors do not consider that they are part of "management".

The names and details of the Company's Non-executive Directors in office at any time during the financial year are as follows (Directors were in office for this entire period unless otherwise stated):

Mr James Strong, Ms Yasmin Allen, Mr John Astbury, Mr Geoffrey Cousins, Mr Neil Hamilton, Mr Rowan Ross, Mr Brian Schwartz.

During the year the following persons were the executives identified as key management personnel, with the greatest authority and responsibility for planning, directing and controlling the activities of the IAG Group:

| **Name** | **Current title** |
|---|---|
| Mr MJ Hawker | Chief Executive Officer and Managing Director |
| Mr JP Breheny[i] | Chief Executive Officer – Asia |
| Mr AM Coleman | Chief Risk Officer and Group Actuary |
| Mr NB Hawkins [ii] | Chief Executive Officer – IAG New Zealand |
| Mr DA Issa [ii] | Chief Executive Officer – Personal Insurance |
| Ms JS Johnson [ii] | Chief Executive Officer – Business Partnerships |
| Ms CF McLoughlin [iii] | Group Executive – Strategy |
| Ms SJ Mostyn | Group Executive – Culture & Reputation |
| Mr MJ Pirone | Chief Executive Officer – CGU Insurance |
| Mr J van der Schalk[iv] | Chief Executive Officer – Asset Management and Reinsurance |
| Mr G Venardos | Chief Financial Officer |

(i) Mr JP Breheny, joined the Group as Chief Executive Officer – Asia, on 20 March 2006.

(ii) On 8 February 2006, IAG announced a new structure for its operations. This led to a change in the executive team structure. Mr DA Issa has held his current positions since this time previously held the position of Chief Information Officer. Mr NB Hawkins and Ms JS Johnson were appointed to their roles on 1 March 2006 and 13 February 2006 respectively.

(iii) Ms CF McLoughlin, joined the Group on 2 August 2005 and her current position is Group Executive – Strategy.

(iv) On 26 May 2006 Mr Jan van der Schalk was appointed to the role of Chief Executive Officer – Asset Management and Reinsurance following Mr RJ Jackson leaving the IAG Group.

Mr IF Brown retired on 31 December 2005. Mr DRA Pearce left on 31 August 2005, Mr DJP Smith left on 8 February 2006 and Mr RJ Jackson left on 26 May 2006.

**Note 34. Related party disclosures (continued)**

**(d) Key management personnel (continued)**

(i) Details of compensation (continued)

The aggregate compensation of the key management personnel is set out below:

| | CONSOLIDATED | |
|---|---|---|
| | **2006** | 2005 |
| | **$000** | $000 |
| Short-term employee benefits | **12,242** | 12,590 |
| Post-employment benefits | **1,012** | 1,479 |
| Other long-term benefits | **187** | 435 |
| Termination benefits | **2,440** | 1,062 |
| Share-based payments | **3,242** | 2,435 |
| | **19,123** | 18,001 |

The key management personnel receive no compensation specifically in relation to the management of the Company. The compensation disclosed in the table above represents the key management personnel's estimated compensation received from the IAG Group in relation to their involvement in the activities with the Consolidated entity.

The Consolidated entity has applied the exemption under Corporations Amendment Regulations 2006 which exempt listed companies from providing remuneration disclosures in relation to the key management personnel in the financial statements as recognised by Accounting Standard AASB 124. These remuneration disclosures are provided in the Remuneration Report of the Directors' report.

(ii) Interest in securities

*Holdings of PARs*
Movements in total number of PARs on issue by each of the key management personnel are as follows:

| | **PARs on issue 1 Jul 2005** | **PARs granted during the year** | **PARs exercised during the year** | **PARs lapsed during the year** | **PARs on issue 30 Jun 2006** | **PARs vested and exercisable 30 June 2006** |
|---|---|---|---|---|---|---|
| | Number | Number | Number | Number | Number | Number |
| Mr MJ Hawker | 1,200,000 | 600,000 | ( 168,000 ) | - | 1,632,000 | - |
| Mr JP Breheny | - | 100,000 | - | - | 100,000 | - |
| Mr AM Coleman | 258,195 | 90,000 | ( 54,176 ) | - | 294,019 | - |
| Mr NB Hawkins | 168,456(1) | - | - | - | 168,456 | - |
| Mr DA Issa | 223,177 | 83,500 | ( 47,675 ) | - | 259,002 | - |
| Ms JS Johnson | 87,300(1) | - | ( 5,972 ) | - | 81,328 | - |
| Ms CF McLoughlin | - | 80,000 | - | - | 80,000 | - |
| Ms SJ Mostyn | 214,307 | 80,000 | ( 45,508 ) | - | 248,799 | - |
| Mr MJ Pirone | 239,881 | 90,000 | ( 47,675 ) | - | 282,206 | - |
| Mr J van der Schalk | 149,004(1) | - | - | - | 149,004 | 22,753 |
| Mr G Venardos | 305,048 | 100,000 | ( 66,745 ) | - | 338,303 | - |
| **Total** | 2,845,368 | 1,223,500 | ( 435,751 ) | - | 3,633,117 | 22,753 |
| *Executives who ceased as key management personnel during the year:* | | | | | | |
| Mr IF Brown | 221,716 | - | - | - | 221,716 | 45,508 |
| Mr RJ Jackson | 161,451 | 90,000 | - | - | 251,451 | - |
| Mr DRA Pearce | 196,232 | - | - | - | 196,232 | 49,029 |
| Mr DJP Smith | 238,167 | 80,000 | ( 48,560 ) | - | 269,607 | - |
| **Total** | 817,566 | 170,000 | ( 48,560 ) | - | 939,006 | 94,537 |

(1) This balance represents the PARs held by Mr Hawkins, Ms Johnson and Mr van der Schalk at the date of appointment as executive.

The Non-executive Directors, who are key management personnel, did not participate in the PARs Plan.

**Note 34. Related party disclosures (continued)**

**(d) Key management personnel (continued)**

(ii) Interest in securities (continued)

*Holdings of PSRs*
The PSRs Plan was closed for issuing further PSRs from the financial year ended 30 June 2003. Following is a summary of the movements in total number of PSRs on issue by each key management personnel:

| | PSRs on issue 1 Jul 2005 | PSRs exercised during the year | PSRs lapsed during the year | PSRs on issue 30 Jun 2006 | PSRs vested and exercisable 30 Jun 2006 |
|---|---|---|---|---|---|
| | Number | Number | Number | Number | Number |
| Mr MJ Hawker | 60,000 | ( 60,000 ) | - | - | - |
| Ms SJ Mostyn | 68,670 | ( 68,670 ) | - | - | - |
| Mr J van der Schalk | 40,000 (1) | - | - | 40,000 | 40,000 |

(1) This balance represents the PSRs held by Mr van der Schalk at the date of appointment as executive.

The Non-executive Directors, who are key management personnel, did not participate in the PSRs Plan.

*Holding of ordinary shares*
The relevant interest of each key management personnel and their related parties in ordinary shares of IAG:

| | Shares held at the beginning of the year | Shares granted as remuneration during the year | Shares received on exercise of PSRs | Shares received on exercise of PARs | Net movement of shares due to other changes(2) | Total shares held at the end of the year | Shares held nominally at the end of the year (1) |
|---|---|---|---|---|---|---|---|
| Mr JA Strong | 225,547 | 33,918 | - | - | - | 259,465 | 247,382 |
| Ms YA Allen | 3,437 | 4,522 | - | - | - | 7,959 | 7,959 |
| Mr JF Astbury | 51,772 | 4,522 | - | - | 9,400 | 65,694 | 55,611 |
| Mr GA Cousins | 171,689 | 4,522 | - | - | - | 176,211 | 26,211 |
| Mr ND Hamilton | 80,744 | 20,351 | - | - | 173 | 101,268 | 96,278 |
| Mr RA Ross | 154,100 | 11,306 | - | - | - | 165,406 | 62,849 |
| Mr B Schwartz | 3,906 | 6,783 | - | - | - | 10,689 | 10,689 |
| Mr MJ Hawker | 1,150,059 | - | 60,000 | 168,000 | - | 1,378,059 | - |
| Mr JP Breheny | - | - | - | - | - | - | - |
| Mr AM Coleman | 65,896 | - | - | 54,176 | ( 58,020 ) | 62,052 | 54,176 |
| Mr NB Hawkins | - | - | - | - | 24,332(3) | 24,332 | - |
| Mr DA Issa | - | - | - | 47,675 | ( 47,675 ) | - | - |
| Ms JS Johnson | - | - | - | 5,972 | - | 5,972 | - |
| Ms CF McLoughlin | - | - | - | - | - | - | - |
| Ms SJ Mostyn | 16,083 | - | 68,670 | 45,508 | - | 130,261 | - |
| Mr MJ Pirone | 31,388 | - | - | 47,675 | - | 79,063 | 11,432 |
| Mr J van der Schalk | - | - | - | - | - | - | - |
| Mr G Venardos | 38,289 | - | - | 66,745 | 5,746 | 110,780 | 27,632 |
| *Executives who ceased employment during the year:* | | | | | | | |
| Mr IF Brown | 253,691 | 36,920 | - | - | ( 2,530 ) | * | * |
| Mr RJ Jackson | 7,351 | - | - | - | - | * | * |
| Mr DRA Pearce | 7,806 | - | - | - | ( 6,738 ) | * | * |
| Mr DJP Smith | 129,591 | - | - | 48,560 | ( 54,511 ) | * | * |

(1) Nominally held shares are included in the column headed total shares held at the end of the year. These shares are held by the key management personnel's related parties, inclusive of domestic partner, dependents and entities controlled, jointly controlled or significantly influenced by the key management personnel.

(2) Net movement of shares relate to acquisition and disposal transactions by the key management personnel and their related parties during the year. It includes any opening balances of shares held by key management personnel who were appointed during the year.

(3) This balance represents the shares held by Mr Hawkins at the date of appointment as executive.

* These key management personnel ceased employment during the financial year. Information on shares held only disclosed up to the date of their cessation.

**Note 34. Related party disclosures (continued)**

**(d) Key management personnel (continued)**

(ii) Interest in securities (continued)

*Holdings of reset preference shares*
No key management personnel had any interest in reset preference shares at any time during the financial year.

*Holdings of reset exchangeable securities*
In respect of the relevant interest of each key management personnel in reset exchangeable securities ("RES") of IAG Finance (New Zealand) Limited, other than Mr Hawker who held 1,000 RES nominally at the beginning and the end of the financial year. There were no other movements in holdings of RES by any key management personnel during the financial year ended 30 June 2006.

**(e) Other related parties**

Contributions are made to various superannuation plans, both defined contribution and defined benefit plans. Information regarding transactions with the plans is provided in note 31.

**Note 35. Financial risk management**

**The Parent**

The Parent is a non-operating holding company and so has limited direct exposure to financial risks. The Board of the Parent sets the risk management policies for the IAG Group.

The financial assets and liabilities of the Parent are limited to amounts receivable from / payable to related bodies corporate, loans to / from related bodies corporate, and an interest-bearing liability. The Parent does not use derivatives but is party to an embedded derivative in relation to reset exchangeable securities outlined in note 33(b)(iv). The intragroup balances are considered highly liquid and of negligible credit risk and so the carrying amount is a reasonable approximation of the fair value of the balances. The intragroup balances bear a variable interest rate or bear no interest but are repayable on demand. The interest-bearing liability represents the issue of reset preference shares (refer note 23). The impact from interest rate risk is as discussed in the notes below for the Consolidated entity.

**(a) Interest rate risk exposures**

The exposure to interest rate risk and the weighted average effective interest rates on the interest-bearing financial assets and liabilities of the Parent are summarised in the table below. Where assets and liabilities on the balance sheet include both interest-bearing and non interest-bearing amounts, they are included as interest-bearing assets and liabilities for the purposes of this note. All other assets and liabilities presented on the balance sheet are non-interest bearing and therefore not subject to interest rate risk.

| | | PARENT | | | | | |
|---|---|---|---|---|---|---|---|
| | | Fixed interest rate maturing in | | | | | |
| | Floating interest rate | 1 year or less | Over 1 to 5 years | More than 5 years | Non-interest bearing | Total | Weighted average interest rate |
| **2006** | **$m** | **$m** | **$m** | **$m** | **$m** | **$m** | **%** |
| **Financial assets** | | | | | | | |
| Cash and cash equivalents | **1** | **-** | **-** | **-** | **-** | **1** | **5.50** |
| Amounts receivable from related bodies corporate | **-** | **-** | **-** | **-** | **-** | **-** | **-** |
| Loans to related bodies corporate | **-** | **-** | **-** | **-** | **-** | **-** | **-** |
| **Financial liabilities** | | | | | | | |
| Loans from related bodies corporate | **( 138 )** | **-** | **-** | **-** | **175** | **( 313 )** | **6.20** |
| Reset preference shares * | **-** | **( 350 )** | **( 200 )** | **-** | **-** | **( 550 )** | **5.33** |
| Net financial assets / (liabilities) | **( 137 )** | **( 350 )** | **( 200 )** | **-** | **( 175 )** | **( 862 )** | |

* The reset preference shares were previously presented as equity under Australian GAAP, but are presented as debt from 1 July 2005 onwards (refer to note 38 for further details). These shares have no maturity date but they do have a reset date upon which certain terms, including the dividend rate, can be changed.

2005

The only interest-bearing financial asset or liability during the year ended 30 June 2005 was cash and cash equivalents of $1 million bearing a floating interest rate. The weighted average interest rate on cash and cash equivalents of $1 million for the year ended 30 June 2005 was 5.25%. Loans from related bodies corporate of $184 million were not interest bearing.

| | PARENT | |
|---|---|---|
| | **2006** | 2005 |
| **Reconciliation of net financial assets to net assets** | **$m** | $m |
| Net financial assets | | |
| - Interest-bearing | **( 862 )** | 1 |
| - Other | **4,873** | 4,579 |
| Net non financial assets | **( 62 )** | ( 140 ) |
| Net assets | **3,949** | 4,440 |

**Note 35. Financial risk management (continued)**

**The Consolidated entity**

The Consolidated entity is exposed to a variety of financial risks in the normal course of business; market risk (including currency risk, fair value interest rate risk and price risk), credit risk, liquidity risk and cash flow interest rate risk. The Board and senior management of the IAG Group have developed, implemented and maintain a Risk Management Strategy ("RMS") which is in accordance with the prudential standards issued by APRA. The RMS is updated annually and approved by the Board. The RMS:

- Describes Board and management approved parameters (ie risk appetite) within which key decisions must be made;
- Is a key input into how regulators and the external auditor understand and assess the approach to risk management; and
- Forms the basis of twice yearly declarations provided by executives and senior management to the Board.

The RMS (together with the Derivative Risk Management Statement ("DRMS") and the Reinsurance Management Strategy ("REMS")) identifies the IAG Group's policies and procedures, processes and controls that comprise its risk management and control systems. These systems address all material risks, financial and non-financial, likely to be faced by the IAG Group. Annually, the Board certifies to APRA that adequate strategies have been put in place to monitor those risks, that the IAG Group has systems in place to ensure compliance with legislative and prudential requirements and that the Board has satisfied itself as to the compliance with the RMS and REMS.

That part of the RMS concerning financial risk focuses on the unpredictability of financial markets and seeks to minimise potential adverse effects on the financial performance. Key aspects of the processes established in the RMS to mitigate financial risks include:

- Having an Asset and Liability Committee ("ALCO") comprised of key executives with relevant oversight responsibilities that meets on a regular basis;
- Monthly stress testing is undertaken to determine the impact of adverse market movements and the impact of any derivative positions;
- Maintenance of an approved counterparty credit risk policy which is reviewed at least annually; and
- The external auditors of IAG conduct a complete review of IAG Asset Management's operations on a yearly basis, including compliance with risk management strategies and other operational documents, as well as conducting reviews of internal controls.

The IAG Group's risk management policies include the use of derivatives for both investment operations and corporate treasury operations. The DRMS sets out the permissible use of derivatives in relation to investment strategies, the parameters within which the derivatives may be used, and the control environment within which they are used.

Derivatives used in investment operations include share price index futures, equity swap agreements, exchange traded options and bank bill and bond futures. Derivatives used in corporate treasury operations include cross currency swaps, interest rate swaps, and forward foreign exchange contracts. Derivatives used include exchange traded derivatives which are standardised and over-the-counter derivatives which are individually negotiated between the contracting parties.

**Note 35. Financial risk management (continued)**

**(a) Market risk**

(i) Currency risk

Currency risk is the risk of loss arising from an unfavourable move in market exchange rates. The Consolidated entity is exposed to currency risk on its investments in international equities, receivables, payables and borrowings denominated in a currency other than Australian dollars, and the net investment in controlled foreign operations. The currencies giving rise to this risk are primarily New Zealand dollars and Thai Baht for insurance contracts and United States dollars, Japanese Yen and Euros for investment activities. Derivatives are used to manage selected currency exposures.

*Forward foreign exchange contracts*
The most common form of derivative used to manage currency risk is forward foreign exchange contracts. At reporting date, the contractual amount and maturity profile of these derivatives was as follows:

| | **CONSOLIDATED** | |
|---|---|---|
| | **2006** | 2005 |
| | **$m** | $m |
| Forward foreign exchange contracts | | |
| - matures within 1 year | **1,094** | 325 |
| - matures within 4 to 5 years | **31** | - |
| | **1,125** | 325 |

*Cross currency swaps on US Dollar subordinated term notes*
Insurance Australia Limited ("IAL") has entered into cross currency swaps to fully hedge the Australian dollar value of principal and interest flows on the Consolidated entity's US subordinated term notes. The swaps mature in 2010. Over the term of the swaps, IAL will receive US dollar payments equal to the interest payable on the notes and will pay interest at either a fixed rate or variable rate of the three month bank bill swap rate plus a margin on a principal amount of A$401 million. On maturity of the swap, the IAG Group will repay the principal amount of A$401 million and receive US$240 million based on the original spot exchange rate at inception. Hedge accounting is applied in relation to these swap agreements (refer note 23).

*Net investment hedges*
Forward foreign exchange contracts are used to manage the currency risk relating to the net investment in controlled foreign operations. At the reporting date, hedge accounting was used for the net investment in the New Zealand operations of the Consolidated entity.

(ii) Interest rate risk

The exposure to interest rate risk results from the holding of financial assets and liabilities in the normal course of business. Fixed interest rate assets and liabilities create exposure to fair value interest rate risk which is a market risk. Financial assets and liabilities with floating interest rates create exposure to cash flow interest rate risk. The two types of interest rate risk are disclosed here together for convenience. The most commonly used derivatives to manage interest rate risk exposures are interest rate swap agreements and futures.

**Note 35. Financial risk management (continued)**

**(a) Market risk (continued)**

(ii) Interest rate risk (continued)

*Interest rate risk exposures*

The exposure to interest rate risk and the weighted average effective interest rates on the interest-bearing financial assets and liabilities of the Consolidated entity are summarised in the table below. Where assets and liabilities on the balance sheet include both interest-bearing and non interest-bearing amounts, they are included as interest-bearing assets and liabilities for the purposes of this note. All other assets and liabilities presented on the balance sheet are non-interest bearing and therefore not subject to interest rate risk.

| | CONSOLIDATED | | | | | | |
|---|---|---|---|---|---|---|---|
| | | Fixed interest rate maturing in | | | | | |
| | Floating interest rate | 1 year or less | Over 1 to 5 years | More than 5 years | Non-interest bearing | Total | Weighted average interest rate |
| **2006** | **$m** | **$m** | **$m** | **$m** | **$m** | **$m** | **%** |
| **Financial assets** | | | | | | | |
| Cash and cash equivalents | **678** | **26** | **-** | **-** | **14** | **718** | **5.32** |
| Premium funding loans | **-** | **125** | **-** | **-** | **-** | **125** | **14.40** |
| Money market securities | **92** | **2,026** | **3,470** | **1,475** | **-** | **7,063** | **5.91** |
| **Financial liabilities** | | | | | | | |
| NZ senior term notes | **-** | **-** | **( 41 )** | **-** | **-** | **( 41 )** | **7.25** |
| Subordinated term notes | **( 50 )** | **-** | **( 249 )** | **( 2 )** | **-** | **( 301 )** | **6.46** |
| US subordinated term notes | **-** | **-** | **( 323 )** | **-** | **-** | **( 323 )** | **5.19** |
| Reset preference shares* | **-** | **( 350 )** | **( 200 )** | **-** | **-** | **( 550 )** | **5.33** |
| Net interest-bearing financial assets | **720** | **1,827** | **2,657** | **1,473** | **14** | **6,691** | |
| 2005 | | | | | | | |
| **Financial assets** | | | | | | | |
| Cash and cash equivalents | 451 | - | - | - | 5 | 456 | 5.28 |
| Premium funding loans | - | 128 | - | - | - | 128 | 14.65 |
| Money market securities | 26 | 2,760 | 3,111 | 1,356 | - | 7,253 | 5.59 |
| **Financial liabilities** | | | | | | | |
| NZ senior term notes | - | ( 46 ) | ( 45 ) | - | - | ( 91 ) | 7.12 |
| Subordinated term notes | ( 50 ) | - | ( 249 ) | ( 2 ) | - | ( 301 ) | 6.35 |
| US subordinated term notes | - | - | - | ( 315 ) | - | ( 315 ) | 5.19 |
| Net interest-bearing financial assets | 427 | 2,842 | 2,817 | 1,039 | 5 | 7,130 | |

* The reset preference shares were previously presented as equity under Australian GAAP, but are presented as debt from 1 July 2005 onwards (refer to note 38 for further details). These shares have no maturity date but they do have a reset date upon which certain terms, including the dividend rate, can be changed.

The spread of maturity of the money market securities for the financial year ended 30 June 2006, is approximately 29% for 1 year or less, 18% for 1 to 2 years, 14% for 2 to 3 years, 6% for 3 to 4 years, 15% for 4 to 5 years, and 18% for more than 5 years (2005 – 39%, 13%, 14%, 10%, 6%, and 18%).

The significant terms and conditions of the interest-bearing liabilities are disclosed in note 23.

| | CONSOLIDATED | |
|---|---|---|
| | **2006** | 2005 |
| **Reconciliation of net financial assets to net assets** | **$m** | $m |
| Net financial assets | | |
| - Interest-bearing | **6,691** | 7,130 |
| - Other | **2,447** | 2,652 |
| - Net insurance liabilities | **( 7,738 )** | ( 7,663 ) |
| Net non financial assets | **2,271** | 2,384 |
| Net assets | **3,671** | 4,503 |

**Note 35. Financial risk management (continued)**

**(a) Market risk (continued)**

(ii) Interest rate risk (continued)

*Interest rate swap agreements*
IAL has entered into interest rate swap agreements to manage the interest rate exposure on the Consolidated entity's borrowings. IAL pays a fixed rate of interest under the swap agreements and receives a variable rate of interest equal to the amount payable on the underlying hedged borrowings. The interest income and expense associated with the swap agreements are recognised in profit or loss on a daily basis over the term for which the swap is effective as a hedge of the underlying borrowing. As at 30 June 2006, the weighted average fixed interest rate payable under the swap agreements was 6.77% per annum (2005 - 6.77% per annum) and the weighted average floating rate receivable was 7.32% per annum (2005 - 7.20% per annum).

As at reporting date, the notional principal amounts and period of expiry of these swap agreements were as follows:

| | **CONSOLIDATED** | |
|---|---|---|
| | **2006** | 2005 |
| | **$m** | $m |
| Interest rate swap agreements | | |
| - within 1 to 2 years | **50** | - |
| - within 2 to 5 years | **350** | 400 |
| | **400** | 400 |

Hedge accounting is applied in relation to these swap agreements (refer note 23).

As at reporting date, the notional principal amounts and periods of expiry of the swap agreements included in investments were as follows:

| | | |
|---|---|---|
| Interest rate swap agreements | | |
| - within 2 to 5 years | **203** | - |
| - within 5 to 7 years | **39** | - |
| - over 7 years | **721** | - |
| | **963** | - |

*Futures*
At reporting date, the notional principal amounts and period of expiry of the interest rate related futures contracts were as follows:

| | | |
|---|---|---|
| Futures | | |
| - matures within 1 year | **3,252** | 2,306 |
| - matures within 1 to 2 years | **1,029** | 449 |
| | **4,281** | 2,755 |

(iii) Price risk

The Consolidated entity is exposed to equity markets price risk through its investment in equities and the use of equity related derivative contracts. At reporting date, the notional principal amounts and period of expiry of the equity related derivative contracts were as follows:

| | | |
|---|---|---|
| SPI futures | | |
| - matures within 1 year | **1,032** | 865 |
| Options | | |
| - purchased – within 1 year | **4** | 28 |
| - written – within 1 year | **59** | 35 |
| | **1,095** | 928 |

**Note 35. Financial risk management (continued)**

**(b) Fair value of financial instruments**

The net carrying amount on the balance sheet of all financial instruments is either the fair value of the assets and liabilities or a reasonable approximation of the fair value of the assets and liabilities. The measurement of the fair value of certain financial instruments is determined using valuation techniques and the use of different pricing models and assumptions could affect the reported fair value of these instruments. Provided below is information regarding the fair value of derivatives.

The net fair value of derivatives presented as investments at 30 June 2006 was $1 million (2005 - $6 million).

The total fair value of all derivatives for which cash flow hedge accounting was applied at 30 June 2006 was $95 million (1 July 2005 - $95 million). At reporting date, cash flow hedge accounting was applied in relation to two economic hedges relating to the US subordinated term notes (refer note 23(c)(iii)) and the hedge of the deferred consideration payable in relation to the acquisition of Alba Group Pte Limited. This was an anticipated transaction at reporting date.

The total fair value of all derivatives for which net investment hedge accounting was applied at 30 June 2006 was $12 million (1 July 2005 - $Nil). At the reporting date, hedge accounting was applied in relation to only the net investment in the IAG New Zealand operations of the Consolidated entity.

**(c) Credit risk**

Credit risk is the risk of loss from a counterparty failing to meet their financial obligations. The Consolidated entity's credit risk arises predominantly from investment activities, reinsurance activities (refer note 12), and dealings with intermediaries (refer note 10(d)). The Consolidated entity's credit quality management roles, principles and processes are detailed in the IAG Group Credit Risk Management Policy document which is approved by the IAG Board and complies with APRA's requirements for credit risk management by a general insurer. The policy outlines the framework and procedures in place to ensure an adequate and appropriate level of monitoring and management of credit quality throughout the IAG Group. The IAG Group Treasury function is responsible for ensuring that the policies governing the management of credit quality risk are properly implemented. The IAG Group's credit risk appetite relies heavily on credit rating agency research and is heavily weighted towards obligors of high quality investment grade. All new, changed and continuing credit risk exposures must be approved in accordance with the IAG Group's approval authority framework.

The IAG Group is exposed to credit risk from investments in third parties where the IAG Group holds debt and other securities issued by those companies. The credit risk relating to investments is monitored and assessed, and maximum exposures are limited. The investments comprising assets held to back insurance liabilities are restricted to investment grade securities.

Some of the more significant credit exposures relate to reinsurance receivables. For further information refer to note 12(e).

Only derivatives in liquid markets are used. As the primary purpose for using derivatives is hedging, any over-the-counter derivatives used have been transacted with investment grade quality financial institutions only. The IAG Group's credit policy and procedures ensure that exposures to counterparty risks are monitored constantly to operate within the risk limits approved by the IAG Board. As the exchange traded derivatives are being settled on a daily basis with the clearing house of the respective exchange, credit risk associated with these contracts is minimal.

Concentrations of credit risk exist if a number of counterparties have similar economic characteristics. At the reporting date, there were no material concentrations of credit risk as the Consolidated entity transacts with a large number of counterparties in various countries without any individual debtor having a material outstanding balance. The maximum exposure to credit risk is represented by the carrying amount of each financial asset, including derivatives, on the balance sheet.

**Note 35. Financial risk management (continued)**

**(d) Liquidity risk**

Liquidity risk is concerned with the risk of there being insufficient cash resources to meet payment obligations without affecting the daily operations or the financial condition of the Consolidated entity. Liquidity facilitates the ability to meet expected and unexpected requirements for cash. The liquidity position is derived from operating cashflows, investment portfolios and access to outside sources of liquidity such as bank lines of credit, established debt funding programmes, reinsurance arrangements and other sources. The balance sheet is prepared using the liquidity format in which the assets and liabilities are presented broadly in order of liquidity. The liquidity management roles, principles and processes are detailed in the IAG Group Liquidity Risk Management Policy document which is approved by the IAG Board and complies with APRA's requirements for liquidity risk management by a general insurer. The policy outlines the framework and procedures in place to ensure an adequate and appropriate level of monitoring and management of liquidity.

Sound liquidity risk management implies maintaining sufficient cash and marketable securities, the availability of funding through an adequate amount of committed credit facilities and the ability to close-out market positions. The nature of insurance activities means that the timing and amount of cash flows are uncertain. The liquidity risk management policy is concerned with ensuring the ongoing ability to meet the payment obligations to policyholders and other creditors across a wide range of operating conditions without suffering any significant additional cost. These processes are principally in the control of the IAG Group Treasury function.

Management of liquidity risk includes asset and liability management strategies. The assets held to back insurance liabilities consist predominantly of Government securities (the most liquid of securities) and other very high quality securities which can generally be readily sold or exchanged for cash. The assets are managed so as to effectively match the maturity profile of the assets with the expected pattern of claims payments. The money market securities are restricted to investment grade securities with concentrations of investments managed by various criteria including issuer, industry, geography and credit rating.

Information regarding access to unutilised credit facilities is available in note 23(d).

The reset exchangeable securities (refer note 1(ff)) are a part of the liquidity management of the Consolidated entity. The ability to access external sources of liquidity from domestic and international capital market raisings is assisted by the strong financial strength rating of the IAG Group.

## Note 36. Capital management

### (a) Capital management strategy

The capital management strategy plays a central role in managing risk to create shareholder value whilst meeting the crucial and equally important objective of providing an appropriate level of capital to protect policyholders' and lenders' interests and satisfy regulators. Capital finances growth, capital expenditure and business plans and also provides support in the face of adverse outcomes from insurance and other activities and investment performance.

The determination of the capital amount and mix is built around three core considerations:

(i) Regulatory minimum capital requirements

All insurers within the Consolidated entity that carry on insurance business in Australia are registered with the Australian Prudential Regulation Authority ("APRA") and are subject to the prudential standards which set out the basis for calculating the minimum capital requirement ("MCR") which is a minimum level of capital that the regulator deems must be held to meet policyholder obligations. The MCR utilises a risk-based approach to capital adequacy and is determined to be the sum of the capital charges for insurance, investment, investment concentration and catastrophe concentration risk. It is IAG Group policy to ensure that each of the licensed insurers maintains an adequate capital position from an entity perspective. The IAG Group also voluntarily applies the MCR prudential standards to the IAG Group as a whole, as if the Consolidated entity was an APRA regulated entity (refer note 36(c)).

It is IAG Group policy to hold capital levels in excess of the MCR. The current target capital multiple for the Consolidated entity is 1.55 times (1.55x) the MCR. The policy also requires management to not take any action that would further reduce the capital multiple if an identified minimum capital multiple is reached, currently set as 1.35x MCR for the Consolidated entity.

Capital calculations for regulatory purposes are based on the premium liabilities model which is different to the deferral and matching model which underpins the measurement of assets and liabilities in the financial statements. The premium liabilities model assesses future claims payments arising from future events insured under existing policies, assessed on a prospective basis. This differs to the measurement of the outstanding claims liability on the balance sheet which considers claims relating to events that occur only up to and including the reporting date.

(ii) Rating agency capital guidelines and expectations

The IAG Group aims to maintain the capital strength of the IAG Group by reference to a target financial strength rating from an independent ratings agency. The ratings are important because they reflect the 'very strong' financial strength of the IAG Group and demonstrate to stakeholders the ability to pay claims for the long term.

Key wholly owned insurers within the IAG Group had the following ratings published by Standard and Poor's Rating Services at 30 June 2006:

| Entity | Issuer credit rating | Financial strength rating |
|---|---|---|
| Parent | | |
| Insurance Australia Group Limited | AA-/Stable | AA-/Stable |
| Licenced insurers | | |
| Insurance Australia Limited | AA/Stable | AA/Stable |
| IAG New Zealand Limited | AA/Stable | AA/Stable |
| CGU Insurance Limited | AA/Stable | AA/Stable |
| Swann Insurance (Aust) Pty Ltd | AA/Stable | AA/Stable |

The objective is to retain the 'AA' category rating for the key wholly owned insurers within the IAG Group which is considered in the long term interests of shareholders in view of the security it provides to lenders, reinsurers, policyholders and shareholders in an industry that is, by its nature, subject to risk and volatility outside the participants' control.

**Note 36. Capital management (continued)**

**(a) Capital management strategy (continued)**

(iii) Capital needs of the business

In conjunction with the considerations set out above, which are important to the functioning of the business, consideration is given to the operational capital needs of the business. Targeting a capital multiple above the minimum regulatory requirement aims to ensure the ongoing strength and security of the IAG Group whilst suitably protecting policyholders and lenders. The objective is to maintain capital levels and mix commensurate with 1:750 year risk of absolute ruin.

The maintenance of the target financial strength rating referred to above impacts directly on the cost of capital. When accessing funds in the market, the strong rating improves both the availability of capital and the cost at which it can be secured as potential investors generally demand a lower risk premium.

An important influence on the capital levels is the payment of dividends. The Consolidated entity aims to maintain normalised earnings payouts within a ratio range approved by the IAG Board. As part of the management of capital, a special dividend was declared and paid during the year ended 30 June 2006.

The capital objectives are achieved through dynamic management of the balance sheet and capital mix, the use of a risk-based capital adequacy framework for capital needs that relies on explicit quantification of uncertainty or risk, and the use of modelling techniques such as Dynamic Financial Analysis which provide valuable input to the capital management process and provide the capacity to quantify and understand this risk/return trade-off. The influence on capital needs of product mix, the reinsurance programme, catastrophe exposure, investment strategy, profit margins and capital structure are all assessed through the Dynamic Financial Analysis modelling.

The capital management processes comprise two main aspects:

- Balance sheet management – fundamentally concerned with the IAG Group's long term target capital mix in terms of equity, hybrid equity and debt capital. This includes establishing appropriate balance sheet criteria in terms of shareholder objectives (eg. dividend objectives and overall return criteria) and cost of capital considerations (availability, rating and appetite for risk).
- Asset and liability management – seeks to quantify the levels of overall capital needed to accommodate any given risk tolerance, taking account of any factors considered relevant to capital needs. This is accomplished using Dynamic Financial Analysis modelling which comprises integrated asset and liability models, which simulate experience over future periods.

**(b) Capital composition**

The IAG Group's capital comprises ordinary shares and interest-bearing liabilities. The interest-bearing liabilities include reset preference shares which are a hybrid security having characteristics of both debt and equity. The balance sheet capital mix was:

| | | **CONSOLIDATED** | |
|---|---|---|---|
| | **Target** | **2006** | 2005 |
| | % | **%** | % |
| Ordinary equity | 68 | **73** | 71 |
| Hybrid securities | 12 | **11** | 12 |
| Debt | 20 | **16** | 17 |
| | 100 | **100** | 100 |

As at 30 June 2006, the balance sheet capital mix held more ordinary equity than targeted due to the level of surplus capital held. A special dividend was paid to shareholders during the year as a return of excess capital in line with the commitment to ensure capital is managed efficiently. The capital disclosed above does not include the $550 million of contingent capital made available through the reset exchangeable securities (refer note 1(ff)).

**Note 36. Capital management (continued)**

**(c) Regulatory capital compliance**

The insurers within the Consolidated entity have at all times during the current and prior financial year complied with the externally imposed capital requirements to which they are subject. The MCR calculation for the Consolidated entity provided below is based on applying in principle the APRA standards for individual entities to the consolidated position, pending the publication by APRA of a comprehensive standard to determine prudential capital at a consolidated level (such a standard is expected during the 2007 financial year). A similar basis is used for both the Australian and international insurance businesses.

APRA requires general insurers to report capital adequacy based on previous Australian GAAP. The Parent has received approval from APRA to apply AIFRS accounting treatments for certain items. For all other items the previous Australian GAAP treatment is applied. Changes in the MCR calculation methodology do not apply retrospectively for the determination of regulatory compliance. For this reason, the MCR calculation for the comparative period is disclosed as it was at that date, as reported to APRA, and has not been restated for current period changes in the calculation.

| | CONSOLIDATED | |
|---|---|---|
| | **2006** | 2005 |
| **Statutory capital** | **$m** | $m |
| *Tier 1 capital* | | |
| Ordinary shares | **3,263** | 3,263 |
| Treasury shares | **( 40 )** | - |
| Reset preference shares (i) | **550** | 550 |
| Reset preference shares transaction costs | **( 3 )** | ( 11) |
| Reserves | **( 6 )** | ( 6 ) |
| Retained earnings | **274** | 59 |
| Excess technical provisions (net of tax) (ii) | **421** | 499 |
| | **4,459** | 4,354 |
| Less deductions from capital for APRA purposes: | | |
| Goodwill | **( 1,486 )** | ( 1,371 ) |
| Intangibles | **( 57 )** | ( 7 ) |
| Net deferred tax assets | **( 123 )** | ( 100 ) |
| Other | **( 62 )** | - |
| | **2,731** | 2,876 |
| *Tier 2 capital* | | |
| Subordinated term notes | **624** | 616 |
| **Total statutory capital** | **3,355** | 3,492 |
| **Minimum capital requirements (MCR)** | | |
| Australian general insurance businesses | **1,574** | 1,511 |
| International insurance businesses | **260** | 235 |
| **Total MCR** | **1,834** | 1,746 |
| **MCR multiple** | **1.83** | 2.00 |

(i) While the presentation of the reset preference shares has changed from equity to debt under AIFRS, it is expected that such shares will continue to qualify as Tier 1 capital for capital adequacy purposes.

(ii) The excess technical provisions represent the difference between the insurance liabilities incorporating a risk margin (refer note 11(f)) on the balance sheet based on the deferral and matching model and the insurance liabilities incorporating a risk margin equivalent to a probability of adequacy of 75% used for regulatory reporting purposes based on the premium liabilities model.

The increase in the total minimum capital requirement for the year ended 30 June 2006 is principally due to the increase of $100 million in the maximum event retention from 1 January 2006.

**Note 36. Capital management (continued)**

**(c) Regulatory capital compliance (continued)**

The MCR calculation does not include the $550 million of contingent capital made available through the reset exchangeable securities (refer note 1 (ff)), which if exchanged, would bring the MCR multiple to 2.13 (2005 – 2.32).

The elements of the MCR calculation are as follows:

| | CONSOLIDATED | |
|---|---|---|
| | **2006** | 2005 |
| | **$m** | $m |
| Insurance risk | **1,085** | 1,091 |
| Investment risk | **549** | 555 |
| Investment concentration risk | **-** | - |
| Catastrophe concentration risk | **200** | 100 |
| Total MCR | **1,834** | 1,746 |

The investment concentration risk charge is zero reflecting that the holding of particular assets, including reinsurance recoveries, and exposure to a particular obligor, are sufficiently diversified for the purposes of the regulatory capital calculations.

| | Consolidated | |
|---|---|---|
| | **2006** | 2005 |
| | **$** | $ |
| **Note 37. Net tangible assets** | | |
| Net tangible asset per ordinary share (i) | **1.22** | 1.18 |
| Net tangible asset per reset preference share (ii) | **n/a** | 100.00 |

(i) Net tangible assets per ordinary share has been determined after adjusting for minority interests, goodwill (note 20) and other intangible assets (note 19) and the value of reset preference shares on issue (only for reporting date at 30 June 2005, refer (ii) below for further details).

(ii) While for accounting purposes the reset preference shares were previously presented as equity under Australian GAAP, they are presented as debt from 1 July 2005 onwards (refer to note 38 for further details) and hence the net tangible assets disclosure is not relevant. When presented as equity, the net tangible assets per reset preference share were reflected at the face value of $100, as the entitlement to the net assets in all circumstances is limited to the face value of the reset preference shares.

**Note 38. Explanation of transition to Australian equivalents to International Financial Reporting Standards**

This financial report is the first annual financial report to be prepared in accordance with AIFRS. In this note we provide reconciliations and explanations of the differences to Australian GAAP to assist readers in understanding the impact of the transition on the financial position and performance of the Parent and the Consolidated entity. The only impact on the cash flow statements was with the distributions on the reset preference shares, previously presented as dividends paid, in the financing activities section, now presented as finance costs paid, in the operating activities section. The net movement in cash held has not changed.

**(a) Income statement**

Provided below are reconciliations of the income statements under Australian GAAP to that under AIFRS for the year ended 30 June 2005.

| | Notes | PARENT AGAAP Year ended 30 Jun 2005 | PARENT Adj | PARENT AIFRS Year ended 30 Jun 2005 | CONSOLIDATED AGAAP Year ended 30 Jun 2005 | CONSOLIDATED Adj | CONSOLIDATED AIFRS Year ended 30 Jun 2005 |
|---|---|---|---|---|---|---|---|
| | | $m | $m | $m | $m | $m | $m |
| Premium revenue | | - | n/a | - | 6,561 | n/a | 6,561 |
| Reinsurance expense | | - | n/a | - | ( 417 ) | n/a | ( 417 ) |
| Net premium revenue | | - | n/a | - | 6,144 | n/a | 6,144 |
| Claims expense | (ii)(v) | - | n/a | - | ( 4,729 ) | ( 21 ) | ( 4,750) |
| Reinsurance and other recoveries | | - | n/a | - | 660 | n/a | 660 |
| Net claims expense | | - | n/a | - | ( 4,069 ) | ( 21 ) | ( 4,090) |
| Acquisition costs | (ii)(v) | - | n/a | - | ( 1,075 ) | 5 | ( 1,070 ) |
| Other underwriting expenses | (ii)(v) | - | n/a | - | ( 339 ) | ( 38 ) | ( 377 ) |
| Fire service levies | | - | n/a | - | ( 177 ) | n/a | ( 177 ) |
| Underwriting expenses | | - | n/a | - | ( 1,591 ) | ( 33 ) | ( 1,624 ) |
| Underwriting profit | | - | n/a | - | 484 | ( 54 ) | 430 |
| Investment income on assets backing insurance liabilities | | - | n/a | - | 525 | n/a | 525 |
| Investment expenses on assets backing insurance liabilities | | - | n/a | - | ( 9 ) | n/a | ( 9 ) |
| Insurance profit | | - | n/a | - | 1,000 | ( 54 ) | 946 |
| Investment income on equity holders' funds | (vi) | 585 | n/a | 585 | 530 | ( 12 ) | 518 |
| Other income | | - | n/a | - | 178 | 1 | 179 |
| Finance costs | | - | n/a | - | ( 69 ) | n/a | ( 69 ) |
| Corporate, administration and other expenses | (i)(v)(vi) | - | n/a | - | ( 381) | 92 | ( 289 ) |
| **Profit before income tax** | | 585 | - | 585 | 1,258 | 27 | 1,285 |
| Income tax credit / (expense) | | 2 | n/a | 2 | ( 379 ) | 22 | ( 357 ) |
| **Profit for the year** | | 587 | - | 587 | 879 | 49 | 928 |
| **Profit for the year attributable to:** | | | | | | | |
| Equity holders of the Parent | | 587 | - | 587 | 760 | 51 | 811 |
| Minority interests | | n/a | n/a | n/a | 119 | ( 2 ) | 117 |
| **Profit for the year** | | 587 | - | 587 | 879 | 49 | 928 |

Certain items have been reclassified from the prior year's financial reports to conform to the current year's presentation (refer to note 1(b)(iv) for further details). These items do not represent a change in recognition and measurement criteria arising from the transition to AIFRS and so have been incorporated into the AGAAP figures rather than being disclosed as AIFRS adjustments.

**Note 38. Explanation of transition to Australian equivalents to International Financial Reporting Standards (continued)**

**(b) Balance sheet (the Consolidated entity only)**

Provided below are reconciliations of the balance sheets under Australian GAAP (referred to in the tables as AGAAP) and AIFRS together with narrative descriptions explaining the adjustments. The AIFRS adjustments applicable for the first time from 1 July 2005 represent a change in accounting policy made in accordance with the provisions of AASB 1. A balance sheet reconciliation is not provided for the Parent because the only adjustment prior to 1 July 2005 related to taxation.

| | Notes | AGAAP 30 June 2005 | AIFRS Adj | AIFRS 30 June 2005 | AIFRS Adj | AIFRS 1 July 2005 | AGAAP 30 June 2004 | AIFRS Adj | AIFRS 1 July 2004 |
|---|---|---|---|---|---|---|---|---|---|
| | | $m | $m | $m | $m | $m | $m | $m | $m |
| **Assets** | | | | | | | | | |
| Cash and cash equivalents | | 456 | n/a | 456 | n/a | 456 | 424 | n/a | 424 |
| Investments | (viii) | 10,370 | n/a | 10,370 | 1 | 10,371 | 9,686 | n/a | 9,686 |
| Premium receivable | | 1,710 | n/a | 1,710 | n/a | 1,710 | 1,606 | n/a | 1,606 |
| Trade and other receivables | | 827 | n/a | 827 | - | 827 | 912 | n/a | 912 |
| Current tax assets | | 4 | - | 4 | - | 4 | - | - | - |
| Reinsurance and other recoveries receivable on outstanding claims | | 883 | n/a | 883 | n/a | 883 | 745 | n/a | 745 |
| Inventories | | 2 | n/a | 2 | n/a | 2 | 2 | n/a | 2 |
| Prepayments | (iii)(iv) | 54 | (16) | 38 | n/a | 38 | 56 | (14) | 42 |
| Deferred levies and charges | | 105 | n/a | 105 | n/a | 105 | 104 | n/a | 104 |
| Deferred reinsurance expense | | 194 | n/a | 194 | n/a | 194 | 184 | n/a | 184 |
| Deferred acquisition costs | | 621 | n/a | 621 | n/a | 621 | 558 | n/a | 558 |
| Deferred tax assets | (x) | 264 | (133) | 131 | 2 | 133 | 296 | (115) | 181 |
| Property, plant and equipment | (vi) | 258 | 1 | 259 | n/a | 259 | 231 | 13 | 244 |
| Investment in joint ventures and associates | | 8 | n/a | 8 | n/a | 8 | 7 | n/a | 7 |
| Intangible assets | (v) | 7 | 24 | 31 | n/a | 31 | 18 | n/a | 18 |
| Goodwill | (i) | 1,371 | 92 | 1,463 | n/a | 1,463 | 1,455 | n/a | 1,455 |
| Total assets | | 17,134 | (32) | 17,102 | 3 | 17,105 | 16,284 | (116) | 16,168 |
| **Liabilities** | | | | | | | | | |
| Trade and other payables | (vii) | 721 | n/a | 721 | 1 | 722 | 803 | n/a | 803 |
| Reinsurance premiums payable | | 195 | n/a | 195 | n/a | 195 | 134 | n/a | 134 |
| Restructuring provision | | 11 | n/a | 11 | n/a | 11 | 29 | n/a | 29 |
| Current tax liabilities | | 193 | - | 193 | - | 193 | 222 | - | 222 |
| Unearned premium liability | | 3,586 | n/a | 3,586 | n/a | 3,586 | 3,472 | n/a | 3,472 |
| Lease provision | (vi) | - | 21 | 21 | n/a | 21 | - | 21 | 21 |
| Employee benefits provision | (ii) | 206 | 23 | 229 | n/a | 229 | 188 | (57) | 131 |
| Minority interests in unitholders' funds | (xi) | - | n/a | - | 421 | 421 | - | n/a | - |
| Deferred tax liabilities | (x) | 163 | (139) | 24 | - | 24 | 99 | (99) | - |
| Outstanding claims liability | | 6,840 | n/a | 6,840 | n/a | 6,840 | 6,327 | n/a | 6,327 |
| Interest-bearing liabilities | (vii)(ix) | 779 | n/a | 779 | 552 | 1,331 | 786 | n/a | 786 |
| Total liabilities | | 12,694 | (95) | 12,599 | 974 | 13,573 | 12,060 | (135) | 11,925 |
| Net assets | | 4,440 | 63 | 4,503 | (971) | 3,532 | 4,224 | 19 | 4,243 |
| **Equity** | | | | | | | | | |
| Share capital | (vii) | 3,802 | n/a | 3,802 | (539) | 3,263 | 3,802 | n/a | 3,802 |
| Treasury shares held in trust | (iv) | - | (34) | (34) | n/a | (34) | - | (21) | (21) |
| Reserves | (iii)(ix) | (6) | 13 | 7 | (5) | 2 | (5) | 5 | - |
| Retained earnings | | 59 | 83 | 142 | (5) | 137 | (259) | 32 | (227) |
| Parent interest | | 3,855 | 62 | 3,917 | (549) | 3,368 | 3,538 | 16 | 3,554 |
| Minority interests | (xi) | 585 | 1 | 586 | (422) | 164 | 686 | 3 | 689 |
| Total equity | | 4,440 | 63 | 4,503 | (971) | 3,532 | 4,224 | 19 | 4,243 |

Certain items have been reclassified from the prior year's financial reports to conform to the current year's presentation (refer to note 1(b)(iv) for further details). These items do not represent a change in recognition and measurement criteria arising from the transition to AIFRS and so have been incorporated into the AGAAP figures rather than being disclosed as AIFRS adjustments.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2006**

**Note 38. Explanation of transition to Australian equivalents to International Financial Reporting Standards (continued)**

**(c) Total equity**

Provided below are reconciliations of total equity under Australian GAAP to that under AIFRS. The adjustments disclosed for each date are cumulative of all adjustments up to and including that date. The adjustments applicable for the first time from 1 July 2005 represent a change in accounting policy made in accordance with the provisions of AASB 1.

| | | PARENT | | | CONSOLIDATED | | |
|---|---|---|---|---|---|---|---|
| | Notes | 1 July 2005 | 30 June 2005 | 1 July 2004 | 1 July 2005 | 30 June 2005 | 1 July 2004 |
| | | $m | $m | $m | $m | $m | $m |
| Total equity under Australian GAAP as reported in the 2005 annual financial report | | 4,440 | 4,440 | 4,295 | 4,440 | 4,440 | 4,224 |
| Adjustments applicable from 1 July 2004 | | | | | | | |
| *Adjustments to retained earnings* | | | | | | | |
| Reversal of goodwill amortisation | (i) | n/a | n/a | n/a | 92 | 92 | n/a |
| Recognition of defined benefit plans | (ii) | n/a | n/a | n/a | ( 23 ) | ( 23 ) | 57 |
| Adjustment to share based remuneration expense | (iii) | n/a | n/a | n/a | 5 | 5 | 2 |
| Capitalisation of software development costs | (v) | n/a | n/a | n/a | 24 | 24 | n/a |
| Reversal of market value movement on property | (vi) | n/a | n/a | n/a | ( 8 ) | ( 8 ) | - |
| Recognition of depreciation on buildings | (vi) | n/a | n/a | n/a | ( 1 ) | ( 1 ) | n/a |
| Recognition of lease provision amortisation | (vi) | n/a | n/a | n/a | ( 11 ) | ( 11 ) | ( 8 ) |
| Net tax impact of AIFRS adjustments | (x) | n/a | n/a | n/a | 6 | 6 | ( 16 ) |
| Adjustment for minority interests | | n/a | n/a | n/a | ( 1 ) | ( 1 ) | ( 3 ) |
| | | | | | 83 | 83 | 32 |
| *Adjustments to reserves* | | | | | | | |
| Recognition of share based payment reserve | (iii) | n/a | n/a | n/a | 13 | 13 | 5 |
| *Adjustments to treasury shares* | | | | | | | |
| Consolidation of share based remuneration trusts | (iv) | n/a | n/a | n/a | ( 34 ) | ( 34 ) | ( 21 ) |
| *Adjustments to minority interests* | | | | | | | |
| Net adjustments impacting minority interests | | n/a | n/a | n/a | 1 | 1 | 3 |
| Adjustments applicable from 1 July 2005 | | | | | | | |
| *Adjustments to retained earnings* | | | | | | | |
| Adjustment to valuation of investments | (viii) | n/a | n/a | n/a | 1 | n/a | n/a |
| Amortisation of reset preference shares transaction costs | (vii) | ( 6 ) | n/a | n/a | ( 6 ) | n/a | n/a |
| Accrual for distribution on reset preference shares | (vii) | ( 1 ) | n/a | n/a | ( 1 ) | n/a | n/a |
| Net tax impact of AIFRS adjustments | (x) | - | n/a | n/a | - | n/a | n/a |
| Adjustment for minority interests | | n/a | n/a | n/a | 1 | n/a | n/a |
| | | ( 7 ) | n/a | n/a | ( 5 ) | n/a | n/a |
| *Adjustments to reserves* | | | | | | | |
| Adjustment for cash flow hedge accounting | (ix) | - | n/a | n/a | ( 7 ) | n/a | n/a |
| Net tax impact of AIFRS adjustment | (x) | - | n/a | n/a | 2 | n/a | n/a |
| | | - | n/a | n/a | ( 5 ) | n/a | n/a |
| *Adjustments to share capital* | | | | | | | |
| Reclassification of reset preference shares | (vii) | ( 550 ) | n/a | n/a | ( 550 ) | n/a | n/a |
| Reclassification of reset preference shares transaction costs | (vii) | 11 | n/a | n/a | 11 | n/a | n/a |
| | | ( 539 ) | n/a | n/a | ( 539 ) | n/a | n/a |
| *Adjustments to minority interests* | | | | | | | |
| Reclassification of minority interests in unitholders' funds | (xi) | n/a | n/a | n/a | ( 421 ) | n/a | n/a |
| Net other adjustments impacting minority interests | | n/a | n/a | n/a | ( 1 ) | n/a | n/a |
| | | n/a | n/a | n/a | ( 422 ) | n/a | n/a |
| Total equity under AIFRS | | 3,894 | 4,440 | 4,295 | 3,532 | 4,503 | 4,243 |

**Note 38. Explanation of transition to Australian equivalents to International Financial Reporting Standards (continued)**

**(d) Profit for the year**

Provided below are reconciliations of profit under Australian GAAP to that under AIFRS for the year ended 30 June 2005.

| | Notes | **PARENT** Year ended 30 June 2005 | **CONSOLIDATED** Year ended 30 June 2005 |
|---|---|---|---|
| | | $m | $m |
| Profit for the year as reported under Australian GAAP | | 587 | 879 |
| Reversal of goodwill amortisation | (i) | - | 92 |
| Movement in defined benefit plans | (ii) | - | ( 80 ) |
| Adjustment to share based remuneration expense | (iii) | - | 3 |
| Capitalisation of software development costs | (v) | - | 24 |
| Reversal of market value movement on property | (vi) | - | ( 8 ) |
| Recognition of depreciation on buildings | (vi) | - | ( 1 ) |
| Recognition of lease provision amortisation | (vi) | - | ( 3 ) |
| Net tax impact of AIFRS adjustments | (x) | - | 22 |
| Profit for the year under AIFRS | | 587 | 928 |

### Note 38. Explanation of transition to Australian equivalents to International Financial Reporting Standards (continued)

### (e) Notes to the reconciliations for sections (a) to (d) above

(i) Goodwill (transition adjustment is relevant to the Consolidated entity only)

The elimination of the requirement to amortise goodwill under AIFRS resulted in the reversal of the goodwill amortisation expense for the year to 30 June 2005 of $92 million. There was a corresponding increase in goodwill of $92 million as at 30 June 2005 on the balance sheet.

(ii) Defined benefit plans (transition adjustment is relevant to the Consolidated entity only)

Under AIFRS the relevant net position of defined benefit plans is recognised on the balance sheet. The movement in the net position is recognised in profit or loss, except for actuarial gains and losses, which are recognised directly in retained earnings. This is the result of an accounting policy selection made.

There are five arrangements that qualify as defined benefit plans under AIFRS. These consist of a defined benefit superannuation plan in Australia, two defined benefit superannuation plans in New Zealand, and two pension schemes, both of which are unfunded. The net position of the three defined benefit superannuation plans was previously not recognised on the balance sheet under Australian GAAP. The present value of each of the two unfunded pension liabilities was previously recognised on the balance sheet, however the measurement and accounting treatment under AIFRS is different.

All cumulative actuarial gains and losses on defined benefit plans have been recognised in equity at the date of transition to AIFRS.

The adjustments required to recognise the defined benefit plans upon transition to AIFRS involved an increase in retained earnings and a reduction in employee benefits provision as at 1 July 2004 of $57 million. Recognising the movement in the net positions of the plans for the year to 30 June 2005 involved recognition of an expense through the AIFRS income statement for the year to 30 June 2005 of $80 million, with a corresponding impact to retained earnings which was rounded to zero as at 30 June 2005 and an increase in employee benefits provision of $23 million as at 30 June 2005. The net result of these changes was a reduction of $23 million in retained earnings as at 30 June 2005.

(iii) Share based remuneration (transition adjustment is relevant to the Consolidated entity only)

IAG shares are acquired on-market and held in trust to satisfy future obligations for share based remuneration. The shares are purchased on or near grant date at the then market price. Previously under Australian GAAP the cost of acquiring the shares was recorded as a prepayment and then expensed in full, generally over the period during which the employees provided related services.

Under AIFRS the fair value at grant date of the equity instruments granted as share based remuneration is expensed over the relevant period rather than the actual cost of acquiring the shares to support the arrangements. The fair value is expensed over the period from grant date until the equity instruments vest fully to the employee. For equity settled share based payments, an equity reserve is created as the expense is recognised. At each reporting date the total accumulated expense is adjusted through profit or loss based on the latest estimate of the number of equity instruments that will vest, considering only employee turnover, and taking into account the expired portion of the vesting period. The AIFRS accounting policy has not been retrospectively applied to share based payments granted prior to 7 November 2002 and/or that vested prior to 1 January 2005 as permitted under the transitional provisions for first time adoption of AIFRS.

A transitional adjustment for the Consolidated entity was made to increase retained earnings as at 1 July 2004 by $2 million representing the accumulated reduction in the expense up to that date. An adjustment for the Consolidated entity was made to increase retained earnings as at 30 June 2005 by $5 million representing the accumulated reduction in the expense up to that date. The adjustments involved the recognition of a share based remuneration reserve in equity of $5 million as at 1 July 2004 and $13 million as at 30 June 2005.

(iv) Consolidation of share based remuneration trusts (transition adjustment is relevant to the Consolidated entity only)

The equity based remuneration trusts used to manage the share based remuneration arrangements are subsidiaries of the Consolidated entity under AIFRS. Two trusts are consolidated directly by the Parent while one trust is consolidated directly by a subsidiary. The amount previously recognised as a prepayment in relation to the share based remuneration plans has converted into an investment in subsidiary under AIFRS which eliminates against the unitholders' funds in the trusts upon consolidation. The Consolidated entity recognises the consolidated IAG shares, the major asset of the trusts, as treasury shares. The treasury shares are measured at cost (total amount paid to acquire the shares), and are presented as a deduction from equity. The shares controlled by the trusts as at 30 June 2005, were acquired on different dates at a total cost of $33 million for the Parent and $34 million for the Consolidated entity (30 June 2004 - $20 million for the Parent and $21 million for the Consolidated entity). When the relevant rights are exercised, the shares will effectively be reissued and recognised as equity measured at the net expense incurred in providing the shares.

**Note 38. Explanation of transition to Australian equivalents to International Financial Reporting Standards (continued)**

**(e) Notes to the reconciliations for sections (a) to (d) above (continued)**

(v) Intangible assets (transition adjustment is relevant to the Consolidated entity only)
Certain software development expenditure has been capitalised as an intangible asset under AIFRS that was previously expensed under the application of Australian GAAP. Only software development expenditure incurred after 1 July 2004, the AIFRS transition date, was eligible for capitalisation under AIFRS. The adjustment relating to software development expenditure was a net reduction in the expense for the year to 30 June 2005 of $24 million (capitalised expenditure of $24 million less an amount of amortisation which rounded to zero). There was a corresponding increase in intangible assets on the balance sheet of the Consolidated entity for the same amount.

(vi) Property, plant and equipment (transition adjustment is relevant to the Consolidated entity only)
All of the property within the Consolidated entity is classified as owner occupied property under AIFRS. Prior to transition to AIFRS, all land and buildings were carried at fair value with movements in fair value recognised in profit or loss. Under AIFRS, land and buildings are measured at cost with the cost of the buildings being depreciated over their useful life. The carrying value of land and buildings is subject to impairment testing. For land and buildings held as at 30 June 2004, the fair value at that date is used as the deemed cost as allowed upon first time adoption of AIFRS. This required reversal of the movement in the market value of the property recognised in the reported profit for the year to 30 June 2005 of $8 million. There was a corresponding decrease in property, plant and equipment on the balance sheet of the same amount.

Depreciation of the buildings introduced a depreciation expense for the year to 30 June 2005 of $1 million.

Certain of the operating leases for property require that the land and/or building be returned to the lessor in its original condition. Under AIFRS, the present value of the estimated future cost for the plant and equipment to be removed and the premises to be returned to the lessor in its original condition are recognised as a lease provision when the relevant alterations are made to the premises, capitalised as part of the cost of plant and equipment, and depreciated over the useful lives of the assets.

Under Australian GAAP, these costs were not recognised until it was probable that the expenditure would be incurred generally referring to when a decision was made to cancel or not renew a lease.

At 1 July 2004, a lease provision of $21 million was recognised for the Consolidated entity with a corresponding increase in property, plant and equipment. The net carrying amount of this provision remained the same at 30 June 2005 and 1 July 2005. The initial recognition of the addition to property, plant and equipment was accompanied by a depreciation expense of $8 million up to 1 July 2004 as a reduction to retained earnings. The net balance capitalised as part of property, plant and equipment upon AIFRS transition at 1 July 2004 was $13 million. The net balance capitalised as part of property, plant and equipment fell to $10 million as at 30 June 2005 as a result of additional depreciation expense recognised for the year to 30 June 2005 of $3 million.

Under AIFRS the definition of income includes both revenue and gains. Gains are determined on a net basis (proceeds less the carrying amount and/or costs of achieving the proceeds). Under Australian GAAP the net gain or loss from the disposal of property, plant and equipment items were presented on a gross basis. Hence, upon the disposal of the items, under previous Australian GAAP the gross proceeds from the disposal were included in revenue while under AIFRS only the net gain would be included. The disposal of property for the Consolidated entity for the year ended 30 June 2005 involved recognition of a gain on sale of $4 million recognised as a realised gain on investments. The disposal of plant and equipment for the Consolidated entity for year ended 30 June 2005 involved gross proceeds of $9 million, the carrying amount of the items prior to disposal of $12 million, and a net loss of $3 million. The net impact on profit for the year under both Australian GAAP and AIFRS was a net income of $1 million. The adjustment to recognise the net gain on the sale of property, plant and equipment as other income under AIFRS reduced the realised gain on investments by $4 million, reduced the revenue for the year ended 30 June 2005 by $9 million and reduced the expenses for the period by the same amount. There was no impact on profit for the year then ended and no consequential tax effect.

(vii) Reset preference shares (applied from 1 July 2005) (transition adjustment is relevant to the Parent and the Consolidated entity)
The reset preference shares ("RPS") were presented as equity under Australian GAAP as they are not considered a mandatory convertible instrument, are perpetual, and there is no obligation to pay distributions. The RPS are presented as debt under AIFRS because there are circumstances under which the holder can demand conversion of the instruments, and are carried at amortised cost using the effective interest method. This involved a reclassification of $550 million from share capital to interest-bearing liabilities as at 1 July 2005.

**Note 38. Explanation of transition to Australian equivalents to International Financial Reporting Standards (continued)**

**(e) Notes to the reconciliations for sections (a) to (d) above (continued)**

(vii) Reset preference shares (applied from 1 July 2005) (continued)

The transaction costs incurred from the issuance of the two tranches of RPS, totalling $11 million, were recognised directly in equity under Australian GAAP as a reduction in the proceeds of the instruments. With the RPS presented as debt under AIFRS those transaction costs are capitalised, presented together with the related liability, and recognised on an effective yield basis (amortised over the period to the first reset date). This required an adjustment as at 1 July 2005 of $11 million to recognise the capitalisation of the transaction costs, and a reduction in retained earnings of $6 million representing the portion of the transaction costs that have been effectively amortised up to that date.

Distributions on the instruments made after 1 July 2005 are treated as interest rather than dividends and so have a negative impact on reported profit. With the distributions treated as interest under AIFRS, the distributions are recognised on an accruals basis, which is different to the previous policy of recognising a provision for the distributions only when the distributions were declared. The adjustment to recognise the interest payable as at 1 July 2005 was a decrease in retained earnings of $1 million.

(viii) Investments (applied from 1 July 2005) (transition adjustment is relevant to the Consolidated entity only)
Upon transition to AIFRS, the Consolidated entity has continued to measure all investments at market value with movements in market value being recognised in profit or loss. This is the result of an accounting policy selection made. This includes all derivatives used in relation to investment activities. This has basically been a continuation of previous practice with small adjustments for disposal costs (Australian GAAP used net market value rather than gross market value) and a change in market price determination (Australian GAAP used last sale price rather than bid/offer price). The net adjustment for the change was a $1 million increase in investments with a corresponding increase in retained earnings as at 1 July 2005.

(ix) Derivatives (applied from 1 July 2005) (transition adjustment is relevant to the Consolidated entity only)
All of the derivative contracts selected for hedge accounting as at 1 July 2005 qualified as a cash flow hedge. The adjustment required to recognise the application of cash flow hedge accounting under AIFRS for these transactions involved an increase in the measurement of the derivatives recognised on the balance sheet of $7 million ($8 million increase in interest-bearing liabilities and a $1 million increase in trade and other receivables) with a corresponding net decrease to an equity reserve.

(x) Taxation (transition adjustment is relevant to both the Parent and the Consolidated entity only)
The transition to AIFRS involved three types of tax adjustments. There were adjustments arising from the different methodology used for the determination of tax adjustments, consequential tax impacts arising from the different recognition treatments of certain assets and liabilities under AIFRS, and adjustments relating to changes in the tax consolidation system.

*Impact from change in methodology*
Income tax is calculated based on the “balance sheet approach” replacing the “income statement approach” previously used. The AIFRS treatment focuses on the closing balances rather than the movements for the period. This method recognises deferred tax balances when there is a difference between the carrying value of an asset or liability, and its tax base (being the amount attributed to an asset or liability for tax purposes) rather than for differences between accounting and taxable profit or loss. Deferred tax assets under AIFRS are recognised based on a ‘probable’ criterion rather than the ‘beyond reasonable doubt’ criterion, or ‘virtually certain’ criterion for unused tax losses, under previous Australian GAAP. In addition, current and deferred taxes attributable to amounts recognised directly in equity are recognised in equity. Deferred tax balances continue to be undiscounted under AIFRS. This change in methodology had no impact on the recognition of tax related assets and liabilities. However, the tax effect of the AIFRS transition adjustments relating to items that were recognised directly in equity was also recognised in equity which would not have been in accordance with previous Australian GAAP.

*Impact of consequential tax impacts arising from other AIFRS transition adjustments*
Apart from the change in methodology, the transition to AIFRS also involved consequential tax impacts arising from the different recognition treatments of certain assets and liabilities under AIFRS. These consequential tax impacts involved a net reduction in retained earnings at 1 July 2004 of $16 million and a net increase in retained earnings at 30 June 2005 of $6 million and at 1 July 2005 of $6 million. There were also some tax amounts recognised directly in equity.

**Note 38. Explanation of transition to Australian equivalents to International Financial Reporting Standards (continued)**

**(e) Notes to the reconciliations for sections (a) to (d) above (continued)**

(x) Taxation (continued)

*Tax consolidation*
Under previous Australian GAAP, the Parent recognised current and deferred tax amounts relating to transactions and balances of the Australian tax-consolidated subsidiaries as if those transactions and balances were its own. Under AIFRS, the Parent only recognises the current tax payable and deferred tax assets arising from unused tax losses assumed from wholly-owned subsidiaries in the tax-consolidated group. There is no impact on the Consolidated entity. For the Parent, net deferred tax assets decreased by $120 million with an equivalent net adjustment to intercompany loan balances.

(xi) Minority interests in unitholders' funds (applied from 1 July 2005) (transition adjustment is relevant to the Consolidated entity only)
The Consolidated entity includes IAG Asset Management Wholesale Trusts in which the Consolidated entity has a controlling interest for accounting purposes. Previously, when consolidating the trusts, an amount was recognised in equity for the minority interest in the trusts, being the value attributable to unitholders outside the Consolidated entity. Under AIFRS, the residual interests in the trusts qualify as a liability on the balance sheets of the trusts and is not recognised as equity. Therefore, upon consolidation of the trusts under AIFRS, the value attributable to unitholders outside the Consolidated entity is recognised as a liability on the balance sheet of the Consolidated entity and not in equity as a minority interest. The change has also resulted in the distributions from the trusts to those unitholders, previously presented as net profit attributable to minority interests, forming part of the profit for the period. The change has no impact on the equity attributable to equity holders of the Parent.

These changes required a reclassification of $421 million as at 1 July 2005 from minority interest presented as equity on the balance sheet to minority interest in unitholders' funds presented as a liability on the balance sheet. The adjustment also impacts on the treatment of net income attributable to minority interests in unitholders' funds in the income statement which is applicable for the first time for the year ended 30 June 2006 and involves no prior period adjustment.

**Note 39. Events subsequent to reporting date**

As the following transactions occurred after reporting date and did not relate to conditions existing at reporting date, no account has been taken of them in the financial statements for the year ended 30 June 2006.

**(a) Declaration of final dividend**

On 25 August 2006, a final dividend of 16.0 cents per share, 100% franked, was declared by the Company. The dividend will be paid on 9 October 2006.

**(b) Progress of negotiations with a China based general insurance business**

IAG announced on 7 February 2006 that it had signed a memorandum of understanding with a view to acquiring 24.9% of China Pacific Property Insurance Co., Ltd. ("CPPI"). IAG announced on 3 July 2006 that draft transaction agreements had been confirmed for the purposes of lodgement with the China Insurance Regulatory Commission for preliminary review. Under the terms of the draft transaction agreements, IAG will acquire 24.9% of CPPI for approximately $350-375 million.

The parties intend to proceed to signing the transaction agreements as soon as possible following formal approval by relevant regulators.

**INSURANCE AUSTRALIA GROUP LIMITED AND CONTROLLED ENTITIES**

**DIRECTORS' DECLARATION**

In the opinion of the Directors of Insurance Australia Group Limited:

(a) the financial statements and notes 1 to 39, including the remuneration disclosures that are contained in the Remuneration Report in sections A to D of the Directors' report, are in accordance with the Corporations Act 2001 including:

  (i) giving a true and fair view of the financial position of the Company and consolidated entity as at 30 June 2006 and of their performance, as represented by the results of their operations and their cash flows, for the year ended on that date; and

  (ii) complying with Accounting Standards and the Corporations Regulations 2001; and

(b) the Remuneration Report in sections A to D of the Directors' report comply with Australian Accounting Standard AASB 124 *Related Party Disclosures*; and

(c) there are reasonable grounds to believe that the Company will be able to pay its debts as and when they become due and payable.

The Directors have been given the declaration required by section 295A of the Corporations Act 2001 from the chief executive officer and chief financial officer for the financial year ended 30 June 2006.

Signed at Sydney this 25th day of August 2006 in accordance with a resolution of the Directors.

....................................................Director

James Strong ....................................................Director

## INDEPENDENT AUDIT REPORT

***To the shareholders of Insurance Australia Group Limited***

***Scope***

*The financial report, remuneration report and directors' responsibility*

The financial report comprises the income statements, statements of recognised income and expense, balance sheets, cash flow statements, accompanying notes 1 to 39 to the financial statements, and the directors' declaration for both Insurance Australia Group Limited (the "Company") and Insurance Australia Group Limited and its Controlled Entities (the "Consolidated Entity"), for the year ended 30 June 2006. The Consolidated Entity comprises both the Company and the entities it controlled during that year.

As permitted by the *Corporations Regulations 2001*, the Company has disclosed information about the remuneration of directors and executives ("remuneration disclosures"), including those required by Australian Accounting Standard AASB 124 *Related Party Disclosures*, under the heading "Remuneration Report" in sections A to D of the directors' report and not in the financial report.

The directors of the Company are responsible for the preparation and true and fair presentation of the financial report in accordance with the *Corporations Act 2001*. This includes responsibility for the maintenance of adequate accounting records and internal controls that are designed to prevent and detect fraud and error, and for the accounting policies and accounting estimates inherent in the financial report. The directors are also responsible for preparing the relevant reconciling information regarding the adjustments required under the Australian Accounting Standard AASB 1 *First-time Adoption of Australian equivalents to International Financial Reporting Standards*. The directors are also responsible for the Remuneration Report contained in the director's report.

*Audit approach*

We conducted an independent audit in order to express an opinion to the shareholders of the Company. Our audit was conducted in accordance with Australian Auditing Standards in order to provide reasonable assurance as to whether the financial report is free of material misstatement and that the remuneration disclosures comply with AASB 124. The nature of an audit is influenced by factors such as the use of professional judgement, selective testing, the inherent limitations of internal control, and the availability of persuasive rather than conclusive evidence. Therefore, an audit cannot guarantee that all material misstatements have been detected.

We performed procedures to assess whether in all material respects the financial report presents fairly, in accordance with the Corporations Act 2001, Australian Accounting Standards and other mandatory financial reporting requirements in Australia, a view which is consistent with our understanding of the Company's and the Consolidated Entity's financial position, and of their performance as represented by the results of their operations and cash flows and whether the remuneration disclosures comply with Australian Accounting Standard AASB 124.

We formed our audit opinion on the basis of these procedures, which included:

- examining, on a test basis, information to provide evidence supporting the amounts and disclosures in the financial report; and
- assessing the appropriateness of the accounting policies and disclosures used and the reasonableness of significant accounting estimates made by the directors.

While we considered the effectiveness of management's internal controls over financial reporting when determining the nature and extent of our procedures, our audit was not designed to provide assurance on internal controls.

***Audit opinion***

In our opinion:

1) the financial report of Insurance Australia Group Limited is in accordance with:

   a) the *Corporations Act 2001*, including:

      i. giving a true and fair view of the Company's and Consolidated Entity's financial position as at 30 June 2006 and of their performance for the financial year ended on that date; and;

      ii. complying with Australian Accounting Standards and the Corporations Regulations 2001; and

   b) other mandatory financial reporting requirements in Australia; and

2) the Remuneration Report in sections A to D of the directors' report complies with Australian Accounting Standard AASB 124 *Related Party Disclosures*.

KPMG

**KPMG**

**Dr Andries B Terblanché**
Partner

**Sydney**
25th August 2006