The impending Solvency II regulatory regime in the European Union requires insurance companies to perform a regular attribution of profits and losses as one of the tests to gain approval for the use of an internal model in calculating capital requirements. Traditional analysis of surplus processes, depending on an arbitrary choice of order in which the risks affecting the company are assumed to occur, may not be adequate to meet the standard of profit and loss attribution required by Solvency II. This paper proposes an approach to profit and loss attribution that does not depend on an arbitrary choice of order, which has the following further advantages over traditional analysis of surplus processes:

- Greater integration is possible between financial reporting and risk management within the business because items in the attribution correspond directly to risk factors considered in the internal model and/or in the Own Risk and Solvency Assessment (ORSA).
- Second (and higher) order impacts can be incorporated into the attribution in a systematic way.
- Each item in the attribution is more amenable to validation, because it is expressed as a percentage of a risk factor that has occurred multiplied by a figure for the sensitivity to that risk factor.
- The approach will enable risks not currently allowed for in the internal model or ORSA to be identified.

The approach is illustrated by means of an example applying it to analyse the change in the value of a portfolio of annuity liabilities.

Key words: Solvency II; Profit and Loss Attribution; Internal Models; Financial Reporting; Risk Management; Annuities