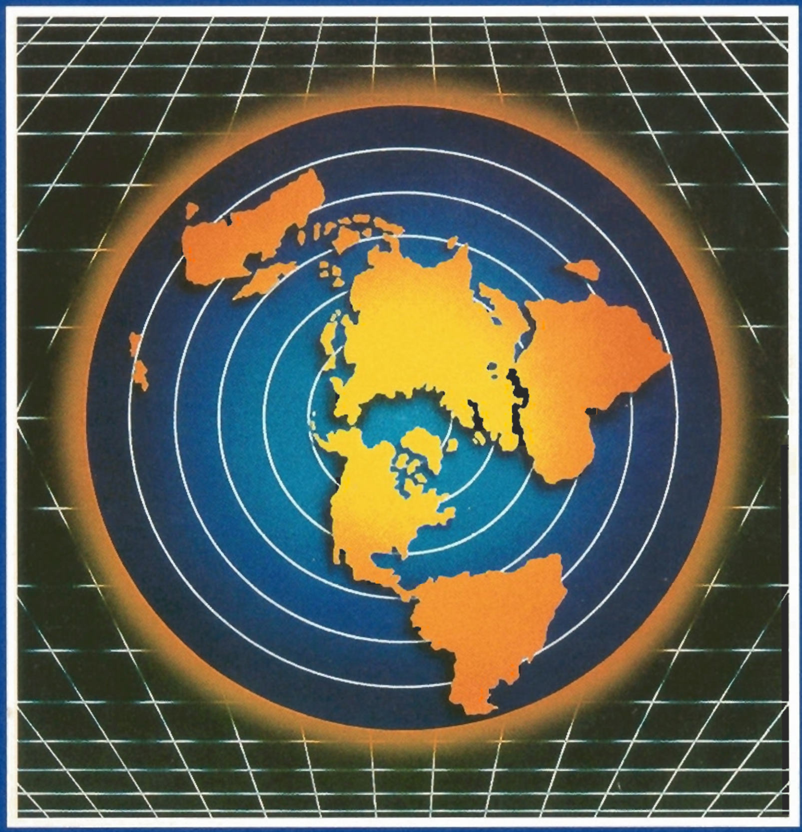
Alexander & Alexander



International Insurance Brokerage
Risk Management and Consulting Services
1986 Annual Report

Alexander & Alexander Services Inc. is the second largest international insurance brokerage company and the world's leading retail insurance broking firm. Through its 18,000 employees, A&A provides a broad range of risk management and financial services to companies, organizations and individuals.

Alexander & Alexander plans, places and services all types of insurance and risk management programs, including property, casualty, marine, life and group. The corporation and its subsidiaries provide reinsurance placement, underwriting management, risk analysis and management, and self-insurance services. In addition, A&A offers a variety of human resource management consulting services, including actuarial and administrative services for pension, compensation and benefit plans, employee communications and management consulting. A&A also provides property tax consulting and premium finance services.

Alexander & Alexander serves clients through offices in more than 158 cities in the United States, Canada and the United Kingdom, and operates in over 70 countries and territories worldwide through subsidiaries, joint ventures and correspondent relationships.

TO OUR SHAREHOLDERS:

1986 was a year of progress for A&A. We reached a major milestone in becoming a billion dollar revenue company. Although continuing operations fell short of expectations during the last six months, they reflected significant improvement over the prior year. Our largest operating units, A&A Inc., A&A International Inc. and Alexander Howden Group Limited, had fine years. New business development was strong.

We have become the world's leading retail broker, with a particularly substantial presence in the U.S., Canada, the U.K. and Australia. Our expansion has greatly strengthened the Company's ability to provide multinational servicing capabilities. We have an equity position in approximately 90 percent of our worldwide servicing capabilities.

A&A returned to a solid level of profitability in 1986. Income from continuing operations sustained the recovery from the effects of the soft insurance market. Pre-tax profits increased more than 50 percent over 1985. Except for significant costs incurred in 1986 and 1985 in connection with combining A&A and Reed Stenhouse post-merger operations as well as litigation which arose out of the 1982 Alexander Howden Group plc acquisition, operating margin improvement would have been significantly better. Such costs are not expected to have a material effect in 1987.

The worldwide nature of insurance markets, competitive shifts and regulatory changes in financial services industries defy precise forecasts of the specific new challenges A&A will meet in the months and years ahead.

Your Company is positioned with the necessary resources to compete effectively in an environment of constant change. We have people with the depth of experience to implement our blueprint for ensuring that A&A is the quality global broker for the balance of the century and beyond.

The essential foundation of A&A Services is the expanding retail business of A&A Inc. and A&A International. As a result, we are able to provide substantial business to our other operating units and subsidiaries. This means premium flow-through and profit enhancement for the worldwide company.

The formation of Alexander Howden Limited in 1984 was a critical building block. It put us squarely in the wholesale broking business in London. Alexander Howden is known today for its innovative services to A&A and scores of other retail brokers in the U.S. and abroad.

We have also created a wholesale broking force in North America. Last summer, five of our U.S. surplus lines insurance brokerage firms merged to form Alexander Howden North America, Inc. This new organization specializes in excess and surplus lines that are frequently difficult to place and offers our clients increased access to the Lloyd's market.

Reinsurance broking is a second strategic building block. Alexander Howden Reinsurance Brokers is a major force in the London and global markets. In the U.S., our reinsurance business is marked by the expanding success and profitability of Thomas A. Greene & Company, now among the nation's largest and most rapidly growing reinsurance brokerage firms.

Risk management services, performed by Anistics and Alexsis, are a third building block. Anistics is a state-of-the-art resource for A&A broking operations and gives us a competitive edge in international broking. During 1986, the Risk Management Services Group became a global organization and Luther T. Griffith was named chief executive officer.

RETAIL BROKING

Alexander & Alexander is the world's leading retail insurance broker. Through A&A Inc. and A&A International Inc., the Company handles diverse lines of coverage including ocean marine, boiler and machinery, property, general liability, professional liability, workers compensation and product liability, as well as political risk and environmental impairment liability.

In addition, A&A provides specialized services to financial institutions and to clients in industries such as aerospace, health care, energy and entertainment.

A&A's support services include loss analysis and control, policy design, insurance marketing and claims administration.

WHOLESALE BROKING

Alexander & Alexander's wholesale broking operations, Alexander Howden Limited and Alexander Howden North America, Inc., provide access to Lloyd's of London and other global insurance markets. They also offer clients a wide range of services and expertise in "hard-to-place" risks.

Human resource management consulting is our fourth building block and we now compete with the largest benefits consulting firms. We formed a new global employee benefits organization. The Alexander Consulting Group Inc. A. M. D'Alessandro has been elected president and chief executive officer, and will continue as CEO of the firm's U.S. employee benefits operation.

John D. Loudon has become chief executive officer of The Alexander Consulting Group Ltd.—U.K. and Europe. Brian E. Kennedy has been named president and chief executive officer of The Alexander Consulting Group Ltd.—Canada.

The Alexander Consulting Group is a key element in our overall business strategy. It complements our other operations and reinforces A&A's position as a full service company. We are committed to the long-term growth and future development of our human resource management capabilities.

Niche financial services, including Property Tax Service Company and TIFCO, our insurance premium finance company, comprise a fifth building block. These services are instrumental in developing new business and servicing existing clients.

All of these units, when brought together, give A&A strategic value beyond the sum of its parts. The Company's success in diversifying within its core business is best demonstrated by the fact that retail broking generated 92 percent of our revenues in 1969. Today, that figure is 62 percent. A&A's commitment to capitalize on a wide range of services will ensure our long-term growth and viability in the years ahead.

In November, we reported that the Company reached a settlement with former auditors of Alexander Howden Group. Settlement terms provided for the payment of approximately $24 million to A&A. Rather than reflecting this as an income item in our financial statements, we have placed the full amount in reserve pending the final resolution of other related contingencies. In January, 1987, we settled all outstanding matters of litigation with former Howden director Ian R. Posgate.

Pursuing these matters has been expensive and time consuming. However, we have achieved settlements which are in the best interests of the Company and its shareholders. The primary burdens associated with Howden-related litigation are now behind us.

During 1986, the Company sold its discontinued underwriting operations, Sphere Reinsurance Company of Canada and its manager, Sphere Drake Canada Limited, for approximately book value. We also sold the licenses of Stone Mountain Insurance Co. in Georgia. Additionally, we retained an investment banking firm to further assist our efforts in the sale of Sphere Drake Insurance Company.

The long-tail nature of business previously written by our insurance companies makes it difficult to project future losses definitively. We continue to monitor the reserving practices and reinsurance collectibles of these companies by employing internal and external specialists. Despite these uncertainties, our comfort level continues to increase.

We are pleased that J. Roy Nicholas, former chairman and chief executive officer of the Royal Insurance Company (U.S.), has joined A&A as a senior vice president. He has management responsibility for our underwriting operations.

REINSURANCE BROKING

Alexander Howden Reinsurance Brokers is a major reinsurance presence in London and a leader in worldwide marine, non-marine, aviation and excess of loss markets.

Alexander & Alexander's U.S. reinsurance subsidiary, Thomas A. Greene & Company, is among the largest and fastest growing reinsurance brokers in North America.

RISK MANAGEMENT SERVICES

Risk Management Services Group is a state-of-the-art resource for the Company's brokerage operations. Organized as a global operating unit in 1986, the group gives A&A a competitive edge for producing and servicing international brokerage business.

Anistics, the group's risk management information and consulting unit, specializes in applied research and development for computer software products, loss forecasting, financial analysis and risk management consulting services.

Alexander Insurance Managers Limited offers comprehensive captive management services through its worldwide facilities.

Alexander Trade Services provides political risk and trade finance related services on a global basis.

A&A Inc.'s Alexsis unit supplies complete operations to facilitate alternate funding mechanisms, including self-insurance, risk retention and fronted programs.

As part of our strategy to lessen the Company's exposure to the risk assumption portion of the insurance business, we are pursuing the sale of Shand, Morahan & Company, Inc. and its partially owned subsidiary, Evanston Services, Inc.

The first half of 1986 was marked by continued worldwide shrinkage of insurance capacity and dramatic escalation in insurance prices. Although these conditions moderated considerably later in the year, they caused severe financial hardship for many of our clients. A&A's years of investment in risk management services have positioned us to respond to these changing market conditions.

Many clients are seeking alternative funding vehicles and we have initiatives under way to develop capacity in some of the more difficult lines of coverage. We are in the process of forming Environmental Protection Insurance Company, a risk retention group. It focuses on environmental impairment liability concerns of small and medium-sized companies.

Another A&A program, Municipal Liability Claims Funding, developed in cooperation with AMBAC Indemnity Corporation, provides municipal entities the ability to fund liability claims through guaranteed lines of credit with local banks.

Although insurance markets have begun to "soften" significantly in 1987, traditional insurance is increasingly regarded as only one of several alternatives for protection against risk. Some consumers are abandoning the conventional insurance industry for large segments of their risk program.

We believe that many of these responses may become permanent. Further changes are inevitable. The insurance industry will never return to "business as usual," and A&A is committed to a future of innovation to meet emerging client needs.

As representatives of insurance consumers, our executives have actively participated in the public policy discussion about our clients' liability problems. We have called on our industry to join A&A in positioning brokers as "problem solvers," and we have taken leadership roles with a variety of coalitions ranging from the national brokers' association to the U.S. Chamber of Commerce's Civil Justice Action Group. In May, A&A Services senior vice president Robert H. Moore completed a one-year term as president of the National Association of Insurance Brokers. Other A&A executives in the U.S. and abroad are also increasingly sought out by business and trade press because of their demonstrated expertise.

In the midst of volatile market conditions, A&A has continued to expand and grow. During 1986, we completed acquisitions in over a dozen U.S. cities including Atlanta, Chicago, Dallas, Denver, Kansas City, Phoenix, San Francisco and Seattle. We also opened a new office in Tampa. Our expansion adds new capabilities in various lines of service.

William D. Baker, senior vice president, A&A International Inc., has been named director of international business development and a member of A&A International's executive and operations committees. Ronald W. Forrest has become chief executive officer of Alexander Stenhouse Limited—United Kingdom. Michael J. Barrett has been appointed chief executive officer of Alexander Stenhouse Europe Limited.

THE ALEXANDER CONSULTING GROUP

The Alexander Consulting Group Inc., established as a global operating unit in 1986, competes with the world's largest employee benefit and management consulting firms.

The Alexander Consulting Group provides services in executive employee compensation and benefit plans, human resource management and related employee communications, as well as placement of individual and group life, accident and health insurance. The group's compensation practice provides management consulting services beyond direct and indirect compensation plans, in areas such as organizational structures, personnel practices, affirmative action programs and long-range planning.

FINANCIAL SERVICES

Financial services are instrumental in developing new business and servicing existing clients.

Alexander & Alexander provides specialized financial services through operating units and subsidiaries such as Property Tax Service Company and TIFCO, A&A's premium finance company.

In addition, William C. Thomas, senior vice president, A&A International Inc., has responsibility for a new combined region comprising the Middle East and Southeast Asia. Jack R. Perez has been appointed senior vice president, A&A International Inc., and has responsibility for our operations in Central and South America.

The dramatic rise in economic activity in Japan, and between Japan and the rest of the world, requires an increased commitment. A&A's experience in Japan, through Alexander Howden, dates back to the 1920s, and we have maintained an office in Tokyo since 1971. In connection with our continued expansion in the Far East, James Y. Paulding has been named president, Alexander & Alexander of Japan Inc.

Our U.S. brokerage operations were further strengthened last spring with the appointment of Robert J. Murphy as director of national marketing for A&A Inc. He has assumed responsibility for the Company's national resource groups which focus on risk management and insurance needs for the health care, energy and aviation/aerospace industries, as well as overseeing the Company's financial products group, and corporate research and development.

Also in 1986, Donald R. Bell, formerly Northeast regional director, became director of A&A Inc.'s Greater New York region. Gerald M. Brown became Northeast regional director. Thomas G. Hardy, Jr. was named executive director of our Executive Planning Services Division.

A&A has the resources in place to give multinational clients the ultimate in service wherever they operate. We have the critical mass to support information resources, research and development, and provide unique services. We have the ability to enhance profits by leveraging premium flow-through. And, we have an integrated and coordinated organization to serve our clients with greater efficiency and increase our market share.

None of this would be possible without the dedication, professionalism and commitment of our 18,000 employees around the world. We are proud of their performance and congratulate them on achieving a record year.

Our challenge for 1987 is to continue to maximize our resources and capabilities. We believe that in the years ahead, four or five worldwide brokerage firms will be increasingly predominant. Although A&A is a leader in this group, we remain dedicated to the principle that outstanding client service at the local and regional level is the real key to success wherever we operate.

We are looking forward to working with our clients during 1987 and continuing to earn their loyalty and respect.

John A. Bogardus Jr.

JOHN A. BOGARDUS, JR.
Chairman of the Board and
Chief Executive Officer

Tinsley H. Irvin

TINSLEY H. IRVIN
President and
Chief Operating Officer

Selected Financial Data

Alexander & Alexander

(in millions, except per share amounts)

	1986	1985	1984	1983	1982
Summary of Operations					
Operating revenues	**$1,068.2**	$ 913.6	$ 788.0	$ 778.6	$ 778.1
Operating income	**109.8**	80.3	42.3	60.2	68.2
Income from continuing operations	**66.6**	44.7	28.3	23.4	44.4
Loss from discontinued operations	**(24.0)**	(52.0)	(77.1)	(22.1)	(18.8)
Extraordinary items	**0.6**	—	1.6	6.9 (a)	(40.0)(b)
Net income (loss)	**$ 43.2**	$ (7.3)	$ (47.2)	$ 8.2	$ (14.4)
Per share of common stock					
Income from continuing operations	**$ 1.62**	$ 1.17	$ .78	$ .66	$ 1.27
Loss from discontinued operations	**(.58)**	(1.36)	(2.12)	(.63)	(.54)
Extraordinary items	**.01**	—	.04	.20	(1.14)
Net income (loss)	**$ 1.05**	$ (.19)	$ (1.30)	$ .23	$ (.41)
Cash dividends	**$ 1.00**	$ 1.00	$ 1.00	$ 1.00	$ 1.94
Weighted average number of shares	**41.2**	38.2	36.3	35.3	35.1
Financial Position					
Current assets	**$1,855.3**	$1,635.6	$1,308.8	$1,239.1	$1,302.9
Working capital	**52.8**	52.6	37.1	26.2	(22.9)
Total assets	**2,428.6**	2,127.4	1,832.7	1,844.9	1,963.8
Long-term debt	**97.9**	125.7	176.5	184.7	200.7
Stockholders' equity	**324.4**	284.0	263.6	335.3	357.8

(a) Represents realization of prior year's net operating losses of certain foreign subsidiaries and additional tax benefits previously not recognizable.

(b) The $40.0 million extraordinary charge reported in 1982 represents the deficiencies in Alexander Howden's net tangible assets which were discovered by the Company after its acquisition of Alexander Howden.

In connection with the investigation referred to in Note 14 of Notes to Financial Statements, the SEC staff has expressed an accounting interpretation that the purchase accounting discount of Alexander Howden's insurance claim liabilities (which had the effect of reducing the extraordinary charge) should have been apportioned between those liabilities known at the date of acquisition and those additional liabilities discovered by the Company after the acquisition. The SEC staff has expressed the view, applying this interpretation, that the 1982 extraordinary charge would have been increased by approximately $11 million. While the SEC staff has not yet advised the Company of its view as to the effect, if any, of such increase on subsequent periods, the Company assumes that the effect of the staff's accounting interpretation would be a corresponding reduction in the amount of goodwill relating to the Alexander Howden insurance underwriting companies, that the loss from discontinued operations for 1982, 1983 and 1984 would have been reduced in the aggregate by an equal amount and that there would have been no effect on results of operations for years subsequent to 1984.

The Company continues to believe, and its independent auditors concur, that the accounting treatment followed by the Company was appropriate.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Alexander & Alexander

Results of Continuing Operations

Nineteen eighty-six was a year of record revenues and increased profitability for A&A. Operating revenues grew 16.9% in 1986 topping the billion dollar mark for the first time in A&A's history. This increase in operating revenues followed a 15.9% increase in 1985 after three successive years of little growth.

Insurance services generate over 88% of the Company's operating revenues. Consolidated revenues from this segment increased 17.1% in 1986 and 17.4% in 1985. The primary reasons for the double-digit growth rates were successful new business production efforts and insurance premium rate increases.

Future revenue growth will be a function of new business production, additional business from existing clients, product development and movement in insurance premium rates. Premium rates are cyclical in nature and can vary widely based on insurance market conditions. The rise in premiums throughout the industry during the last two years reversed the trend of declining underwriting results for insurance companies experienced during the first half of this decade. The effect of adverse underwriting results was a reduction in the capacity of the market to underwrite risks, which resulted in insurance premium increases and reduced coverage for our clients. As capacity returns through new capital and improved operating results, rate increases should stabilize.

An escalation in legislative and other changes affecting employee benefit plans contributed to a 19.4% increase in employee benefit and management consulting operating revenues for 1986. Operating revenues for this segment increased 5.3% in 1985 and 3.3% in 1984 due primarily to new business production. During the latter part of 1986, the operations which comprise the Company's employee benefit and management consulting segment were organized into a coordinated global operating unit. This ability to better service a growing multinational client base along with the current changes in legislation should result in sustained revenue growth.

Better than 30% of the Company's operating revenues have been generated outside the United States, primarily in Canada and the United Kingdom. While these operations are exposed to fluctuations in foreign currency rates, the net effect over the last two years has been minimal.

Operating expenses grew 15.0% in 1986 and 11.7% in 1985. Costs associated with sales and client services have risen at double-digit rates, parallel to revenue growth rates. These increases were due largely to higher costs in the area of salaries, incentives and employee benefits reflecting, in part, the need to increase staff levels in order to service an expanding client base and to ensure that the Company remains competitive in the industry. Other operating expenses, such as premises costs and travel and entertainment expense, also increased at comparable rates further reflecting an expanding organization handling an increased volume of business. As noted for operating revenues, the net effect of fluctuations in foreign exchange rates in translating foreign operating expenses for 1986 and 1985 when making prior year comparisons was minimal.

Impacting operating expense in both 1986 and 1985 was the increased cost for most lines of insurance carried by the Company. The reduced availability of professional liability insurance, primarily errors and omissions ("E&O") coverage, and an increase in the frequency of claims has affected A&A as well as other professional service organizations. Based upon the Company's experience in recent years, management believes that A&A's E&O coverage provides sufficient protection to A&A in the conduct of its business. However, the Company's level of self-insured retention is increasing while terms and levels of coverage have, until recently, tightened. These changes had some adverse effect on 1986 operating expenses and are expected to continue. In response to this increase in exposure, the Company is emphasizing an enhanced quality control program designed, in part, to mitigate its effect.

Equity in unconsolidated operations increased by $10.0 million in 1986 and $5.1 million in 1985 primarily as a result of an increased volume in premium financing combined with related lower financing costs. Reference is made to Note 4 of Notes to Financial Statements for additional information concerning the Company's premium finance subsidiary and other unconsolidated operations.

Consolidated investment income increased 23.9% and 17.8% in 1986 and 1985, respectively. The growth largely reflects an increase in investment levels, partially offset by lower short-term interest rates. Throughout 1985 and 1986 premium volume grew in line with rising premium rates and increases in new business. These fiduciary funds represent a large portion of A&A's investment earnings base and were the principal reason for the increase in investment levels.

Interest expense declined 15.9% in 1986 and 9.2% in 1985 due to a decrease in average consolidated debt and lower interest rates on the Company's short-term borrowings. Funds available from operations were used to reduce outstanding debt. These funds were supplemented significantly during 1985 with the proceeds of an equity placement.

Other expense increased $6.2 million in 1986 primarily as a result of legal and other related costs incurred in connection with the Company's litigation against former auditors and officials of Alexander Howden Group plc ("Alexander Howden") and the amortization of the Company's 1981 investment in purchased tax benefits.

In November, 1986 the Company settled its lawsuit against certain former auditors of Alexander Howden. The terms of the settlement included the payment of approximately $24.0 million to A&A. Recognition of this recovery in the Statement of Consolidated Income has been deferred pending final resolution of specific loss contingencies which arose out of the Alexander Howden acquisition and were known at the date of settlement. See Notes 12 and 13 of Notes to Financial Statements.

Other expense for 1985 of $17.7 million includes the pre-tax gain of $11.9 million realized on the sale of A&A's Lloyd's managing agency businesses offset by $20.5 million of Reed Stenhouse merger related expenses. Reference is made to Note 3 of Notes to Financial Statements for additional information.

The effective tax rates for continuing operations were 54.6% in 1986, 53.9% in 1985 and 49.6% in 1984 compared with the U.S. statutory rate of 46% in each year. An analysis of changes in income taxes and the effective income tax rates is presented in Note 5 of Notes to Financial Statements.

The high effective tax rates for all three years were principally the result of non-deductible items and current year losses by certain foreign subsidiaries which were not available to offset other profits for tax purposes. As these operating losses are carried forward to offset taxable profits of the respective foreign subsidiaries in future periods, the related tax benefits will be recognized.

The recently enacted Tax Reform Act of 1986 (the "Act") and the potential effect of the recently issued Financial Accounting Standards Board's Exposure Draft on Accounting for Income Taxes will have an impact on the Company's consolidated income tax position. The Act will affect the Company primarily in the form of reduced U.S. corporate tax rates, offset in part by an increase in the non-deductibility of certain operating expenses and more restrictive criteria for the recognition of foreign tax credits. The Exposure Draft would require the Company to change its method of accounting for deferred income taxes to the liability method. If adopted in its present form, it would result in a reduction in deferred taxes payable reflecting the reduction in the tax rates at which the timing differences would ultimately reverse. Negatively affecting the Company is the provision of the Exposure Draft to provide taxes on unremitted earnings of foreign subsidiaries, whether or not considered permanently invested. Given the preliminary status of the Exposure Draft and the Company's complex legal structure, the Company is not in a position to predict the ultimate outcome and its effect on the Company. While the combined effect of the Act and the Exposure Draft may result in a reduction in the Company's overall effective tax rate, the Company continues to implement strategies to become more tax efficient. Despite this possible reduction in the effective tax rate, in 1986 the Company was tax-paying in all of its principal locations around the world, with the exception of the United States. As net operating loss carryforwards are realized during 1987, it is expected that the Company will become a significant taxpayer in the United States as well.

As a result of the settlement with certain former auditors of Alexander Howden, referred to previously, the Company will increase its tax deduction above that taken in 1982 in connection with the loss sustained in the Alexander Howden acquisition. Consistent with the original deduction, no recognition of the related tax benefit will be given in the statement of consolidated income until realization is reasonably assured. Refer to Note 5 of Notes to Financial Statements for additional information.

An extraordinary credit of $0.6 million or $.01 per share was recognized in 1986 representing the realization of tax benefits resulting from the utilization of approximately $1.2 million of Reed Stenhouse net operating loss carryforwards. Due principally to the increased tax deduction referred to previously relating to the loss sustained in the Alexander Howden acquisition, recognition of additional Reed Stenhouse U.S. net operating loss carryforwards, which otherwise would have been utilized in 1986, will be deferred to future years. Reference is made to Note 5 of Notes to Financial Statements for additional information.

The weighted average number of common and common equivalent shares outstanding increased 7.9% in 1986, 5.2% in 1985 and 2.8% in 1984. Though all three years were affected by shares issued in business combinations, 1986 reflects an increase in the number of acquisitions consummated when compared to previous years. The 1985 increase was largely affected by the private placement of equity securities in Canada in the third quarter of that year and 1984's increase was primarily the result of the common stock for debenture exchange. Additionally, the increases in all three years included shares issued to fund certain employee benefit plans. The dilutive effect of the increase in the number of shares outstanding was not significant.

Changing economic conditions continue to affect the Company. However, over the last three years, inflation did not have a significant effect on the Company's operations.

Discontinued Operations

During 1986 the Company progressed in its efforts to dispose of its discontinued underwriting operations. Sales were completed on all companies held for sale, except for the Sphere Drake Insurance companies ("Sphere Drake") in the U.K. An investment banking firm was retained in 1986 to further assist the Company in Sphere Drake's expected sale during 1987.

The Company is continuing its settlement of claims or otherwise reducing the claims inventory of the insurance companies in run-off. An accounting of the discontinued underwriting operations is provided in Note 2 of Notes to Financial Statements.

The additional provision made in 1986 and the reserve for loss on disposal takes into account a large number of factors and is based on management's best judgment. The Company believes that the provisions made to date are sufficient to adequately provide for the estimated losses through the period of run-off or sale; however, there is no assurance that further adverse deviation may not occur.

Liquidity and Capital Resources

The Company's operations have historically been financed with internally generated funds and the use of short-term borrowings. During the past three years, cash flow from operations has been used principally to fund property additions and discontinued operations, pay dividends and reduce consolidated debt. Proceeds from equity issuances in both 1985 and 1984 were used entirely to reduce consolidated debt. Reference is made to the Statements of Changes in Consolidated Financial Position for an analysis of the Company's sources and uses of funds.

The net increase in cash and investments for the last three years was principally an increase in fiduciary assets. While these premium trust funds make up a significant portion of the Company's investment portfolio, they are not used to meet any of the Company's working capital needs, except in certain foreign operations where legally permissible.

In addition to an increase in fiduciary assets, cash flow in 1986 was significantly benefited by the $24.0 million auditors' settlement referred to previously together with a material reduction in 1986 income taxes payable resulting from the additional tax deduction. Reference is made to Note 5 of Notes to Financial Statements for further information concerning this deduction and the related deduction taken in 1982. These tax deductions are or will be the subject of IRS review; however, it is unlikely the issue will be settled in 1987. While the Company believes it will be successful in sustaining the deductions, the Company expects internally generated funds and other sources of working capital to be sufficient to meet operational needs.

During 1986, the Company contributed $22.0 million of additional capital to Sphere Drake Insurance Company plc ("Sphere"), which is part of discontinued operations, in order to meet London market expectations with respect to operating ratios necessary for the ongoing conduct of Sphere's underwriting operations. Also, during the year, the Company contributed $20.0 million of additional capital to the Atlanta insurance companies in run-off. In early 1987, A&A remitted $32.1 million to Atlanta International Insurance Company in payment for the realized and expected benefits in the Company's consolidated federal income tax return from that company's losses.

The Company maintains a $50.0 million bank credit agreement as further described in Note 7 of Notes to Financial Statements. As a result of the improvement in the Company's financial position, a new long-term credit agreement is being negotiated with the same bank which would further enhance the Company's financial flexibility. In the event short-term borrowings cannot be made advantageously, A&A intends, if necessary, to use this facility to refinance its short-term borrowings on a long-term basis and, accordingly, $9.9 million has been reclassified to long-term debt at December 31, 1986. Supplementing the bank credit agreement, A&A has lines of credit as additional support for future working capital requirements.

The Company is assessing its options with respect to redeeming in 1987 its 11% convertible subordinated debentures. Reference is made to Note 7 of Notes to Financial Statements for information on the terms of redemption. If called in full, it is expected that a major portion of the debentures will be replaced with lower cost borrowings.

Information concerning the asset based financing of the Company's premium finance subsidiary is provided in Note 4 of Notes to Financial Statements.

Future improvement in liquidity and working capital will come from various sources in addition to operating earnings. Subsidiaries of the Company have entered into two agreements for the sale of office buildings in 1987 with a combined sales price of approximately $30.0 million. The Company is also evaluating its options in connection with a possible sale or partial divestment of its interests in Shand, Morahan & Company, Inc. and is continuing with its efforts to sell Sphere Drake Insurance Company in 1987.

As a result of the provisions for estimated loss on disposal of the discontinued underwriting operations, A&A's consolidated retained earnings have been significantly reduced. This will not affect its dividend policy provided that retained earnings are available to cover dividend payments. While under Maryland law dividends may be paid from unrestricted paid-in capital, A&A's Board of Directors has no present intent of doing so.

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&Alexander

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Opinion of Deloitte Haskins & Sells, Independent Certified Public Accountants

To the Shareholders of Alexander & Alexander Services Inc.:

We have examined the consolidated balance sheets of Alexander & Alexander Services Inc. and its consolidated subsidiaries as of December 31, 1986 and 1985, and the related statements of consolidated income, of changes in consolidated financial position, and of consolidated stockholders' equity for each of the three years in the period ended December 31, 1986. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, such consolidated financial statements present fairly the financial position of the companies at December 31, 1986 and 1985, and the results of their operations, and the changes in their financial position for each of the three years in the period ended December 31, 1986, in conformity with generally accepted accounting principles consistently applied during the period except for the change, with which we concur, in 1985 in the method of accounting for pension costs of United States pension plans as described in Note 10 to the Financial Statements.

Deloitte Haskins & Sells

Baltimore, Maryland
March 16, 1987

Statements of Consolidated Income

Alexander & Alexander

(in millions, except per share amounts)

For the three years ended December 31,	1986	1985	1984
Operating revenues:			
Insurance services	**$ 943.3**	$805.8	$686.3
Employee benefit and management consulting	**105.3**	88.2	83.8
Other	**19.6**	19.6	17.9
Total	**1,068.2**	913.6	788.0
Operating expenses:			
Salaries and benefits	**609.5**	515.6	464.1
Other	**348.9**	317.7	281.6
Total	**958.4**	833.3	745.7
Operating income	**109.8**	80.3	42.3
Equity in unconsolidated operations (note 4)	**22.8**	12.8	7.7
Other income (expenses):			
Investment income	**67.3**	54.3	46.1
Interest expense	**(17.5)**	(20.8)	(22.9)
Amortization of intangible assets	**(11.8)**	(12.0)	(11.8)
Other expense—net (note 3)	**(23.9)**	(17.7)	(5.3)
Total	**14.1**	3.8	6.1
Income from continuing operations before income taxes	**146.7**	96.9	56.1
Income taxes (note 5)	**80.1**	52.2	27.8
Income from continuing operations	**66.6**	44.7	28.3
Loss from discontinued operations (note 2)	**(24.0)**	(52.0)	(77.1)
Income (loss) before extraordinary items	**42.6**	(7.3)	(48.8)
Extraordinary items, net (notes 5 and 7)	**0.6**	—	1.6
Net income (loss)	**$ 43.2**	$ (7.3)	$ (47.2)
Per share of common stock (note 1):			
Income from continuing operations	**$ 1.62**	$ 1.17	$ .78
Loss from discontinued operations	**(.58)**	(1.36)	(2.12)
Income (loss) before extraordinary items	**1.04**	(.19)	(1.34)
Extraordinary items, net	**.01**	—	.04
Net income (loss)	**$ 1.05**	$ (.19)	$ (1.30)
Cash dividends	**$ 1.00**	$ 1.00	$ 1.00
Weighted average number of shares	**41.2**	38.2	36.3

See notes to financial statements.

Statements of Changes in Consolidated Financial Position

Alexander & Alexander

(in millions)

For the three years ended December 31,	**1986**	1985	1984
Funds from operations:			
Income from continuing operations	**$ 66.6**	$ 44.7	$ 28.3
Depreciation and amortization	**42.6**	39.3	36.8
Undistributed income of unconsolidated operations	**(11.9)**	(4.4)	(2.6)
Deferred income taxes	**4.1**	14.1	22.8
Adjustment to conform fiscal year of RSC	**—**	(4.9)	—
Other, principally provisions for non-current liabilities	**21.3**	9.5	5.2
Total from continuing operations	**122.7**	98.3	90.5
Discontinued operations, net of non-fund items	**(0.2)**	(5.4)	(10.7)
Funding of discontinued operations	**(28.6)**	(19.4)	(8.0)
Extraordinary items, net of non-fund items	**0.6**	—	0.2
Total after extraordinary items	**94.5**	73.5	72.0
Changes in certain working capital items:			
Increase in accounts receivable	**(120.0)**	(182.1)	(44.8)
Increase in accounts payable	**209.0**	205.9	125.3
Increase (decrease) in other current liabilities	**33.5**	104.3	(67.0)
Effect of exchange rate changes on working capital	**11.6**	(2.1)	(2.8)
Cash dividends	**(41.0)**	(36.8)	(33.6)
Net funds provided internally	**187.6**	162.7	49.1
Financing transactions:			
Decrease in short-term debt	**(6.7)**	(1.1)	(1.4)
Additions to long-term debt	**5.8**	41.6	18.3
Payments of long-term debt	**(33.9)**	(94.9)	(10.5)
Shares issued in private placement	**—**	45.2	—
Other stock transactions	**21.0**	15.4	12.5
Increase (decrease) in other long-term liabilities	**19.4**	(2.6)	(17.0)
Sales of subsidiaries, net	**—**	14.9	4.8
Net funds provided in financing transactions	**5.6**	18.5	6.7
Investment transactions:			
Additions to property—net	**51.6**	33.8	24.8
Capital contribution to insurance company held for sale	**22.0**	—	—
Investment in unconsolidated operations	**4.3**	13.2	(1.0)
Additions to intangible assets—net	**18.2**	(9.1)	9.6
Other	**6.9**	(1.4)	(2.5)
Net funds used for investments	**103.0**	36.5	30.9
Increase in cash and investments	**$ 90.2**	$ 144.7	$ 24.9

See notes to financial statements.

Consolidated Balance Sheets

Alexander & Alexander

(in millions)

As of December 31,	1986	1985
Assets		
Current assets:		
Cash and investments (principally interest-bearing time deposits)	$ 573.0	$ 482.8
Accounts receivable (net of allowance for doubtful accounts of $24.4 in 1986 and $19.7 in 1985):		
Customer accounts	1,192.8	1,046.4
Other	89.5	106.4
Total current assets	1,855.3	1,635.6
Property and equipment—at cost:		
Land and buildings	18.7	19.4
Furniture and equipment	213.0	180.9
Leasehold improvements	74.1	68.5
Total	305.8	268.8
Less accumulated depreciation and amortization	135.9	120.8
Property and equipment—net	169.9	148.0
Equity in unconsolidated operations (note 4)	100.3	83.2
Net assets held for disposal (note 2)	31.2	4.4
Intangible assets—(net of accumulated amortization of $53.2 in 1986 and $42.8 in 1985)	214.5	202.5
Other assets	57.4	53.7
Total	$2,428.6	$2,127.4
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$1,572.4	$1,363.4
Short-term debt (note 6)	5.1	11.8
Accrued compensation	72.8	44.5
Other payables and accrued expenses	152.2	163.3
Total current liabilities	1,802.5	1,583.0
Long-term liabilities:		
Long-term debt (note 7)	97.9	125.7
Deferred income taxes (note 5)	132.2	100.5
Other (note 13)	71.6	34.2
Total long-term liabilities	301.7	260.4
Commitments and contingent liabilities (notes 11 and 12)		
Stockholders' equity (notes 7, 8 and 9):		
Preferred stock, authorized 10.0 shares $1 par value; none issued	—	—
Common stock, authorized 60.0 shares $1 par value; issued and outstanding 35.4 and 32.5 shares, respectively	35.4	32.5
Class A common stock, authorized 13.0 shares $.00001 par value; issued and outstanding 5.0 and 5.6 shares, respectively	—	—
Class C common stock, authorized 5.5 shares $1 par value; issued and outstanding 1.5 and 1.8 shares, respectively	1.5	1.8
Paid-in capital	327.7	308.8
Retained earnings	14.7	13.0
Accumulated translation adjustments	(54.9)	(72.1)
Total stockholders' equity	324.4	284.0
Total	$2,428.6	$2,127.4

See notes to financial statements.

Statements of Consolidated Stockholders' Equity

Alexander & Alexander

(in millions)

For the three years ended December 31,	1986	1985	1984
Common Stock:			
Balance, beginning of year	**$ 32.5**	$ 27.4	$ 26.1
Exchange of 11% convertible subordinated debentures, 0.8 shares in 1984 (note 7)	**—**	—	0.8
Contributed to an employee benefit plan, 0.2 shares in 1986, 1985 and 1984 (note 10)	**0.2**	0.2	0.2
Issued for acquisitions of businesses, 1.6, 0.7 and 0.2 shares in 1986, 1985 and 1984, respectively (note 3)	**1.6**	0.7	0.2
Conversions of Class A and Class C shares into common stock, 0.9 and 4.1 in 1986 and 1985, respectively (note 8)	**0.9**	4.1	—
Other	**0.2**	0.1	0.1
Balance, end of year	**$ 35.4**	$ 32.5	$ 27.4
Class A Common Stock:			
Balance, beginning of year	**$ 0.0**	$ 0.0	$ 0.0
Private placement, 1.8 shares (note 8)	**—**	—	—
Issued for acquisitions of businesses, 0.1 shares in 1985	**—**	—	—
Conversions into common stock, 0.6 and 1.7 in 1986 and 1985, respectively	**—**	—	—
Balance, end of year	**$ 0.0**	$ 0.0	$ 0.0
Class C Common Stock:			
Balance, beginning of year	**$ 1.8**	$ 4.2	$ 4.2
Conversions into common stock, 0.3 and 2.4 in 1986 and 1985, respectively	**(0.3)**	(2.4)	—
Balance, end of year	**$ 1.5**	$ 1.8	$ 4.2
Paid-In Capital:			
Balance, beginning of year	**$308.8**	$250.8	$225.7
Exchange of 11% convertible subordinated debentures	**—**	—	13.3
Contributed to an employee benefit plan	**6.0**	4.7	4.0
Issued for acquisitions of businesses	**9.1**	6.0	6.4
Conversions into common stock	**(0.6)**	(1.7)	—
Private placement	**—**	45.2	—
Other	**4.4**	3.8	1.4
Balance, end of year	**$327.7**	$308.8	$250.8
Retained Earnings:			
Balance, beginning of year	**$ 13.0**	$ 62.1	$142.7
Net income (loss)	**43.2**	(7.3)	(47.2)
Adjustment to conform fiscal year of RSC	**—**	(4.9)	—
Dividends:			
Common stock	**(41.0)**	(30.8)	(26.7)
RSC (pre-merger)		(6.0)	(6.9)
Other	**(0.5)**	(0.1)	0.2
Balance, end of year	**$ 14.7**	$ 13.0	$ 62.1
Accumulated Translation Adjustments:			
Balance, beginning of year	**$ (72.1)**	$ (80.9)	$ (63.4)
Foreign currency translation adjustment (note 3)	**17.2**	8.8	(32.4)
Realized translation loss relating to discontinued operations	**—**	—	14.9
Balance, end of year	**$ (54.9)**	$ (72.1)	$ (80.9)

See notes to financial statements.

Notes to Financial Statements
(in millions, except per share amounts)

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1. Significant Accounting Policies

Consolidation The accompanying consolidated financial statements include the accounts of Alexander & Alexander Services Inc. and its subsidiaries ("the Company") which are engaged in insurance broking and consulting services. The Company's unconsolidated subsidiaries and affiliates are accounted for on the equity method (see Note 4). Intercompany transactions and balances between consolidated subsidiaries have been eliminated. Reference is made to Note 2 for discussion of the Company's discontinued operations.

Foreign Currency Translation Assets and liabilities of the Company's international operations are translated at current exchange rates. Operating results are translated at average rates of exchange prevailing during the year. Unrealized gains or losses resulting from translation, including transactions which hedge a foreign currency investment or long-term intercompany investment, are included as a separate component of stockholders' equity. Net transaction gains (losses), amounting to $(1.0) million, $(3.0) million and $4.2 million for the years ended December 31, 1986, 1985 and 1984, respectively, are included in the determination of income from continuing operations.

Forward exchange contracts are purchased by the Company to hedge the impact of currency fluctuations affecting operations of certain foreign subsidiaries. Gains and losses on these hedging contracts generally are deferred and recognized in the period the hedged transactions are realized.

Property and Depreciation The cost of property and equipment is depreciated over the estimated useful lives of the related assets which range up to forty years for buildings and ten years for equipment. Leasehold improvements are capitalized and amortized over the shorter of the life of the asset or the lease term. Maintenance and repairs are charged to operations when incurred.

Intangible Assets Intangible assets resulting from acquisitions, principally goodwill and expiration lists, are amortized on a straight-line basis over periods not exceeding forty years. The costs of non-compete agreements are amortized on a straight-line basis over the terms of the agreements.

Income Taxes Deferred income taxes are provided on revenue and expense items recognized for financial accounting purposes in different periods than for income tax purposes. Income taxes are provided on undistributed earnings of foreign subsidiaries which are not considered to be permanently invested to the extent that distribution of such earnings would not be offset by foreign tax credits. Investment tax credits, prior to January 1, 1986, were included as a reduction of federal income tax expense in the year the asset was placed in service. The Tax Reform Act of 1986 repealed the investment tax credit for property placed in service after December 31, 1985.

Fiduciary Funds Premiums receivable from insureds are reported as assets of the Company and as corresponding liabilities, net of commissions, to the insurance carriers. Premiums received from insureds not yet remitted to the carriers are held as cash or investments in a fiduciary capacity subject to regulation by various jurisdictions in which the Company operates.

Revenue Recognition Commissions are recognized generally on the effective date of the policies or the billing date, whichever is later. Any subsequent premium adjustments, including policy cancellations, are recognized upon notification from the insurance carriers. Contingent commissions, commissions on policies billed and collected directly by insurance carriers and profit-sharing commissions from Lloyd's syndicates are recognized when received. Fees for services rendered are generally recognized when earned.

Presentation Unless otherwise indicated, all amounts are stated in millions of U.S. dollars. Certain prior period amounts have been reclassified to conform with the 1986 presentation.

Per Share Data Earnings per share data are based on the weighted average number of shares and their economic equivalents (see Note 8) outstanding during each period, adjusted for shares issued in poolings and, if dilutive, shares issuable under stock option plans or debenture conversion rights. Dividends per share data are based on the Company's common shares outstanding at each record date.

2. Discontinued Operations

The Company's discontinued operations include primarily the insurance underwriting companies acquired in 1982 as part of the Alexander Howden Group plc ("Alexander Howden") acquisition. The decision to dispose of these operations was taken in March, 1985. Since that date, the Company has sold the Stone Mountain Insurance Company, Sphere Reinsurance Company

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of Canada Ltd. ("Sphere Re") and Sphere Drake Canada Limited. The Company received proceeds from these sales of $8.9 million in cash and an interest bearing note receivable of $2.0 million due September 1991, which is subject to the satisfaction of certain warranties and representations in the Sphere Re sales agreement.

During 1986, the Company retained the investment banking firm of Salomon Brothers Inc. to assist in the proposed sale in 1987 of the Sphere Drake Insurance companies, the remaining entities held for sale. The operations of the Bermuda and Atlanta insurance companies are being run-off.

Operating results for these entities before discontinuance, the estimated loss on disposal and changes to the estimate are reported in the Statements of Consolidated Income under Loss from Discontinued Operations, as follows:

	1986	1985	1984
Operating loss before income taxes	**$ —**	$ —	$(28.3)
Income tax benefit	**—**	—	3.1
Net operating loss	**—**	—	(25.2)
Expected loss on disposal, net of income tax benefits of $13.4 million, $53.6 million and $1.5 million in 1986, 1985 and 1984, respectively	**(24.0)**	(52.0)	(51.9)
Total	**$(24.0)**	$(52.0)	$(77.1)

The Company considers estimated realizable values, estimated operating results through disposal and other related costs in determining the expected loss on disposition. In connection with the Bermuda and Atlanta insurance companies, future investment income has been taken into consideration in the estimated cost of run-off of these operations.

The components of loss from discontinued operations before income taxes are as follows:

For the years ended December 31,	**1986**	1985	1984
United States	**$(23.4)**	$ (95.4)	$(17.9)
Foreign	**(14.0)**	(10.2)	(63.8)
Total	**$(37.4)**	$(105.6)	$(81.7)

The components of the provision (credit) for income taxes on discontinued operations are as follows:

For the years ended December 31,	**1986**	1985	1984
Federal			
Current	**$ (8.9)**	$(36.3)	$(1.4)
Deferred	**(1.4)**	(10.1)	0.1
Foreign			
Current	**(2.3)**	(5.2)	(2.6)
Deferred	**(0.8)**	(2.0)	(0.7)
Total	**$(13.4)**	$(53.6)	$(4.6)

A reconciliation of the tax credit and the amount computed by applying the U.S. Federal income tax rate of 46% to income is as follows:

For the years ended December 31,	**1986**	1985	1984
Computed "expected" tax credit	**$(17.2)**	$(48.6)	$(37.6)
Foreign statutory rates under U.S. Federal statutory rate	**0.8**	1.2	—
Losses in non-taxing jurisdictions	**4.8**	2.4	3.6
Subsidiaries' losses receiving no tax benefit	**—**	—	11.1
Use of net operating loss carryforwards	**(2.8)**	—	—
Non-deductible expenses	**0.9**	—	15.9
Non-taxable income	**—**	(2.1)	(0.5)
Tax benefit on prior year's provision	**—**	(3.8)	—
Other	**0.1**	(2.7)	2.9
Total	**$(13.4)**	$(53.6)	$ (4.6)

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An analysis of the Company's reserve for estimated loss on disposal of its insurance underwriting companies is as follows:

	1986	1985	1984
Balance, beginning of year	**$ 20.3**	$ 25.5	$ —
Provision recorded for estimated loss on disposal	**24.0**	52.0	51.9
Provision applicable to:			
Write-off of intangible assets	**—**	—	(11.2)
Realization of foreign exchange loss	**—**	—	(14.9)
Operating income (loss) of:			
Companies held for sale (a)	**3.0**	(6.7)	—
Companies being run-off (b)	**(22.2)**	(48.9)	—
Gain on sales	**1.2**	—	—
Other	**(3.2)**	(1.6)	(0.3)
Balance, end of year	**$ 23.1**	$ 20.3	$ 25.5

(a) Represents, primarily the operating results of the Sphere Drake Insurance companies. The need to strengthen loss reserves resulted in an operating loss of $6.9 million in 1985. Improved underwriting results in 1986 resulted in a profit of $9.4 million which was offset, in part, by provisions related to certain loss contingencies and costs associated with the Company's providing additional capital during the year, principally occurring in the fourth quarter.

(b) The additional provisions for run-off resulted primarily from the need to strengthen insurance underwriting reserves on a pre-tax basis by approximately $21.0 million and $43.0 million in 1986 and 1985, respectively, due to adverse claim experience and to increase the allowance for doubtful reinsurance recoverables by approximately $10.0 million and $60.0 million, respectively, due to developments affecting the ability of certain reinsurers to meet their obligations. Of the total net loss for 1986, $3.1 million occurred in the fourth quarter.

The Company's insurance underwriting subsidiaries cede insurance to other insurance companies on risks in excess of certain retention limits. These subsidiaries remain contingently liable to the extent the reinsuring companies cannot meet their obligations under these reinsurance agreements.

While the reserve for estimated loss on disposal is based on management's best judgment of probable loss on disposal, there is no assurance that further adverse deviation may not occur due to the variables inherent in the estimation process. Future variations, if any, between assumed and actual experience would be reported as adjustments to the estimated loss on disposal from discontinued operations.

Summarized financial information for the discontinued underwriting companies as of December 31, 1986 and 1985, is as follows:

	1986	1985
Assets		
Cash and investments	**$250.1**	$178.6
Accounts receivable	**184.9**	184.9
Income taxes receivable from parent	**38.9**	41.9
Other assets	**25.9**	9.2
Total	**$499.8**	$414.6
Liabilities		
Claim liabilities	**$368.4**	$264.8
Other accrued liabilities	**77.1**	125.1
Reserve for estimated loss on disposal	**23.1**	20.3
Total	**$468.6**	$410.2
Net assets held for disposal	**$ 31.2**	$ 4.4

During 1986, the Company contributed $22.0 million of additional capital to Sphere Drake Insurance Company plc (Sphere) in order to meet London market expectations with respect to operating ratios necessary for the ongoing conduct of Sphere's insurance operations. This capital infusion was funded from borrowings which will be paid off with proceeds from the sale of Sphere. Also, during 1986, the Company contributed additional capital of $20.0 million to the Atlanta insurance companies in order to meet statutory surplus requirements.

3. Acquisitions and Dispositions

Poolings of Interests Effective July 31, 1985, the Company acquired all of the voting equity securities of Reed Stenhouse Companies Limited (RSC) in exchange for approximately 9.6 million shares which are the economic equivalent of the Company's common stock (reference is made to Note 8 for a description of the economic equivalent shares). The transaction has been accounted for as a pooling of interests and, accordingly, the consolidated financial statements of the Company for all periods prior to the merger date have been restated to include the operations of RSC as if it had operated as part of the consolidated group.

To effect the combination and to integrate the operations of RSC and the Company, certain costs and expenses were incurred amounting to $20.5 million in 1985. These merger-related expenses included primarily professional fees, net costs of eliminating duplicate facilities and systems, severance arrangements and provisions to conform accounting practices between the two companies and are included in other income (expenses) in the Statements of Consolidated Income. In 1986, in connection with the completion of the integration of RSC, an adjustment of $8.0 million relating principally to the translation of intangible assets denominated in foreign currencies, is included in the December 31, 1986 Consolidated Balance Sheet. This adjustment had the effect of reducing accumulated translation adjustments and did not affect results of operations.

The total number of shares issued in transactions accounted for as poolings of interests, excluding the RSC merger, aggregated 1.5 million and 0.7 million during 1986 and 1985, respectively. Operating results of these businesses for periods prior to their merger were not significant and, accordingly, the financial statements of the Company were not restated for these poolings.

Purchases The cost of businesses acquired in transactions accounted for as purchases aggregated $4.5 million (including 0.1 million shares of common stock) and $8.9 million (including 0.2 million shares of common stock) during 1986 and 1984, respectively. There were no purchases in 1985. The excess of the total acquisition costs over the fair value of the net assets acquired was $5.1 million and $6.1 million, respectively, and is being amortized over periods not exceeding forty years. Operating results of these businesses for periods prior to their acquisition were not significant.

Dispositions During 1985, the Company sold its Lloyd's managing agency businesses for cash of $23.8 million, resulting in a pre-tax gain of $11.9 million which is included in other income (expenses) in the Statements of Consolidated Income. The sale was mandated by United Kingdom law. Operating revenues for these operations were $13.0 million and $11.5 million and pre-tax income was $4.4 million and $8.3 million for the years ended December 31, 1985 and 1984, respectively.

4. Unconsolidated Operations

The Company's equity in the net operating results and net assets of its unconsolidated subsidiaries and affiliates is as follows:

For the years ended December 31,	**1986**	1985	1984
Equity in net operating results:			
Premium finance (A)	**$ 13.1**	$ 6.9	$2.2
Special purpose insurance companies (B)	**6.1**	3.4	3.0
Insurance broking (C)	**3.6**	2.5	2.5
Income before taxes	**22.8**	12.8	7.7
Income taxes	**7.8**	2.9	1.9
Net income	**$ 15.0**	$ 9.9	$5.8

As of December 31,	**1986**	1985
Equity in net assets:		
Premium finance (A)	**$ 35.0**	$23.8
Special purpose insurance companies (B)	**50.5**	47.0
Insurance broking (C)	**14.8**	12.4
Total	**$100.3**	$83.2

At December 31, 1986 the Company's share of the unremitted earnings of unconsolidated operations was approximately $33.8 million.

(A) Premium Finance TIFCO Inc. ("TIFCO"), a wholly owned subsidiary, is engaged in the financing of insurance premiums for clients of the Company and of other insurance agents and brokers. Summary financial information is as follows:

For the years ended December 31,	**1986**	1985	1984
Revenues	**$ 42.9**	$ 28.0	$14.2
Expenses	**29.8**	21.1	12.0
Income before income taxes	**13.1**	6.9	2.2
Income taxes	**6.4**	3.4	1.1
Net income	**$ 6.7**	$ 3.5	$ 1.1

As of December 31,	**1986**	1985
Assets:		
Cash	**$ (7.5)**	$ (1.0)
Receivables	**226.9**	261.4
Property and other assets	**27.2**	25.3
Total	**$246.6**	$285.7
Liabilities and stockholders' equity:		
Accounts payable	**$ 17.0**	$ 19.7
Notes payable and long-term debt	**178.8**	232.2
Other liabilities	**15.8**	10.0
Stockholders' equity	**35.0**	23.8
Total	**$246.6**	$285.7

During 1986, TIFCO entered into an agreement with a financial institution to sell, with limited recourse, $150.0 million of interests in designated pools of premium financing notes. Subsequent collections of these notes are reinvested in the pool to maintain an aggregate outstanding balance of approximately $150.0 million, which remains uncollected at December 31, 1986.

Also, during 1986, TIFCO instituted a commercial paper program and arranged unsecured lines of credit totaling $140.0 million as support for the program, plus a line of credit provided by the Company equal to 25% of such outstanding debt. The amount of commercial paper outstanding was approximately $133.0 million at December 31, 1986.

TIFCO has entered into liability based interest rate swap agreements to hedge a portion of its debt against short-term interest rate fluctuations. Any differences in interest expense between the fixed and floating interest rates related to these contracts are recorded monthly. As of December 31, 1986, the principal amounts of swap agreements outstanding approximated $25.0 million.

In August 1985, TIFCO entered into a sale-leaseback transaction with Shand, Morahan & Company, Inc. (Shand), a consolidated subsidiary of the Company, for the purchase of an office building. The cost of the office building was approximately $23.3 million of which $20.9 million was financed with non-recourse mortgage notes. The lease term is twenty-five years and is accounted for as an operating lease.

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(B) Special Purpose Insurance Companies The Company's investments in special purpose insurance companies include Evanston Services, Inc. (52% owned) and Security National Insurance Company (100% owned). The primary purpose of these investments is to maintain marketing facilities for certain of the Company's broking subsidiaries. In addition, also included are wholly owned Bermuda insurance companies, which primarily underwrite financing transactions, and a wholly owned Vermont captive company. Summary financial information for these operations is as follows:

For the years ended December 31,	1986	1985	1984
Revenues	**$161.7**	$ 79.7	$55.0
Expenses	**152.5**	82.2	54.5
Income before income taxes	**9.2**	(2.5)	0.5
Income taxes	**0.1**	(0.7)	(1.5)
Net income (loss)	**$ 9.1**	$ (1.8)	$ 2.0

As of December 31,	1986	1985
Assets:		
Cash and investments	**$346.8**	$258.6
Receivables	**87.1**	81.5
Property and other assets	**23.5**	19.0
	$457.4	$359.1
Liabilities and stockholders' equity:		
Claim liabilities and accounts payable	**$270.4**	$279.6
Notes payable	**40.4**	—
Other liabilities	**66.8**	5.9
Stockholders' equity	**79.8**	73.6
	$457.4	$359.1

(C) Insurance Broking The Company has equity investments in 50% or less owned insurance broking companies located principally in Europe and North America. Summary financial information is as follows:

For the years ended December 31,	1986	1985	1984
Revenues	**$ 62.4**	$30.8	$41.1
Expenses	**52.1**	26.0	35.3
Income before income taxes	**10.3**	4.8	5.8
Income taxes	**4.0**	2.5	2.4
Net income	**$ 6.3**	$ 2.3	$ 3.4

As of December 31,	1986	1985
Assets:		
Cash and investments	**$ 88.0**	$30.5
Receivables	**62.3**	25.5
Property and other assets	**17.8**	9.5
	$168.1	$65.5
Liabilities and stockholders' equity:		
Accounts payable	**$124.5**	$17.5
Notes payable	**1.8**	1.1
Other liabilities	**12.1**	32.9
Stockholders' equity	**29.7**	14.0
	$168.1	$65.5

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5. Income Taxes

The components of income from continuing operations before income taxes are as follows:

For the years ended December 31,	1986	1985	1984
United States	**$ 86.4**	$49.1	$19.0
Foreign	**60.3**	47.8	37.1
Total	**$146.7**	$96.9	$56.1

The components of the provision for income taxes on continuing operations are as follows:

For the years ended December 31,	1986	1985	1984
Federal:			
Current	**$41.4**	$18.9	$ (9.6)
Deferred	**1.7**	8.7	17.6
State and local:			
Current	**8.6**	1.5	0.8
Deferred	**(1.8)**	1.4	2.3
Foreign:			
Current	**26.0**	17.7	13.8
Deferred	**4.2**	4.0	2.9
Total	**$80.1**	$52.2	$27.8

The Company files a U.S. federal consolidated tax return which includes the losses of its U.S. discontinued operations. The current federal provision recognizes the amounts payable to the discontinued operations for the tax benefits relating to such losses. Similar arrangements exist to recognize the tax benefits relating to the losses incurred in 1984 and 1985 for the United Kingdom discontinued operations (see Note 2).

The components of the deferred income tax provision on continuing operations are as follows:

For the years ended December 31,	1986	1985	1984
Excess of tax over book depreciation	**$ 3.1**	$ 3.1	$ 1.5
Tax leases	**1.6**	15.5	17.2
Financial accruals not currently deductible	**(17.4)**	(4.2)	6.7
Alexander Howden loss deduction (see below)	**41.6**	—	—
Reclassification to deferred tax liabilities for tax credits and loss carryforwards	**(25.1)**	—	—
Other	**0.3**	(0.3)	(2.6)
Total	**$ 4.1**	$14.1	$22.8

A reconciliation of the tax provision and the amount computed by applying the U.S. Federal Income tax rate of 46% to income from continuing operations before income taxes is as follows:

For the years ended December 31,	1986	1985	1984
Computed "expected" tax expense	**$67.5**	$44.6	$25.8
State and local income taxes—net of federal income tax	**3.7**	2.7	2.0
Foreign statutory rates under U.S. Federal statutory rate	**(1.4)**	(2.5)	(1.0)
Benefit of income taxed at capital gains rates	**(0.2)**	(6.2)	—
Subsidiaries' losses receiving no tax benefit	**2.0**	0.6	1.3
Tax credits	**(0.5)**	(1.9)	(2.7)
Amortization of intangible assets	**2.5**	5.8	4.1
Other non-deductible expenses	**4.2**	2.7	2.2
Adjustment to prior year estimated tax provisions	**4.4**	3.0	2.0
Tax benefit on prior year claims settlement	**—**	—	(2.2)
Other, net	**(2.1)**	3.4	(3.7)
Total tax provision	**$80.1**	$52.2	$27.8

In 1982, a $43.1 million tax deduction, net of estimated recoveries, was claimed by the Company for a loss sustained in connection with the acquisition of Alexander Howden. The related tax refund of $19.8 million was received in 1983. As a consequence of the litigation settlement described in Note 13, the estimated recoveries previously taken into account in determining the original deduction were finalized, resulting in an additional tax deduction approximating $90.4 million which will be claimed on the Company's 1986 tax return. The reduction in current income taxes payable is approximately $41.6 million. These tax deductions will not be recognized for income statement purposes until realization is reasonably assured; and accordingly, are reflected in the deferred income tax balances in the consolidated balance sheet. Additionally, in 1983 and 1984, $23.9 million in tax deductions were claimed by the Company in connection with the payment, to an unrelated third party, for an indemnification policy against the potential adverse effects on the Company from losses arising out of certain underwriting exposures. The related tax benefit of $11.4 million was recognized in the Company's 1983 income statement. All of the above tax deductions are under review by the IRS or are expected to be the subject of an IRS review; however, the Company believes it will be successful in sustaining these deductions.

The extraordinary credit of $0.6 million in 1986 represents the realization of tax benefits resulting from the utilization of approximately $1.2 million of net operating loss carryforwards attributable to the U.S. operations of RSC prior to the merger. At December 31, 1986, the Company had a net operating loss carryforward relating to these operations of approximately $19.0 million which will expire in the years 1993 to 1997.

At December 31, 1986, the Company had net operating loss carryforwards for U.S. tax purposes of $43.4 million which will expire in the year 2000.

At December 31, 1986, the net undistributed earnings of consolidated and unconsolidated foreign subsidiaries aggregated approximately $133.0 million. Since these earnings are considered permanently invested, there is no provision for additional U.S. taxes which might result upon distribution of such earnings; however, foreign tax credits could be available to offset part or all of the U.S. taxes which would be incurred.

6. Short-Term Debt

Consolidated short-term debt consists of the following:

As of December 31,	**1986**	1985
Commercial paper	**$ 9.9**	$32.8
Notes payable to banks	**—**	1.6
Current portion of long-term debt (note 7)	**5.1**	11.8
	15.0	46.2
Less short-term debt reclassified as long-term (note 7)	**9.9**	34.4
Total	**$ 5.1**	$11.8

Information with respect to short-term borrowing activity is as follows:

As of December 31,	**1986**	1985	1984
Commercial paper:			
Balance at year-end	**$ 9.9**	$32.8	$20.8
Weighted average interest rate	**6.4%**	8.3%	8.9%
Maximum outstanding	**$75.1**	$62.1	$44.7
Average outstanding	**$45.9**	$25.0	$13.2
Weighted average interest rate during the year	**7.3%**	8.4%	10.8%
Notes payable to banks:			
Balance at year-end	**$ —**	$ 1.6	$32.6
Weighted average interest rate	**—%**	12.0%	9.4%
Maximum outstanding	**$ 1.6**	$50.9	$62.2
Average outstanding	**$ 0.3**	$28.0	$43.0
Weighted average interest rate during the year	**12.0%**	9.6%	10.8%

The maximum outstanding shown above reflects the maximum amount of each category outstanding at any month end. The maximum aggregate short-term debt outstanding at any month end was $75.1 million, $84.6 million, and $106.8 million in 1986, 1985 and 1984, respectively.

In addition to the $50.0 million credit facility described in Note 7B, the Company has committed unsecured lines of credit totaling $96.9 million as support for outstanding commercial paper and other short-term debt. The lines may be drawn as needed with interest at market rates and carry an annual commitment fee of no greater than 1/4% of the line. There are generally no compensating balance requirements. In addition, the Company has approximately $56.2 million in unused bank lines of credit which require no compensating balances or fees and, subject to bank approval for each drawing, are available for general corporate purposes.

7. Long-Term Debt

Long-term debt outstanding is as follows:

As of December 31,	**1986**	1985
11% convertible subordinated debentures (A)	**$ 74.4**	$ 74.4
Long-term credit agreement (B)	**9.9**	34.4
Term bank loan (C)	**5.0**	5.1
Eurodollar bonds (D)	**—**	6.8
Other	**13.7**	16.8
	103.0	137.5
Less current portion (note 6)	**5.1**	11.8
Total	**$ 97.9**	$125.7

The principal portion of payments required during the next five years is $5.1 million in 1987, $8.8 million in 1988, $3.3 million in 1989, $1.6 million in 1990 and $1.1 million in 1991.

A. 11% Convertible Subordinated Debentures The debentures are unsecured subordinated obligations maturing April 15, 2007. The debentures were issued in connection with the acquisition of Alexander Howden under an Indenture agreement dated February 1, 1982 and are convertible into common shares at $39 per share, subject to adjustment under certain conditions and to prior redemption. The debentures are redeemable any time, at the Company's option at 108.07 prior to April 15, 1987 and at declining prices thereafter until April 15, 1997 and commencing April 15, 1992, at their principal amount through operation of a mandatory sinking fund.

In June 1984, the Company, pursuant to an exchange agreement, issued 781,815 shares of its common stock with a value of $14.1 million in a non-taxable exchange for $15.5 million of debentures. The Company realized a gain from this early extinguishment of debt of $1.6 million which was recorded as an extraordinary item in 1984.

B. Long-Term Credit Agreement The Company has a five-year, $50.0 million credit agreement with a bank. The agreement, as amended effective October 1, 1986, contains various restrictions including limits on minimum net worth, maximum total debt and debt to unconsolidated subsidiaries and minimum consolidated cash flow from continuing operations. Interest on U.S. dollar borrowings under the agreement is at the bank's prime interest rate or alternative bank rates while Eurocurrency loans bear interest at a rate over the London Interbank Offered Rate ("LIBOR"). Current retained earnings are sufficient to pay dividends under the minimum net worth limitation at December 31, 1986. The Company has not borrowed under this agreement.

In the event short-term borrowings cannot be made advantageously, the Company intends to use this facility to refinance a portion of its short-term borrowings on a long-term basis. Accordingly, $9.9 million and $34.4 million of short-term debt has been reclassified as long-term debt at December 31, 1986 and 1985, respectively.

C. Term Bank Loan The Term Bank Loan is an unsecured obligation of RSC. This borrowing is payable in Canadian dollars at varying interest rates which approximate the Canadian Bank Prime rate (9 3/4% at December 31, 1986), and is due January, 1988.

D. Eurodollar Bonds The 9 1/2% Eurodollar bonds were unsecured obligations of Alexander Howden issued prior to the acquisition. In 1985, the Company repurchased approximately $7.0 million principal amount of the Eurodollar bonds and in 1986 repurchased the remaining $6.8 million principal amount.

8. Common and Preferred Stock

In connection with the RSC merger in 1985, the Company issued two new classes of voting equity securities, Class A and Class C shares, with voting rights equal to the Company's Common Stock. Associated with each such share is a dividend paying share issued by a Canadian (RSC Class 1

Share) or a United Kingdom (AAE Dividend Share) subsidiary which pays dividends in Canadian dollars or sterling, respectively, equivalent to the dividends paid on shares of common stock. Holders of these securities, therefore, hold the economic equivalent of shares of common stock.

Each Class A Share (together with an RSC Class 1 Share) and Class C Share (together with an AAE Dividend Share) may be exchanged at any time for a share of common stock. From July 31, to December 31, 1985, 4.1 million shares of common stock were issued in exchange for the economic equivalent shares. During 1986, 0.9 million shares of common stock were issued in exchange for the economic equivalent shares.

No dividends may be declared and paid on the Company's common stock unless an equivalent amount per share is declared and paid on the economic equivalent shares. Accordingly, the Company's ability to pay dividends is limited by the amounts available to the Canadian and U.K. subsidiaries for such purposes. These amounts approximate Canadian $32.0 million or $23.1 million, assuming certain solvency tests are met under Canadian law, and sterling 47.7 million or $70.0 million, respectively, at December 31, 1986. In the event sufficient earnings are not available in Canada or the United Kingdom to declare dividends, the Company's legal structure allows it to make earnings or capital available in those countries to pay dividends.

In September 1985, 1,750,000 economic equivalent shares were issued in a private placement in Canada to a group of Canadian institutions. The offering was made pursuant to certain private placement exemptions contained in Canadian provincial securities legislation.

The Company's preferred stock can be issued in one or more series with full or limited voting rights, with the rights of each series to be determined by the directors before each issuance.

At December 31, 1986 the Company has shares of common stock reserved for issuance of approximately 1.8 million for stock option plans, 1.9 million for conversion of debentures, 0.1 million for contingent issuance under acquisition agreements and 6.5 million for conversion or redemption of economic equivalent shares.

9. Stock Option and Incentive Plans

Long-Term Compensation Program The Company's long-term incentive compensation program consists of a stock option plan, a performance bonus plan and a restricted stock award plan.

Under the 1982 Key Employee Stock Option Plan, participants may be granted incentive stock options or nonqualified options to purchase not in excess of 1,175,000 shares of the Company's common stock. Options may be granted at not less than fair market value of the common stock on the date granted and become exercisable at the rate of 50% a year commencing two years from date of grant and expire ten years from date of grant.

Under the 1982 Executive Performance Bonus Plan, participants may be awarded performance awards based upon certain performance criteria as determined by the Compensation Committee of the Board at the time of grant. Payments with respect to these awards may be made with the Company's common stock (maximum 225,000 shares) or cash or a combination of both. In 1986 and 1985, approximately $1.8 million and $1.4 million, respectively, was provided for awards which will become payable in 1987. There were no awards granted in 1984.

Under the 1982 Key Employee Restricted Stock Award Plan, participants may be awarded shares of the Company's common stock subject to various restrictions which limit the sale or other transfer of the shares until the expiration of a specified time period. In addition, the shares are subject to forfeiture if the participant does not remain in the employment of the Company throughout the restricted time period. A maximum of 325,000 shares may be issued under the plan. There were 51,616, 60,195 and 53,735 shares awarded during 1986, 1985 and 1984, respectively.

The Company has submitted a proposal to its shareholders, for consideration at its May 1987 Annual Meeting, to amend the 1982 Key Employee Stock Option Plan to increase to 2.1 million the number of shares authorized for issuance under the plan, and allow for the issuance of stock appreciation rights.

Long-Term Capital Accumulation Program In 1982, this program was replaced by the Long-Term Compensation Program with all options, totaling 733,932 shares, and awards outstanding at that time remaining in effect. The options became exercisable at the rate of 25% per year and expire ten years from grant date.

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Option transactions under both programs were as follows:

	Number of Shares	Option Price Per Share Range
Outstanding, January 1, 1984	990,505	$17.06–$32.88
Granted	160,087	17.75– 22.25
Cancelled	(86,817)	
Outstanding, December 31, 1984	1,063,775	$17.06–$32.88
Granted	205,270	24.50– 28.88
Exercised	(48,926)	17.06– 23.19
Cancelled	(44,163)	
Outstanding, December 31, 1985	1,175,956	$17.06–$32.88
Granted	553,257	38.63
Exercised	(134,779)	17.06– 31.13
Cancelled	(47,848)	
Outstanding, December 31, 1986	1,546,586	$17.75–$38.63

The number of options exercisable at December 31, 1986, 1985 and 1984 were 759,811, 719,209 and 611,745, respectively.

10. Employees' Retirement Plans and Benefits

The Company has contributory and non-contributory defined benefit pension plans covering substantially all domestic and foreign employees. The plans generally provide pension benefits that are based on the employee's years of service and compensation prior to retirement. The Company's policy is to fund pension costs accrued. An overfunding exists in the United States' two largest plans. As a result, the Company will not make any contributions to those plans until the overfunding is substantially reduced.

Effective January 1, 1985, the Company adopted Statement of Financial Accounting Standards No. 87 (FAS No. 87) for its United States pension plans which reduced pension expense by $4.2 million for 1985. For these plans, net pension provision (credit) is summarized as follows:

	1986	1985
Service cost	**$ 10.4**	$ 7.8
Interest cost	**10.8**	9.3
Actual return on plan assets	**(26.4)**	(38.1)
Net amortization and deferral	**5.6**	20.5
Net periodic pension provision (credit)	**$ 0.4**	$ (0.5)

United States pension expense was $2.2 million in 1984.

The following table sets forth the United States plans' funded status and amounts recognized in the Company's Consolidated Balance Sheet as of December 31, 1986 and 1985:

	1986	1985
Projected benefit obligation	**$(167.1)**	$(109.9)
Plan assets at fair market value	**196.2**	172.9
Excess of plan assets over projected benefit obligation	**29.1**	63.0
Unrecognized net loss (gain)	**14.4**	(15.2)
Unrecognized net assets being amortized over 16 years	**(43.2)**	(47.5)
Prepaid pension cost	**$ 0.3**	$ 0.3
Assumed discount rate	**8.00%**	9.75%
Assumed rate of compensation increase	**7.00%**	7.00%
Expected rate of return on plan assets	**10.75%**	10.75%

At December 31, 1986 and 1985 approximately 52% of plan assets are invested in equity securities and 48% in cash equivalents or debt securities.

International pension expense totaled $13.2 million in 1986, $9.5 million in 1985 and $8.0 million in 1984.

As of their latest actuarial valuation dates, the Company's foreign pension plans have approximately $138.8 million of pension fund assets compared with $118.9 million of estimated vested benefits payable.

The Company maintains thrift or deferred profit-sharing plans for most U.S. and Canadian employees. Under the thrift plans, eligible employees may contribute amounts through payroll deduction, supplemented by Company contributions, for investment in various funds established by the plans. The cost of these plans was $7.3 million, including 0.2 million shares of common stock valued at $6.0 million in 1986, $5.8 million, including 0.2 million shares of common stock valued at $4.9 million in 1985, and $5.2 million, including 0.2 million shares of common stock valued at $4.2 million in 1984.

Substantially all of the Company's U.S. employees and employees in certain foreign countries, may become eligible for certain health care and life insurance benefits if they reach normal retirement age while working for the Company. The cost of providing those benefits for 1,513 retirees is not separable from the cost of providing benefits for the 13,625 active employees. The total cost for these benefits for both active and retired employees was $23.0 million in 1986, $19.8 million in 1985, and $18.4 million in 1984.

11. Commitments

Minimum annual rentals for office space under noncancellable operating leases expiring more than one year after 1986, the last of which expires in 2009 are:

Period	Amount	Period	Amount
1987	$ 66.0	1992–1996	$174.7
1988	62.5	1997–2001	78.6
1989	55.3	2002–2006	36.8
1990	49.1	2007–2009	14.1
1991	44.7		

Rental expense for office space, which includes property taxes and certain other costs, amounted to $61.7 million in 1986, $54.4 million in 1985 and $57.9 million in 1984.

In 1982, by resolution of the Board of Directors, the Company provided assurances with respect to placing certain Alexander Howden subsidiaries in a position to meet claims validly covered by policies issued by Alexander Howden insurance company subsidiaries and to meet specific financial commitments made by Alexander Howden broking subsidiaries in the ordinary course of their authorized business.

The Company has entered into asset based interest rate swap agreements to hedge a portion of its investment portfolio against short-term interest rate fluctuations. Any differences in interest income between the fixed and floating interest rates related to these contracts are recorded monthly. As of December 31, 1986, the principal amounts of swap agreements outstanding approximated $25.0 million.

The Company has guaranteed certain borrowings and letters of credit, issued comfort letters in connection with keepwell agreements and has otherwise agreed to reimburse the payment of certain other asserted or unasserted liabilities of consolidated and unconsolidated subsidiaries.

Certain unconsolidated foreign subsidiaries of the Company have entered into agreements in connection with surplus relief reinsurance for an unrelated domestic life insurance company. In connection with these arrangements, the Company's subsidiaries have outstanding unsecured letters of credit of approximately $159.0 million at December 31, 1986, which are guaranteed by the parent of the life insurance company. Neither the Company nor any of its other subsidiaries has guaranteed the obligations of these unconsolidated foreign subsidiaries.

While these matters may expose the Company to financial consequences, it is management's opinion that any adverse effects will not be material to the Company's financial condition.

12. Contingent Liabilities

Following the acquisition of Alexander Howden in January 1982, certain claims have been or may be asserted by those who believe they have suffered losses as a result of the activities of certain former Alexander Howden officials and others. These include primarily claims relating to the placement of reinsurance by Alexander Howden subsidiaries with companies, some of which were secretly owned by former Alexander Howden officials, and questionable broking and underwriting practices of the former Alexander Howden officials and others.

In particular, claims were brought against the Company on behalf of members of Lloyd's syndicates managed by PCW Underwriting Agencies Ltd. and WMD Underwriting Agencies Ltd. arising from services performed through Alexander Howden subsidiaries, prior to the Company's acquisition of Alexander Howden, with respect to the placement of reinsurance on behalf of syndicates managed by those underwriting agencies. The Company entered into a settlement agreement with the syndicates in 1984. In May 1985, it was announced that certain of the syndicates had suffered severe additional losses, which (on an undiscounted basis) have recently been calculated to total approximately 238.0 million pounds sterling. Following the May 1985 announcement of these losses, draft claims were prepared against the Company and others on behalf of the members of the affected syndicates to set aside the 1984 settlement. The Company is a party to discussions, initiated by others, to determine if an out of court settlement is feasible. In any event, the Company believes that it has full and valid defenses against these claims.

Claims have been or may be asserted against the Company and certain of its subsidiaries alleging, among other things, that certain Alexander Howden subsidiaries accepted, on behalf of certain insurance companies, insurance or reinsurance at premium levels not commensurate with the level of underwriting risks assumed and retroceded or reinsured those risks with financially unsound reinsurance companies. In two pending actions, plaintiffs allege compensatory and punitive damages based on claims arising from common law fraud, breach of contract and negligence, and treble damages totaling $69 million based on claims under the Racketeer Influenced and Corrupt Organizations Act. A third related action contains allegations of negligence, unfair and deceptive practices, bad faith and fraud. Management of the Company and its counsel believe that there are full and valid defenses to all claims that have been or may be asserted with respect to these activities. The Company is vigorously defending the pending actions.

The Company and its subsidiaries are also subject to various claims and lawsuits from both private and governmental parties in the ordinary course of business, consisting principally of alleged errors and omissions in connection with the placement of insurance and in rendering consulting services. In some of these cases, the remedies that may be sought or damages claimed are substantial. Additionally, the Company and its subsidiaries are subject to the risk of losses resulting from the potential uncollectibility of insurance and reinsurance balances and claims advances made on behalf of clients.

The Company's insurance underwriting subsidiaries cede insurance to other insurance companies on risks in excess of certain retention limits. These subsidiaries remain contingently liable in the event the reinsuring companies cannot meet their obligations under these reinsurance agreements.

Shand and its subsidiaries have advanced claim payments and placed insurance and reinsurance with and on behalf of The Mutual Fire, Marine and Inland Insurance Company ("Mutual Fire"). On December 8, 1986, the Commonwealth Court of Pennsylvania entered an Order of Rehabilitation for Mutual Fire and continued the Pennsylvania Insurance Commissioner's Order of Suspension issued in September 1986. A plan of rehabilitation designed to strengthen the financial condition of Mutual Fire and satisfy its creditors is currently being negotiated, but no date has yet been fixed for a court hearing on that plan. In the event of a liquidation of Mutual Fire, a liquidator may challenge the Company's subsidiaries concerning the amount of reinsurance owed to or paid by Mutual Fire and the reimbursement by Mutual Fire of claims payments advanced on its behalf. Other claims have been or may be asserted by other affected parties, including insureds of Mutual Fire. It is not possible to predict with certainty whether Mutual Fire will be successfully rehabilitated or whether it will eventually be placed in liquidation.

These contingent liabilities involve significant amounts, and while it is not possible to predict with certainty the outcome of such contingent liabilities, their coverage under the Company's professional liability insurance policies, or their financial impact on the Company, management presently believes that such impact would not be material to the Company's financial condition.

13. Litigation Settlement

In November 1986, the Company settled its lawsuit, which commenced in 1983, against certain former auditors of Alexander Howden. The terms of the settlement included the payment of approximately $24.0 million to the Company. Recognition of this recovery, in the Statement of Consolidated Income, has been deferred pending final resolution of specific loss contingencies arising out of the Alexander Howden acquisition which were known at the date of the settlement and the amount of the recovery is included in other long-term liabilities in the Company's Consolidated Balance Sheet. Any related future recoveries will be accounted for in the same manner.

14. Other Matters

In July, 1982, the Company brought to the attention of the Securities and Exchange Commission ("the Commission") the business and accounting irregularities discovered to have taken place at Alexander Howden which was acquired by the Company in January, 1982. The Commission, in April, 1983, commenced an inquiry into matters related to the acquisition of Alexander Howden and developments occurring subsequent thereto.

The Commission's inquiry focuses principally on information made public by the Company, after its discovery in 1982 of the Alexander Howden irregularities, regarding the nature, extent and accounting treatment of the losses attributable thereto. The Company has cooperated fully in the Commission's investigation, which is substantially complete. The matter has not been presented to the Commission, and the Company is currently engaged in discussions with the Commission's staff with respect to its recommendations to the Commission.

15. Business Segments

Segment information is provided for the Company's two reportable segments, Insurance Services and Employee Benefit and Management Consulting.

Insurance Services includes a broad range of insurance brokerage services such as negotiating and placing casualty, property and marine insurance, wholesale brokerage, reinsurance brokerage, risk analysis and management, and self-insurance services.

Employee Benefit and Management Consulting Services includes a variety of human resource management services such as actuarial and administrative services for pension, compensation and benefit plans, employee communications consulting and management consulting.

In 1986, cash and investments are included with the respective reportable segments and geographic areas. Such amounts were previously included in General Corporate and, accordingly, the prior years' information has been adjusted to conform with this presentation. The following tables present information about the Company's operations by business segment and geographical areas for each of the three years in the period ended December 31, 1986:

	Operating Revenue	Operating Income	Identifiable Assets
1986			
Insurance services	$ 943.3	$136.0	$2,169.4
Employee benefit and management consulting	105.3	5.6	100.5
Other business	19.6	2.1	22.4
Equity in unconsolidated operations	—	—	100.3
General corporate	—	(33.9)	4.8
Assets held for disposal	—	—	31.2
Consolidated totals	$1,068.2	$109.8	$2,428.6
1985			
Insurance services	$ 805.8	$101.8	$1,941.3
Employee benefit and management consulting	88.2	3.7	69.5
Other business	19.6	(0.1)	20.8
Equity in unconsolidated operations	—	—	83.2
General corporate	—	(25.1)	8.2
Assets held for disposal	—	—	4.4
Consolidated totals	$ 913.6	$ 80.3	$2,127.4
1984			
Insurance services	$686.3	$ 60.0	$1,619.2
Employee benefit and management consulting	83.8	5.0	76.7
Other business	17.9	(0.7)	25.3
Equity in unconsolidated operations	—	—	68.6
General corporate	—	(22.0)	11.3
Assets held for disposal	—	—	31.6
Consolidated totals	$ 788.0	$ 42.3	$1,832.7

	Operating Revenue	Operating Income	Identifiable Assets
Geographical areas:			
1986			
United States	$ 728.4	$119.7	$1,316.4
United Kingdom	145.0	7.5	553.0
Canada, principally RSC	116.1	16.6	194.1
Other countries	78.7	(0.1)	228.8
Equity in unconsolidated operations	—	—	100.3
General corporate	—	(33.9)	4.8
Assets held for disposal	—	—	31.2
Consolidated totals	$1,068.2	$109.8	$2,428.6
1985			
United States	$ 628.6	$ 87.3	$1,133.4
United Kingdom	119.7	8.6	489.3
Canada, principally RSC	98.5	7.5	186.6
Other countries	66.8	2.0	222.3
Equity in unconsolidated operations	—	—	83.2
General corporate	—	(25.1)	8.2
Assets held for disposal	—	—	4.4
Consolidated totals	$ 913.6	$ 80.3	$2,127.4
1984			
United States	$ 522.6	$ 41.9	$ 928.2
United Kingdom	107.5	12.5	409.4
Canada, principally RSC	88.6	6.3	125.8
Other countries	69.3	3.6	257.8
Equity in unconsolidated operations	—	—	68.6
General corporate	—	(22.0)	11.3
Assets held for disposal	—	—	31.6
Consolidated totals	$ 788.0	$ 42.3	$1,832.7

16. Quarterly Financial Data (Unaudited)

Quarterly operating results for 1986 and 1985 are summarized below (in millions, except per share data).

Quarters	Operating Revenue	Operating Income	Income from Continuing Operations	Net Income (Loss)
1986				
First	$ 249.8	$ 28.9	$22.1	$ 22.1
Second	269.2	37.3	22.7	19.6 (a)
Third	267.4	31.1	15.7	(0.9)
Fourth	281.8	12.5	6.1	2.4 (a)
Year	$1,068.2	$109.8	$66.6	$ 43.2
1985				
First	$ 210.5	$ 22.1	$13.2	$ 13.2
Second	227.1	23.1	11.2	8.3
Third	236.3	29.2	17.4	2.1
Fourth	239.7	5.9	2.9	(30.9)(b)
Year	$ 913.6	$ 80.3	$44.7	$ (7.3)

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Per Share of Common Stock

Quarters	Income from Continuing Operations	Net Income (Loss)	Dividends	High(c)	Low(c)
1986					
First	$ .54	$ .54	$ .25	$38	$31 3/4
Second	.55	.48 (a)	.25	40 1/4	32 1/2
Third	.38	(.02)	.25	42 3/8	34 7/8
Fourth	.15	.06 (a)	.25	38	25 1/8
Year	$1.62	$1.05 (d)	$1.00		
1985					
First	$ .35	$ .35	$ .25	$32	$22 1/4
Second	.30	.22	.25	31 1/4	26 1/2
Third	.46	.05	.25	30	26
Fourth	.07	(.78)(b)	.25	33 7/8	27
Year	$1.17(d)	$ (.19)(d)	$1.00		

(a) An extraordinary credit of $4.3 million was recorded in the second quarter of 1986 representing the utilization of net operating loss carryforwards. As a result of an additional tax deduction that will be claimed for 1986 (see Note 5), only $.6 million will be recognized in 1986, resulting in a $3.7 million extraordinary charge in the fourth quarter of 1986.

(b) Includes the additional provision of $33.8 million ($.85 per share) in the fourth quarter for the increase in the estimated loss on disposal of the discontinued underwriting companies resulting from the further strengthening of reserves for claim liabilities and doubtful reinsurance recoverables.

(c) Sales prices on the New York Stock Exchange.

(d) Not equal to the sum of the quarters.

Boards of Directors and Corporate Officers

Alexander & Alexander Services Inc.
Major Operating Units

Alexander & Alexander Inc.

Alexander & Alexander International Inc.

Alexander Howden Group Limited

Alexander Howden North America, Inc.

The Alexander Consulting Group Inc.

Risk Management Services Group

Shand, Morahan & Company, Inc.

Thomas A. Greene & Company, Inc.

TIFCO Inc.

Alexander & Alexander Services Inc.

JOHN A. BOGARDUS, JR. * [1]
Chairman of the Board
Chief Executive Officer
Chairman, Executive Committee

TINSLEY H. IRVIN * [1]
President
Chief Operating Officer

JAMES D. BERRY * [1][3][4]
Vice Chairman
Directors Executive Committee
RepublicBank Corporation

DR. KENNETH BLACK, JR. * [1][2][3]
Regents' Professor of Insurance
Georgia State University

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Senior Vice President

JOHN B. DEVINE *
Senior Vice President

DAVID C. FRENCH *
Senior Vice President

W. DOUGLAS H. GARDINER * [1][3][4]
Former Vice Chairman
Royal Bank of Canada

ANGUS M. M. GROSSART * [1][2][4]
Managing Director
Noble Grossart Limited

CEDRIC G. E. GYLES *
Senior Vice President

RONALD A. ILES *
Senior Vice President

JAMES A. McCORMICK *
Senior Vice President

VINCENT R. McLEAN * [1][2][3][4]

JOHN C. SIENKIEWICZ *
Senior Vice President

KENNETH W. S. SOUBRY *
Former Chairman of the Board

ROLF H. TOWE * [1]
Senior Vice President &
Chief Financial Officer

MICHAEL K. WHITE * [1]
Senior Vice President

WILLIAM M. WILSON * [1]
Senior Vice President

PETER M. DENSEN
Senior Vice President &
Chief of Staff

MAURICE F. GREAVER II
Vice President &
Chief Internal Auditor

JAMES B. LOCKHART III
Vice President & Treasurer

RICHARD E. LYNN
Senior Vice President

JAYNE D. MAAS
Vice President &
Director of Taxes

DR. ROBERT H. MOORE
Senior Vice President
Corporate Relations

J. ROY NICHOLAS
Senior Vice President

MARK E. OLEKSIK
Vice President & Controller
Chief Accounting Officer

JAMES Y. PAULDING
Senior Vice President

RONALD J. ROESSLER
Vice President & General Counsel

HARRY L. SHUFORD
Vice President

THOMAS SOPER III
Vice President

FRANK R. WIECZYNSKI
Secretary

Alexander & Alexander Inc.

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Chairman of the Board

MICHAEL K. WHITE †
President
Chief Executive Officer

WILLIAM D. BAKER
Senior Vice President

DONALD R. BELL
Senior Vice President
Regional Director

GERALD M. BROWN
Senior Vice President
Regional Director

DONALD CLEVELAND †
Senior Vice President
(The Alexander Consulting Group Inc.)

BOBBY J. CLINE †
Vice Chairman
Western Group Director

JACK B. COHEN
Senior Vice President
Consolidation/Automation

PAUL V. COLONY
Senior Vice President
Regional Director

ANGELO M. D'ALESSANDRO
Executive Vice President
(The Alexander Consulting Group Inc.)

PETER M. DENSEN
Senior Vice President

JAMES H. DUNARD †
Senior Vice President
Director, Administrative Operations

LUTHER T. GRIFFITH
Senior Vice President
President & Chief Executive Officer, Anistics Inc.

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Senior Vice President
Executive Director, Executive Planning Services Division

HORACE H. HOLCOMB III
Senior Vice President
Director, IMPACT

GILES H. MADRAY, JR.
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Regional Director

JOHN A. MALASKY
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National Director, Alexsis Inc.

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Eastern Group Director

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Senior Vice President
Regional Director

ROBERT J. MURPHY
Senior Vice President
Director, National Marketing

W. TRAVIS OXFORD
Senior Vice President
Regional Director

EDWARD J. RUDZINSKI
Senior Vice President
(The Alexander Consulting Group Inc.)

JOHN C. SIENKIEWICZ
Senior Vice President

J. RAY TAYLOR
Senior Vice President
Regional Director

EUGENE W. TEAL
Senior Vice President
(The Alexander Consulting Group Inc.)

FRANK R. WIECZYNSKI
Senior Vice President
Director, Special Services

JOSEPH R. ZATTO
Senior Vice President
(The Alexander Consulting Group Inc.)

GARY SINDLER
Secretary

† Member, Management Committee

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Chairman
Chief Executive Officer

WILLIAM D. BAKER
Senior Vice President
Director International Business Development

JOHN A. BOGARDUS, JR.
(Alexander & Alexander Services)

JOHN B. DEVINE
Chairman
United Kingdom & Europe

DAVID C. FRENCH
Chief Executive
Asia Pacific

CEDRIC G. E. GYLES
Chief Executive
Canada

TINSLEY H. IRVIN
(Alexander & Alexander Services)

ROBERT E. O'NEIL
Vice President & Treasurer

DANIEL J. SYDOR
Vice President & Secretary

* Director
(1) Member, Executive Committee
(2) Member, Audit Committee
(3) Member, Compensation Committee
(4) Member, Finance–Investment Committee

Reed Stenhouse Companies Limited

W. DOUGLAS H. GARDINER
Chairman

WILLIAM M. WILSON
President
Chief Executive Officer

THE HONOURABLE JOHN B. AIRD
Partner
Aird & Berlis

W. DAVID ANGUS
Partner
Stikeman Elliott

CEDRIC G. E. GYLES
Chairman
Chief Executive Officer
Reed Stenhouse Limited

JAMES S. HORRICK
President
Chief Operating Officer
Reed Stenhouse Limited

THE HONOURABLE E. PETER LOUGHEED
Partner
Bennett Jones

Alexander Howden Group Limited

RONALD A. ILES
Joint Chairman

DENNIS L. MAHONEY
Joint Chairman

BRIAN C. AINSWORTH
Director
Alexander Howden Limited

TINSLEY H. IRVIN
(Alexander & Alexander Services)

REGINALD W. LARKIN
Chairman
Alexander Howden Group Management Services

FRANCIS N. MARJORIBANKS
Chairman
Alexander Howden Group Financial Services

BERNARD D. STEINART
Deputy Chairman
Alexander Howden Limited

ALAN E. WILLIAMS
Deputy Chairman
Alexander Howden Reinsurance Brokers

JOHN L. HILL
Secretary

The Alexander Consulting Group Inc.

MICHAEL K. WHITE
Chairman

ANGELO M. D'ALESSANDRO
President
Chief Executive Officer

DONALD CLEVELAND
President
Chief Operating Officer
Alexander & Alexander Consulting Group Inc.
Alexander & Alexander Benefits Services Inc.

TINSLEY H. IRVIN
(Alexander & Alexander Services)

BRIAN F. KENNEDY
President
Chief Executive Officer
The Alexander Consulting Group Ltd.—Canada

JOHN D. LOUDON
Chief Executive Officer
The Alexander Consulting Group Ltd.—U.K. & Europe

WILLIAM M. WILSON
(Alexander & Alexander International Inc.)

ALICE RUSSELL
Secretary/Treasurer

Alexander & Alexander Inc.
Major Subsidiary and Operating Units

Albert G. Ruben & Co., Inc.
Beverly Hills, California

Alexander & Associates, Inc.
Dallas, Texas

Alexsis Inc.
Northville, Michigan

Barros & Carrion, Inc.
San Juan, Puerto Rico

Corporate Service, Inc.
Livonia, Michigan

Mel McReynolds Company, Inc.
Dallas, Texas

PBA Inc.
Minneapolis, Minnesota

Property Tax Service Company
Dallas, Texas

S. Hammond Story Agency, Inc.
Atlanta, Georgia

Summit Consulting, Inc.
Lakeland, Florida

Turner and Shepard, Inc.
Columbus, Ohio

Alexander & Alexander International Inc.
Major Subsidiary and Operating Units

Alexander Stenhouse Europe Limited
Continental Europe

Alexander Stenhouse Limited
Asia Pacific

Alexander Stenhouse Limited
United Kingdom

Reed Stenhouse Limited
Canada

Alexander Howden Group Limited
Major Subsidiary and Operating Units

Alexander Howden Limited

Alexander Howden Reinsurance Brokers Limited

Alexander Howden & Beck Limited

Halford, Shead & Co. Limited

Holmes Johnson Lessiter Limited

The Alexander Consulting Group Inc.
Major Subsidiary and Operating Units

Alexander & Alexander Benefits Services Inc.

Alexander & Alexander Consulting Group Inc.

Alexander & Alexander Securities Corp.

The Alexander Consulting Group Ltd.—Australia & New Zealand

The Alexander Consulting Group Ltd.—Canada

The Alexander Consulting Group Ltd.—U.K. & Europe

Benefacts Inc.
Baltimore, Maryland

Risk Management Services Group
Major Subsidiary and Operating Units

Anistics Inc.

Anistics Limited—United Kingdom

Anistics Pty. Limited—Australia

Alexander Insurance Managers Limited

Alexander International Insurance Services Limited

Alexander Trade Services

Hemisphere Marine & General Assurance Company Limited

Alexander & Alexander Operates In:

Argentina
Australia
Austria
Bahamas
Barbados
Belgium
Bermuda
Bolivia
Brazil
Brunei
Cameroon
Canada
Cayman Islands
Channel Islands
Chile
Colombia
Costa Rica
Curacao
Denmark
Dominican Republic
Ecuador
Finland
Fiji
France
Greece
Guadeloupe
Guatemala
Hong Kong
India
Indonesia
Ireland
Isle of Man
Italy
Jamaica
Japan
Malaysia
Mexico
Netherlands
New Zealand
Nigeria
Norway
Panama
Papua New Guinea
Peru
Philippines
Portugal
Puerto Rico
Saudi Arabia
Singapore
South Korea
Spain
Swaziland
Sweden
Switzerland
Taiwan
Thailand
Trinidad & Tobago
Turkey
United Arab Emirates
United Kingdom
United States
Venezuela
West Germany
Zaire

Alexander & Alexander

Approximate Number of Equity Security Holders

As of March 16, 1987, there were approximately 3,900 record holders of the Company's common stock, 1,200 beneficial holders of Class A common stock and 2,000 record holders of Class C common stock.

Notice of Form 10K

Shareholders wishing to receive a copy of the Company's 1986 Annual Report on Form 10K may secure one by writing to Alexander & Alexander Services Inc., Corporate Secretary, 300 East Joppa Road, Baltimore, MD 21204.

Transfer Agents and Registrars

Morgan Guaranty Trust Company, New York, NY
The Equitable Trust Company, Baltimore, MD
The Royal Trust Company, London, England
The Canada Trust Company, Toronto, Ontario, Canada

Auditors

Deloitte Haskins & Sells

Annual Meeting of Shareholders

Date: Thursday, May 21, 1987
Time: 9:30 a.m.
Place: The Equitable Center Auditorium
787 Seventh Ave. between West 51st and West 52nd Streets
New York, New York 10019

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Alexander & Alexander

If you would like to receive a description of Alexander & Alexander's capabilities, please write for our publication, *Managing the Risk Factor*. Contact:

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Alexander & Alexander Services Inc.
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New York, NY 10036

Alexander & Alexander

Corporate Headquarters
Alexander & Alexander Services Inc.
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New York, NY 10036