

# Insurance Evolution

Spring Edition 2010

Welcome to the Spring edition of Insurance Evolution – our thought-leadership forum for the insurance industry.

It is now 10 months since I took over leadership of the Financial Services Group here at Grant Thornton and I am often asked by clients for a view of the market. I thought it might be helpful to let you know where I see things in April 2010.

Large accountancy practices tend to reflect the economy that they serve, and generally, what we are seeing is a gentle, and if I'm honest, somewhat unexciting growth in revenue. So it may be reasonable to deduce this is happening in the financial services sector as a whole: a steady but long drawn out recovery from the precipice of economic catastrophe.

In terms of what our clients demand from us, we are seeing little demand at present for any service that is in any way discretionary from a client's point of view. Where clients have a choice over whether to buy a service from a professional adviser, they may well choose not to buy it. Our strongest service lines therefore are services

where clients must buy our services, for key business, regulatory and prudential reasons. Therefore, demand for services like internal audit, regulatory advice, advice around Solvency II, actuarial assurance, restructuring advice, tax assurance and compliance, and statutory auditing remain strong. This is being helped by an increased regulatory insistence on enhanced governance, improved systems and controls, and better resilience. This pressure is visible across the financial services sector: the insurance market, although not in any way responsible for the gravity of the economic crisis, is nonetheless having to pay costs involved in protecting against future such events.



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Conversely, demand for transactional services – M&A advice, financial and commercial due diligence, and tax structuring – remains light by historic standards. Some deals we are seeing at the moment are deals being done by vendors who feel they have limited options. However, this is not universally true. In a world of poor money returns and volatile equity markets there is, to use the cliché, a wall of money waiting to fall upon good opportunities and there are a small number of deals where good quality assets in the insurance market are changing hands at good prices. It remains the case however that from my perspective there is more chatter than there are due diligence mandates.

Turning to our clients' markets: the non life insurance market, my own speciality, has seen measurable price reductions in 2009 and absent a major catastrophe we would expect this to continue. International intermediaries are to some extent protected against this by the weakness in sterling, and this may be sustained for some time. But the underlying trend in earnings is currently negative. The retail non life market is also under severe price pressure as customers respond to economic constraints, and the growth of internet aggregation will likely continue to suppress shareholder return in those areas.

The market for distribution of life assurance and other related financial products is under acute regulatory strain with RDR in sight and FSA pronouncements leading us to expect future tightening of supervision in these areas. A consolidation of the IFA market has been predicted for as long as I have been in the business (since the early 1980s) but, surely, we are going to see it now. Future consolidation in the life manufacturing sector must also be expected.

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These are tough times and I don't personally think we should expect any early macroeconomic recovery, because public and private debt will take many years to be paid off.

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We are grateful for our clients' support and look forward to working together over the next year.



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# April showers

## why the client money rules for intermediaries are set to dampen Spring

Spring is upon us and, whilst many of us will be hoping for some long awaited warm weather, there is a storm of a different kind looming on the horizon.

### **Not client money again – what’s going on this time?**

It is fair to say that client money has been a key FSA area of focus since January 2005. However, the current environment is very different to the one which existed during 2005.

The ongoing recession has severely dented market confidence within the UK economy which is of concern to both the government (both current and prospective!), regulators and markets alike. A key part of this problem is due to greater pressure on availability of capital and debt across all sectors, and increased risk of insolvency amongst businesses, which has resulted in heightened credit risk for many firms.

An impact of credit risk for insurance brokers is the risk to client monies held. This is a key concern to the Treasury and the FSA since loss of client monies could result in everyday consumers losing out. In turn, this would represent a failure in the regulatory statutory objectives of consumer protection,

and result in further damage to market confidence. Therefore, client money has shot back up the regulatory agenda.

Furthermore, the client money rules remain an area of some confusion for the insurance broking market. The rules are complex and require an understanding of both compliance and accounting, with a sprinkling of trust law – not a combination of skills one often comes across. In addition, there are a number of areas which don’t appear in the client money CASS 5 rules but for which expectation exists (eg unallocated cash, legacy, and credit write backs). The bottom line is that the client money rules are not easy to comply with in practice. However, the FSA’s view is that the general market ‘culture’ is not adequately aligned to compliance with these rules (the old days of putting everything into the IBA account and not worrying about it have passed). This is a clear concern to the regulator.



### The FSA's response

The FSA's response to these concerns and issues has been proactive. Notably, a Dear CEO letter was sent to circa 1000 CEO's of insurance broking and investment management firms during January 2010 and attached the FSA's Client Money & Asset report. This report was produced following client money thematic visits to around 50 firms during 2009.

The report also introduced the new 'CASS risk team' which is probably best described as an FSA hit squad who will be focussing purely on client money and the CASS rules within the foreseeable future.

The CASS risk team will be performing further client money thematic visits to firms, as well as working with the FSA policy teams in reviewing the actual rules themselves and making amendments where appropriate. Therefore, it is important for firms to look out for consultation

papers and feedback comments in order to have their say (speak now or forever hold your peace!)

As well as the CASS risk team, the regulator is also gearing up on the enforcement side, ie the part of the regulator a firm should not want to be involved with at any time. Numerous examples already exist of fines, asset freezes, bans on new business, and delays in acquisitions enforced on firms as a result of client money issues and failures. The expectation is that more of these penalties will be administered in the coming months as the work of the CASS risk team and enforcement bites.

Finally, to offer some consolation to firms, the auditors are also in the spotlight. The FSA has noted numerous instances of incomplete and/or inaccurate client money reports being issued to firms. Therefore work is taking place behind the scenes with audit and accounting bodies such as the ICAEW as to how these issues are best addressed.

### Ok, so what should firms do?

Put simply, firms should ensure they are whiter than white when it comes to compliance with the client money rules – particularly as the regulator appears to have now run out of patience.

Relying upon the client money audit report is not sufficient given that the auditors themselves may not be fully competent, but also due to the fact that this review only takes place once a year – a lot can happen during a year! Should any uncertainty exist then advice should be sought.

In addition, firms should respond to the Dear CEO letter if they have not done so already. In preparing their response, firms should consider that the FSA may well follow up with a visit, so firms should think carefully about exactly what is said in their response.

Finally, firms should also consider their client money and wider credit/liquidity risks in relation to levels of capital held. At the time of writing, the FSA has just issued a further Dear CEO letter to brokers on Threshold Condition 4 (TC4) and financial resources. It is possible that further thematic work could occur in this area, therefore it is important that firms perform the necessary analysis and are able to articulate their position in relation to TC4.

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So whilst we should all enjoy the calm brighter mornings and lighter evenings spring will bring, the client money storm looming on the horizon should not be ignored. All storms eventually pass and taking steps now to address client money should mean the storm can move through with little fuss or damage.

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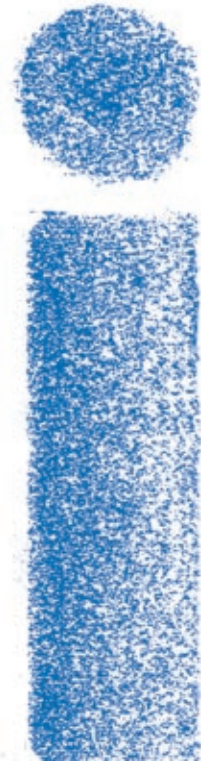
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# The need to know



## Rate adequacy systems for general insurers

In the current uncertain financial times, it is vital for general insurers to clearly understand the profitability of the business they are writing. In good times with a hard market it is possible, although not advisable, for companies to get away without this clear understanding because market conditions assist profitability.

However, at other times, this will not be the case and insurers will need a detailed understanding of what they are underwriting to ensure that either:

- the business is being written at rates that are expected to lead to a profit; or
- if an insurer has decided, for commercial reasons, to write some business at rates that are likely to be unprofitable, it does so with its eyes open; that is, with an appreciation of the likely level of losses.

The worst outcome is for an insurer to write unprofitable business without realising it, and this is a trap that many fell into during the soft market in the late 1990s. By the time many of these companies appreciated what had happened, it was too late to mitigate significant losses.

So what can insurers do in order to avoid the danger? The answer is to develop a management information system to regularly monitor the business they are writing. Such systems are often referred to as “rate adequacy” or “rate monitoring” systems, although this is a bit of a misnomer since a good system will do far more than just track rates.

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Many insurers already have rate adequacy systems in place and those that do not are in danger of finding themselves at a competitive disadvantage.

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### What might be included?

Such a system will monitor a variety of metrics to allow an insurer to measure the success of its underwriting.

These may include:

- renewal retention rates, measured by premium volume
- renewal retention rates, measured by policy count
- a comparison of claim ratios on renewed and lapsed business (as one indicator of whether the insurer is retaining the best business)
- rate changes on renewals
- new business volumes
- a comparison of rates on renewals and new business (to see whether the new business is improving or worsening the book)
- the expected claim ratios and combined ratios of business being written
- changes in commission rates.

This information should be provided at a suitably granular level to be helpful to management, possibly by class of business.

For many of the above metrics, the information produced could include comparisons with the business plan. These are likely to be more informative for senior management and senior underwriters than the metrics themselves since it enables them to judge the results in the context of the company's targets.

One enhancement that can work very well is a simple "traffic light" coding system, where metrics that are significantly behind plan are coloured red, metrics that are broadly in line with plan are coloured orange and metrics that are significantly ahead of plan are coloured green. This can be very effective in focusing users on the areas that require the most urgent attention.

When calculating rate changes, it is important to take account of changes in terms and conditions, including changes in limits and deductibles. In some cases, it may be difficult to accurately adjust the results for the distortions caused by such changes. However, even approximate adjustments will lead to substantially more informative and useful management information than the potentially misleading information produced by making no adjustments at all.



## Features of a good rate adequacy system

There are a number of features that are important when designing an effective rate adequacy system.

**Regular reporting:** The system should produce reports no less frequently than monthly, since it is important for management to be able to react to the results as quickly as possible. Profitability could be reduced if key management decisions are delayed until results become available at, say, the end of the quarter.

**Timeliness:** For similar reasons, it is important for the results to be produced as soon as possible following the month end. The faster the information becomes available, the more valuable it is. Some delays may be unavoidable; for example, it may be a few days after the month end before all policies are loaded onto the IT systems. However, these should be kept to a minimum.

**Homogeneous groupings:** In order to make the results more meaningful, the analysis should be split between blocks of business with similar characteristics that are likely to experience similar rating pressures.

**Relevant groupings:** It is also important that the groupings used are relevant to the way the company is managed. If the account is split in one way for most purposes, it is unhelpful for the rate adequacy system to use a different split. Using groupings that management and underwriters are familiar with will make the analysis more meaningful to them. Otherwise, they are less likely to be able to interpret the results and consequently, less likely to take any notice of them.

**Reliability:** The analysis should be based on accurate data and robust assumptions so that the results can be relied upon. If they are unreliable then either they will be ignored or, worse, they will lead to inappropriate management decisions being taken.

What is more, if there is a history of figures from the rate adequacy system being corrected because of mistakes that have been discovered, users will be more dubious about relying on them in the future.

**Consistency:** It is also important that frequent changes to the methodology used and the presentation of the results are avoided. Constant changes will undermine the confidence that users have in the figures.

**User-friendliness:** The presentation of the results is key - it is important that they are as clear and easy to interpret as possible. This will help to maximise the information that users gain from the output which will, in turn, lead to more informed management decisions.

## Types of insurers

If you were to design a book of insurance business purely to enable the best possible rate adequacy system to be built, it would have the following characteristics:

- complete data available on all policies written; and
- a large numbers of policies, because the results will be based on averaging over groups of policies.

These conditions mean that some types of insurers lend themselves more readily to rate adequacy systems than others. Such systems work particularly well for personal lines insurers who, by the nature of the risks they write, tend to

satisfy both of the above conditions.

The next best results will be for commercial lines insurers who are likely to have good data but who, by comparison to personal lines insurers, write smaller numbers of risks which are, on average, larger.

London market companies also tend to write larger risks. However, because of the nature of the business written and the way it is transacted, they will have less data than commercial lines insurers, meaning that they fail to satisfy either of the conditions above.

Reinsurers are even more problematic since they are very unlikely to have good exposure information on the underlying risks they are insuring.

As you go through the scale from personal lines insurers to reinsurers you get a “double whammy” effect, because not only does it become increasingly difficult to build a rate adequacy system, but the reliability of the system’s output also worsens. However, this categorically does not mean that for some insurers there is no value in developing a rate adequacy system. Having such a system will add considerable value to all insurers, although it is important to understand and communicate the limitations that apply in any particular case.



### Data

The reliability of the results produced by a rate adequacy system will be heavily dependent on the quality of the available data. If the available data is limited it may not be possible to calculate rate changes from information held on the company's IT systems. In such cases, it will be necessary to rely on subjective assessments instead and the best people to make such assessments are the underwriters.

If this approach is adopted, there are two options:

- ask each underwriter to estimate the aggregate rate change achieved each month for the book of business that they are responsible for; or
- ask each underwriter to estimate the rate change on each policy as it is written.

Generally speaking, the latter route is to be recommended as it will provide a more objective assessment. The main drawback is that this will generate more work for the underwriters than just asking them for one aggregate rate change each month. However, it is possible to build a set of questions into the underwriting systems to assist them in collecting the required information.

The more limited the available data, the greater the number of assumptions that will need to be made in undertaking the rate adequacy analysis. The resulting management information will still be of huge benefit to the insurer but it is important to ensure that management understands the sensitivity of the results to the assumptions.

### Some practical issues

There are a number of practical issues to bear in mind when developing a rate adequacy system.

**Start simple:** It can be a daunting and time-consuming task to construct a system that monitors all of the metrics listed earlier. Consequently, it may be preferable to begin by building a system that just includes the key metrics (for example, renewal retention rates, rate changes on renewals and new business volumes). Firstly, this will make the task more manageable and, secondly, it is better to produce something relatively quickly that senior management can use to help run the business, than to wait until the perfect "all-singing, all-dancing" system has been developed. A more advanced system that incorporates additional features can be developed as a second stage.

The development of a rate adequacy system does not necessarily need to be a major IT project. For many insurers, a spreadsheet-based system can be perfectly adequate, and an initial version can be completed in a matter of weeks.

**Automate the system:** The system is going to have to be run every month, if not more frequently, so the effort required to produce the results should be minimised. To this end, the process should be automated as much as possible.

### Update previous results:

As the metrics are produced as soon after the month end as practicable, it is possible that the information on the company's IT systems may change after the data has been extracted. Possible reasons for this include late processing, premium adjustments and corrections of errors. Given this, it is vital not to set the results for a particular month in stone the first time they are produced.

Instead, each time the rate adequacy system is run, the metrics should be adjusted for a number of earlier months to reflect any additional information that has become available since the previous rate adequacy run. One possibility is to calculate and display metrics on a rolling 12-month basis so that, whenever rate adequacy is first run for a particular month, the results for the preceding 11 months are also updated. This will ensure that the final figures produced for each month are as accurate as possible.

**Get users up to speed:** There is clearly no point in building a wonderful rate adequacy system if no-one uses it. The key users of the information are likely to be senior management and senior underwriters and it is worth investing as much time and effort as necessary to explain the output to them, and ensure that they are able to interpret the results.

## Conclusion

For a rate adequacy system to be successful, the system and output need to be both theoretically correct and practically applicable. The two biggest dangers are a system that produces perfect answers but which no-one uses, and a system that is widely used but which gives incorrect results. Arguably, the latter situation is even

more dangerous than the former. However, if these dangers can be avoided, a successful rate adequacy system will be one of the key tools that senior management uses to run an insurance company and insurers who have such a system will have a significant competitive advantage over those who do not.



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# Limited Liability Partnerships

The London insurance market today is populated by in excess of 130 insurance broking firms, many of which are trading as Public or Private Limited Companies (PLCs or Ltds), and for many years operating in one of these forms has been considered 'the norm'. Recently, however, companies have become increasingly interested in looking at an alternative business form which has been more commonly associated with professional firms such as accountants and lawyers, namely a Limited Liability Partnership (LLP).

In this article we look at the pros and cons of the LLP medium and consider some of the issues that should be taken into account if a firm is contemplating such a move.

## So what has prompted this change?

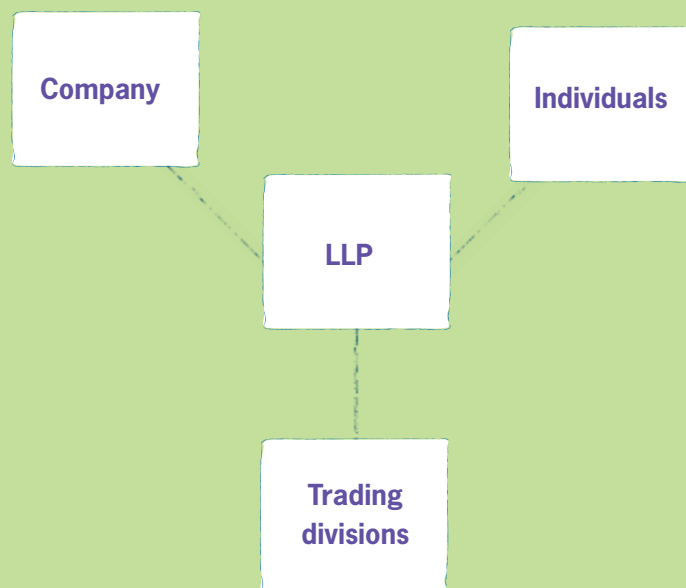
The attractions of partnership status may include simplicity of start-up and management, pooling of resources and skills and sharing of profits. However, in the past one of the main barriers has been that the words 'partnership' and 'limited liability' were mutually exclusive. This made a partnership an unattractive option for businesses which manufactured goods or could be sued for wrongful advice!

During the 1990s however, pressure gradually grew for a change to the law after a number of scandals that pressure resulted in the creation of LLPs after the Limited Liability Partnerships Act 2000 and the Limited Liability Partnerships Regulations 2001 were passed by Parliament.

LLPs were attractive as an alternative business structure for professional firms such as lawyers and accountants, and many of the largest of these firms have subsequently incorporated as LLPs.

It is now clear, however, that LLPs can be used by any business that wishes to combine the benefits of limited liability provided by limited companies, with the benefits of flexibility and tax transparency enjoyed by traditional partnerships.





### What is an LLP?

An LLP is a body corporate which exists as a 'legal person' independently from its members and it can enter into contracts and hold property just like a limited liability company. The membership of an LLP combines both ownership and the right to manage the business.

This contrasts with companies, where a distinction is made between the owners (shareholders) and the managers (directors) although these may be, and often are, the same people.

An LLP is fully liable for its own debts and obligations but the liability of the members is limited to the amount of capital that they have each contributed.

The owners of a limited company are allotted shares in the business representing the amount of capital that they have contributed. An LLP does not have shares so the default status under the Act is that each member will have an equal stake in the business and equal voting rights. As discussed below this is easily altered by agreement.

An LLP does not need to have a memorandum and articles of association instead the members normally agree on the rights and duties that they owe to each other. This 'members agreement' is not, technically, obligatory and there are certain default provisions contained in the Limited Liability Partnerships Act, such as how members share in the capital and profits of the business, in the event that such an agreement is not in place.

The agreement does not have to be published and so can remain confidential, and the members of the partnership have considerable freedom to agree to whatever terms they wish.

### How is an LLP taxed?

For tax purposes an LLP is treated as a partnership and members as partners. Tax is charged on a 'transparent' basis, in other words profits are subject to tax on each partner. For a trading LLP the profits are taxed under the rules which apply to the members ie income tax, national insurance and capital gains for individual members and corporation tax for a corporate member.

### What might the structure look like?

The diagram above shows how a potential move to an LLP might be structured. The first step would be the formation of a new LLP. The existing company would then contribute some or all of its business to the LLP in exchange for an interest in the LLP.

The current senior employees of the company would have their existing employment contracts terminated and would instead become members of the LLP where they will be self-employed and will receive a share of the trading and/or capital profits of the business.. The other employees would have their employment contracts transferred from the company to the LLP.

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So what has made increasing numbers of businesses consider operating through an LLP?

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As the LLP would not be subject to tax in its own right, this provides for a single layer of taxation on profits. For the members receiving the profit share, the LLP structure could provide for a reduced overall rate, as illustrated in the table below using the rates applicable from 6 April 2010:

	LLP	Company
Profits vs salary	100	100
Employers NIC (12.8%)		(11.3)
Tax & Employee NIC (51%)	(51)	(45.2)
Net cash received	49	43.5
Overall tax rate	51.0%	56.5%

Illustration assumes tax and associated NICs are payable at the additional/higher rates and ignores the primary Class 1/Class 2/Class 4 NICs payable up to the various thresholds.

### Benefits Efficiencies

As previously mentioned, each individual member of the LLP will be chargeable to tax on their share of the taxable profit. Members are self-employed rather than employees and as such, there is no liability to Class 1 employer's national insurance contributions (NIC) (currently 12.8% and rising to 13.8% from 6 April 2011). This affords the business significant NIC savings. In addition, there may be cash-flow savings for the members since they would settle their tax liabilities through self assessment rather than through the pay as you earn system.

### Flexibility

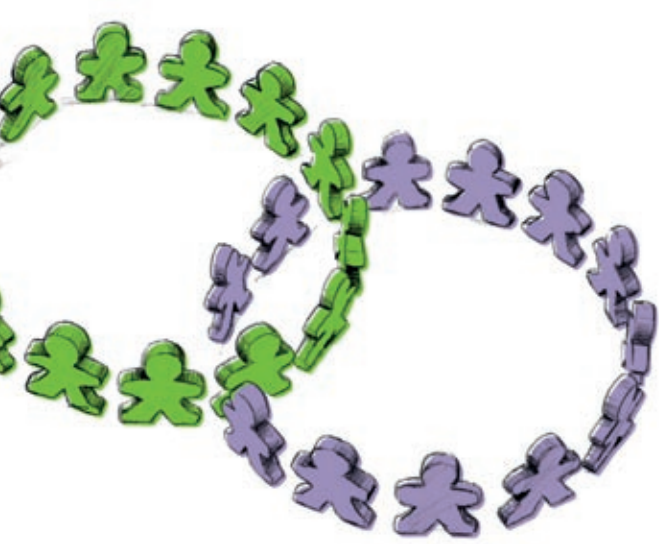
An LLP can also offer greater flexibility around the organisational structure. Unlike a limited company, an LLP may have a profit-sharing and decision-making structure written uniquely for its business and participants. None of the companies act legislation on share capital, management, or meetings and resolutions, applies to LLPs and there is no distinction between the roles of owners and managers of a business.

Members of an LLP do not have shares or employment contracts, instead their rights and responsibilities are set out in the members' agreement. The agreement is a private document which does not need to be filed with Companies House. It offers flexibility for profits to be shared in a myriad of different ways. Income profits and capital profits can be shared differently amongst different members and it is possible to alter the way profits are shared year-on-year.

Typically, the agreement will cover such matters as:

- Formalities, for example the name of the organisation and place of business
- Admission of new partners and retirement/leaving/removal of existing partners
- Management of the LLP
- Rights and obligations of partners including sharing of profits and liabilities





### Participation

In many instances it will be simpler to admit new members to the LLP than to issue new shares in a company. This could potentially be used to allow for wider participation in the business which may engender a greater sense of loyalty and responsibility towards the business and help to reinforce a stronger link between company performance and reward.

The members' agreement can also be specifically drafted to deal with the procedures for withdrawal from the partnership, providing greater organisational flexibility.

### Challenges

There are no specific tax exemptions relating to the transfer of a business from a limited company to an LLP and there are a number of potential pitfalls which need to be avoided to ensure the restructuring does not crystallise a capital gain. In addition, careful consideration would need to be given to the VAT position to ensure no cost arises as a result of the reorganisation. However, with some careful planning these potential risks can be managed. A restructuring gives rise to a number of employment related considerations. The impact on employment rights would need to be addressed where employees become members of the LLP. In addition, the Transfer of Undertakings (Protection of Employment Regulations (TUPE)), which preserve employees' terms and conditions when a business or undertaking is transferred to a new employer, would also need to be taken into account so that staff cannot claim constructive dismissal.

Depending on the nature of existing arrangements, there may be implications for individuals' pension arrangements when moving from employment to membership of an LLP. In particular, it should be noted that the individuals who are members will not be able to benefit from employer's contributions. It would also be necessary to consider any existing benefit arrangement.

The LLP will not be able to take advantage of the various approved share schemes enabling employees to own a small stake in the business and which also enables the employee to generate a value taxed at capital gains rates. With the current differential between capital gains tax rates and income tax rates the effect could be significant. Any existing share schemes or share options in issue would need to be considered.

To the extent that the profits of the LLP are allocated to the corporate member the effective rate on those profits, if they were subsequently to be distributed, may be higher than if they were allocated to the individual members. However, whilst profits need to be retained, using a corporate member may reduce the effective tax on the undistributed profits.

In return for members' limited liability, an LLP must observe various regulatory requirements designed for the protection of creditors, mirroring that applicable to companies. As with a company, an LLP must file annual accounts and an annual report.

### Process

The process of restructuring the business around an LLP will involve a number of different workstreams and it is important that these are identified from the outset.

There will be some one-off costs arising from the transaction along with a considerable amount of management time invested in a project of this nature. These will need to be quantified as part of a feasibility study in order to determine whether or not to proceed.

The formal legal process for forming an LLP is relatively straightforward and involves completion of a form with information on the founding members, the proposed name and location of the LLP, and submitting it to Companies House with a fee of £20.

For insurance intermediaries the FSA will require notice of the proposed change in the status of the company and will wish to be certain that there is a bona fide reason for the change and that no customer detriment will ensue. Firms will need to complete a 'change of legal status' form and, depending upon the circumstances, individual and controller forms if the information on these is different going forward.

Appropriate notification will need to be given to customers and suppliers and any contracts or terms of business amended accordingly.

A final point which should be considered is whether any potential legal issues exist under trust law requiring attention. This is likely to be relevant to insurance intermediaries who are holding client monies. In this case, certain consent may be required from clients before any monies could be transferred to a new legal entity.

In addition, there will be a number of changes required to website information, stationery, signage and other templates which must all reflect the LLP status from day one.

## Conclusions

The potential benefits of restructuring as an LLP need careful consideration in the context of the business in question and it may not be appropriate in all circumstances. Thought needs to be given to the tax profile of the business and its senior employees, along with the regulatory and commercial considerations. However, an LLP can provide greater flexibility around decision-making and profit-sharing arrangements, with scope to flex these to best meet the needs of the business going forward.



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