



**Scottish Friendly prides itself on offering a friendly and effective service.**

As a mutual organisation, the Group provides value for our members, investors and corporate partners through a combination of innovative investment product design, value for money administration and effective investment management.

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2007 has been a milestone year in the history of the Scottish Friendly Group. Not only have we recorded another year of solid business growth, the transfer from Scottish Legal Life has contributed over £170m to the increase in funds under management.

## Financial highlights 2007

- Group sales up by 4.3%, including core life and pensions growth of 25%.
- Funds under management in excess of £830m.



## A proven strategy

It has been just two years since the launch of our three-strand growth strategy as a friendly and effective financial services group and we are already achieving considerable progress in each of the three areas. We are growing organically by developing new products and distribution channels. Our scale is increasing through business acquisitions and, through our provision of business processing outsourcing solutions, we are successfully providing and designing sophisticated financial products for high net worth individuals.

## New products

Innovative new products launched in 2007 include:

### Regular Savings Plan

A 10-year with-profits plan that allows you to save from just £15 a month. Investments of more than £30 a month benefit from enhanced terms.

### UK Select Investment Plan

A 10-year regular investment plan that gives you the choice of a UK stock market tracker fund or an actively managed stock market fund. Invest from just £15 a month.

### Family Savings Plan

A family of four can invest up to £100 a month free of income and capital gains tax with this plan. Investments of more than £30 a month benefit from enhanced terms.





## New partners

Why keep great savings plans a secret? Over the last two years, we've forged new relationships with major partners like Royal London and Phoenix so their customers can benefit from our friendly society tax-free savings plans. And let's not forget the troops and support staff of the UK Armed Forces based at home and overseas. Our partnership with Forces Financial ensures our plans are available to them too! We also spread the word by working with banks, building societies, direct mail and retail organisations so their customers and members, too, can share in the success of our investment plans.

## New members

The transfer of Rational Shelley's business in late 2005 got our mergers and acquisition programme off to a dynamic start. This was followed by the transfer of the life business of Pioneer in June 2007. But it has been the successful consolidation of Scottish Legal Life that has really marked Scottish Friendly as a significant player in this field. As well as increasing funds under management by £170m, the smooth transition of over 100,000 ex-Scottish Legal Life members to Scottish Friendly's state-of-the-art back office administration system has been widely hailed as a major success. The year closed with the completion of another transfer – London Aberdeen and Northern Mutual Assurance Society (LANMAS).

## New markets

Scottish Friendly's IT platform has been the backbone of the Group's launch into the third strand of its growth strategy. The back office and logistical support to the Nucleus Financial Group's wrap has developed apace in 2007. By working closely with our partner we have provided much more than administration and have helped to further develop and innovate the wrap product range, strengthening the presence of Nucleus in the UK financial services market.





Graham Webster  
Chairman

The Scottish Friendly Group achieved meaningful progress across all three fronts of its strategy for growth, and I commend the Chief Executive, the management team and staff for their outstanding performance.

## Strategy

**Organic growth:** Our investment in new product development, more effective direct marketing strategies and the successful establishment of distribution partnerships with some leading household names produced excellent results in 2007. Sales of core life and pensions business were £6.7m, an increase of 25% compared with 2006. Furthermore, it is pleasing to note that Tax-Exempt Savings Plan sales, which are exclusive to friendly societies, increased by an excellent 36% year on year. This was all the more impressive when viewed against a further cut, in real terms, in the value of this tax-free benefit, as the Government continues to freeze the maximum monthly contribution at £25 per month.

**Business Process Outsourcing:** In 2006 the efficiency and flexibility of our back office helped us secure the contract to support the IFA-backed Nucleus Financial Group's wrap business. By working closely with Nucleus in 2007, we have helped to establish them prominently on the UK financial services map, as well as earning valuable income for Scottish Friendly.

**Mergers and Consolidation:** During the year Scottish Friendly secured the transfers of three companies, the most significant of which was Scottish Legal Life. This represented the largest transfer in the UK of a friendly society and the successful integration of Scottish Legal Life policies and assets into Scottish Friendly has brought real benefits to both sets of policyholders. I extend a very warm welcome to all our new policyholders.

## Corporate recognition

Market awareness of Scottish Friendly has increased significantly during the year and I believe the Group is now recognised by the financial services industry and the wider business community as a respected and effective organisation.

In addition, the Group's success has been recognised by two notable awards. Our chief executive, Fiona McBain, was selected in 2007 as the Scottish Enterprise female director of the year and, in September, Scottish Friendly secured a national business award for the best use of technology. This award was all the more impressive as it was won against competition from large multi-national organisations from within and outside of the financial services industry.

The Group received a further accolade at the beginning of 2008 when Celent, an international business consultancy, recognised Scottish Friendly as a "model office for policy administration". One of only five companies named from around the world, Scottish Friendly was the sole European organisation.

## Investment and with-profits bonuses

Funds under management have increased to over £830m. Despite fluctuating markets in the second half of the year, the Scottish Friendly with-profits fund returned 4.3% in the year as a whole and we were able to maintain annual bonuses at their existing levels. Since the year end, however, global equity markets have fallen significantly and, in response, terminal bonus rates will be reduced in the second quarter of 2008.

For business transferred from Scottish Legal Life, where investment returns were lower, it has also been necessary to reduce terminal bonus rates.

### Corporate governance

During 2008 there will be a significant change in the way the financial services industry is governed with the introduction of principles-based regulation by the Financial Services Authority and the implementation, in full, of one of its key initiatives, namely Treating Customers Fairly (TCF). As a mutual organisation, and as a leader in the field of direct marketing, many of the principles underlying TCF come naturally to Scottish Friendly. These include placing the customer at the heart of the organisation, identifying target markets and maintaining appropriate controls and management information over our distribution activities.

We have increased the distribution and scrutiny of our management information within the Group and have ensured that the principles underlying TCF are fully understood within Scottish Friendly at every level.

Scottish Friendly has also continued to play an active role supporting important initiatives promoted by the Association of Friendly Societies and the Association of Mutual Insurers.

### Focus on service

Our customer services team has had to face major challenges, notably the introduction of new products, new distribution channels, new business processes and the impact of three additional business transfers.

It is very impressive that, despite all of these changes and continuing growth, the professionalism of our staff has shone through. Moreover, we have been able to maintain the high levels of customer service to which we aspire. The 2007 Association of British Insurers Customer Impact Survey shows that we have maintained an industry ranking which is well above average. Further details of this survey can be found on page 16. In addition we have not jeopardised our cost efficiency and our administrative renewal expenses remain extremely competitive in the industry.

During the year we have trialled new methods to assist our customers to interact and conduct business with Scottish Friendly. These include online applications and text-based marketing services. Of these, online applications for Scottish and Child Bonds have been a remarkable success and our online activity now represents a significant source of new business. In 2008 we plan to extend our online application activity to our entire product range and have high hopes for this channel.

### The Board

Past Chairman, Douglas Forbes, retired from the Board in April 2007 after 26 years of distinguished service to Scottish Friendly. We wish him well in his retirement.

We are delighted to welcome Malcolm Berryman to the Board of Scottish Friendly as a non-executive director.

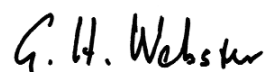
From 1999 until 2005 Mr Berryman was Group Chief Executive of Liverpool Victoria, the UK's largest friendly society, and he guided it through a significant expansion of its operations. His experience and enthusiasm will be a great asset to the board and management of Scottish Friendly.

### Management and staff

On behalf of the Board I would like to thank the management team and the staff of Scottish Friendly for their considerable efforts and professionalism in 2007. Thanks to them Scottish Friendly has continued its remarkable transformation whilst maintaining high levels of customer satisfaction.

### Outlook

During 2007 we have witnessed a major expansion of the Scottish Friendly Group and I believe that its performance during the year has justified its investment in people, technology and innovation. The Board is very conscious of the uncertain economic outlook and will adopt a prudent and careful approach to managing your business.



Graham Webster  
Chairman  
26 March 2008



Fiona McBain  
Chief Executive

2007 has been an extremely successful year for Scottish Friendly and one that we are confident will stand as an exceptional time in our 145 year history. We ended the year more than a third larger, both in terms of assets under management and number of members, as compared to end 2006.

A mere two years following the launch of our three-strand growth strategy of organic growth, mergers and consolidation, and business process outsourcing, we are recording significant results on all fronts, each of which is contributing to the growth, stability and profitability of the Scottish Friendly Group.

### Organic growth

Our impressive increases in new business flowed from our earlier investment in new product development and distribution partnerships.

I noted last year that whilst we would continue to campaign vigorously for an increase in the tax-exempt savings plan limit (currently £25 per month), we believed that the time had come to use product development to address the problem of real cuts in this friendly society exclusive tax benefit. In 2007 we employed wrap technology, which allows products governed by different regulations to be purchased and administered as a single entity, and on the back of this we launched a number of new products which enabled our customers to break free from the monthly contribution limit.

Our Regular Savings Plan and UK Select Investment Plan now not only allow our customers to exploit fully their tax-exempt savings allowance but also provide a way of investing as much as they like. The initial results of both plans are highly encouraging, producing an increase in average premium and a reduction in the cost of acquisition. This has resulted in efficiencies for the Group which will translate into higher financial returns for our members in the long term.

Organic growth of core products was given a major boost when we were selected by household names such as Royal London and Phoenix to distribute tax-free savings products to their customers as well as working with their telephone-based consultancy teams. Additionally during the year we secured a tie-up with Forces Financial, a firm which specialises in distributing family savings products to the British armed forces in the UK, Cyprus and Germany.

This, combined with a range of smaller partnerships, has helped to diversify our distribution capability as well as further reducing our costs of acquisition.

In 2008 we expect to maintain this momentum in our distribution partnership activity as our back office efficiency, flexibility and speed to market continues to attract more partners and opportunities.

### Business process outsourcing

We were proud to secure in 2006 the contract to provide the back office and logistical support to the Nucleus Financial Group wrap. Scottish Friendly had to beat stiff competition from far larger organisations and we believe the last twelve months have demonstrated that our selection was thoroughly warranted. Our product development, IT and back office teams have worked closely with Nucleus to ensure the smooth running of its wrap platform. Furthermore we have supported Nucleus by launching an ISA, PEP transfers, a Self-Invested Personal Pension Scheme, an Appropriate Personal Pension Scheme and an innovative onshore bond contract. All of these contracts have been welcomed by the independent financial advisers supporting the Nucleus wrap.

Our partnership with Nucleus goes from strength to strength as we continue to build and evolve our product range whilst continually improving our levels of service and support. By working closely together, Nucleus and Scottish Friendly staff have helped Nucleus make a significant impact on the financial services industry. This impact was recognised last year when Nucleus won the Scottish Financial Enterprise award for "Innovation in Business Approach".

### Mergers and consolidation

In August 2007, the members of Scottish Legal Life (SLL) voted to transfer to Scottish Friendly and, on 1st October, 130,000 new members and some £170m of assets moved to Scottish Friendly, thus completing the UK's largest friendly society transfer of engagements. All of the former SLL policies are now administered on the Scottish Friendly platform.

It is a real tribute to our staff and the capability of our IT platform that the transfer took place smoothly, further demonstrating our ability to bring the benefits of our back office efficiency to other organisations.

During 2007 Scottish Friendly also acquired a small book of life business from Pioneer and on 31st December 2007 we added a third acquisition with £33m of assets and 6,000 policyholders from London, Aberdeen and Northern Mutual Assurance Society (LANMAS). Once again these transfers were completed with the minimum of disruption to our systems and to our new and existing customers.

Our merger and consolidation activity provides a secure base for our growth strategy, providing existing policyholders and members with greater economies of scale as well as providing new customers with access to efficient services and a wide range of additional products.

Our success in this area means 2007 stands out as a significant year in the history of the Scottish Friendly Group and leaves us well positioned to consider opportunities arising from further consolidation in the sector.

### Analysis of results

Based on the industry standard of 'annual premium equivalent' – regular premiums plus one tenth of single premiums – Scottish Friendly Group business recorded sales of £8.3m in 2007, an increase of 4.3% over 2006.

Ordinary Business regular premium income increased by 3.2% to £65m. Despite the continued run off of Industrial Business, total gross premium income increased from £68m in 2006 to £79m.

As well as new business and total premium income, Scottish Friendly's other key performance indicators relate primarily to expense management. Administrative expenses were 6% of gross premium income, a fall of 1% from 2006. The cost of acquiring new business decreased from 117% of the first year's premium in 2006 to 105%.

Given our considerable success in growing our with-profits assets under management, we are now governed by the FSA's realistic reporting regime. This requires explicit provision to be made within the Long Term Business Provision for terminal bonuses and the cost of guarantees. As a result, there has been a transfer of £119m from the Fund for Future Appropriations, being the funds not yet allocated to policyholders, into allocated technical provisions.

### Investment performance

The main area of risk and uncertainty in the business is investment risk. Scottish Friendly invests in low cost tracker funds combined with actively managed portfolios. This greatly benefits our cost base as well as providing us with flexibility in what was latterly a turbulent year for the global economy and stock markets.

Our investment portfolio continued to perform well in 2007 despite tough market conditions. Our Managed Growth Fund and UK Growth Fund maintained top quartile rankings in the respective investment sectors. Furthermore the UK Growth Fund obtained from Morningstar a 5 star rating, the highest star rating, to 31 December 2007. Star ratings are awarded for strength and consistency of performance relative to other funds in the sector over 36 months.

The overall outlook for investment is clearly uncertain in 2008 as the effects of the credit crunch flow through the economy and analysts study the impact on high street trading and the property market. A sustained slowdown could have a profound effect on the economy especially given the high levels of personal debt. Alternatively a resumption of confidence in the credit market could quickly result in a return to stock market growth and stability in the commercial and residential housing markets. This uncertainty argues for a well managed and balanced portfolio of investments, a principle to which Scottish Friendly remains firmly committed as a long term investor.

### Friendly and effective

All staff at Scottish Friendly are rightly proud of the achievements made in 2007 and are delighted that we have delivered and indeed exceeded our best expectations.

As a result of this progress our assets under management now exceed £830m. This creates real and meaningful benefits for new and existing policyholders as well as for our business processing and distribution partners.

As I said at the beginning of this review, 2007 was an 'exceptional' year in the history of Scottish Friendly. Our aspirations to continue to grow the Group through our proven strategy remain as strong as ever.



Fiona McBain  
Chief Executive  
26 March 2008

## **G H Webster** BSc, FRICS

### **Chairman**

Appointed Chairman in December 2005 and a Director since 1993. Chairman of the Nomination Committee and a member of the Remuneration Committee. Director of the Society's subsidiary companies, Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited and Scottish Friendly Trustee Company Limited. A Director of property and investment companies based in Scotland.

## **G E F Johnston** LLB, CA

### **Vice-Chairman**

Appointed Vice-Chairman in December 2005 and a Director since 1996. A member of the Audit, Remuneration and Nomination Committees. Trustee of the Staff Pension and Life Assurance Scheme. Former Group Chief Executive of the freight transport company Arbuckle Smith and Company Limited. A past Chairman of the Scottish Chambers of Commerce, and past President of Glasgow Chamber of Commerce. Past Chairman of Central College of Commerce.

## **T P Noble** MA, MBA

A Director since 2000. Chairman of the Remuneration Committee and a member of the Audit and Nomination Committees. Chairman of Palmaris Capital plc and Darnaway Venture Capital plc. Former Chairman of Noble Group Limited.

## **Dr B I Wood** BSc, PhD, DIC, AFIMA

Appointed as a Director in May 2001. Member of the Audit and Remuneration Committees. Chairman of Turnkey Computer Technology Limited and a Director of Core Australia Pty Limited.

## **J W Jack** MA, CA

Appointed as a Director in July 2006. Chairman of the Audit Committee. A chartered accountant with many years' experience in the financial services industry. Previously held a number of senior financial positions in the Prudential Group. Finance Director of Living Time Limited.

## **M L Berryman** BSc, FIA

Appointed as a Director in September 2007. Member of the Audit Committee. A qualified actuary with over 30 years' experience in the life insurance industry. Previously Group Chief Executive of Liverpool Victoria Friendly Society and Chief Executive Officer of Crown Financial Management.

## **F C McBain** MA, ACA

A chartered accountant with over 20 years' experience in the financial services industry. Joined Scottish Friendly in 1998, appointed to the Board in April 2005 and Chief Executive since January 2006. Director of the Society's subsidiary companies, Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited and Scottish Friendly Trustee Company Limited. Director of the Association of Friendly Societies and a Director of the Association of Mutual Insurers. Member of the ABI Life Insurance Committee.

## **J Galbraith** BSc, MBA, FFA

Joined Scottish Friendly in 1988 and appointed to the Board in April 2006. A qualified actuary with over 20 years' experience in the life insurance industry. Director of the Society's subsidiary companies, Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited and Scottish Friendly Trustee Company Limited. Trustee of the Scottish Legal Life Pension Scheme.

## **Executive**

<b>F C McBain</b> MA, ACA	Chief Executive
<b>J Galbraith</b> BSc, MBA, FFA	Actuary and Director of Strategy
<b>N E Lovatt</b> ACII, BA, MSc(Dip)	Sales and Marketing Director
<b>D McErlean</b>	Head of Customer Services
<b>C E Saxby</b> BAcc(Hons), CA	Finance Director
<b>J Wilson</b> BSc, B Eng, MSc	Head of IT

The Directors have pleasure in submitting their annual report and accounts for the year ended 31 December 2007. This report should be read in conjunction with the Chairman's Statement and the Chief Executive's Review on pages 4 to 7.

## Activities

The principal activity of the Society is the transaction of long-term insurance business in the United Kingdom. In accordance with the Friendly Societies Act 1992, the Directors confirm that all activities carried on during the year by the Society are believed to have been carried on within its powers.

The Society has three wholly owned subsidiaries: Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited and Scottish Friendly Trustee Company Limited. Scottish Friendly Asset Managers Limited conducted the business of managers for the transactions in Scottish Friendly ISAs, PEPs and Child Trust Funds. The principal activity of Scottish Friendly Insurance Services Limited is the provision of wrap administration services. Scottish Friendly Trustee Company Limited acts as trustee for the Scottish Friendly SIPP.

Scottish Friendly Investment Funds ICVC, an OEIC (Open Ended Investment Company), provides the stocks and shares component of the Scottish Friendly ISA and Child Trust Fund.

All of the above are registered in Scotland.

During the year, there were three transfers of business to Scottish Friendly Assurance Society Limited.

On 30 June 2007, a book of life insurance engagements of Pioneer Friendly Society Limited, a friendly society, was transferred to the Society in accordance with section 86 of the Friendly Societies Act 1992.

On 1 October 2007, the long-term business engagements of Scottish Legal Life Assurance Society Limited, a friendly society, were transferred to the Society in accordance with section 86 of the Friendly Societies Act 1992.

On 31 December 2007, the long-term business engagements of London Aberdeen and Northern Mutual Assurance Society Limited (LANMAS), a mutual insurance company, were transferred to the Society following approval by the High Court.

## Business review

A review of the performance of the business during the year, including a description of the principal risks and uncertainties facing the Group, is included in the Chief Executive's Review on pages 6 to 7.

## Directors and Chief Executive

The current Directors of the Society, including the Chief Executive, are listed on page 8. On 25 April 2007, A D Forbes retired as a Director. M L Berryman was appointed as a Director on 1 September 2007.

Further information on the Board is set out in the Report on Corporate Governance on pages 11 to 13.

## Statement of solvency

In the opinion of the Society's Head of Actuarial Function, the Society had the required margin of solvency as prescribed in the Prudential Sourcebook for Insurers (INSPRU) for each class of relevant business as at 31 December 2007.

## Employees

The Group is committed to a policy which ensures that, in all aspects of recruitment, training and career development, equal opportunities are afforded to job applicants and employees irrespective of their age, race, religion, sex, marital status or disability. If employees become disabled during the period of employment, the Society will endeavour to retrain or redeploy individuals to enable their employment to continue.

The Society has an established system of communication utilising a clearly defined line management structure both to convey information concerning the Society's performance to staff and to receive from staff input relative to the Society and their part in its operation. Regular meetings are held by managerial staff for this purpose, reinforced by newsletters, annual reports and other written communications.

## Policy on complaints by members

The Society's complaints procedures, detailing the action to be taken in the event of a complaint being received from a member, are documented in the Society's Memorandum and Rules, Complaints Manual and Compliance Manual. There is provision for an arbiter to be appointed.

## Policyholders and members

As at 31 December 2007, the Society had 1,344,000 (2006 – 706,000) policyholders and estimated the number of members to be 525,000 (2006 – 399,000).

## Disclosure of information to auditors

The Directors who held office at the date of approval of this Directors' Report confirm that, so far as they are aware, there is no relevant audit information of which the Society's auditors are unaware, and each Director has taken all the steps he ought to have taken as a Director to make himself aware of any relevant audit information and to establish that the Society's auditors are aware of that information.

## Statement of Directors' Responsibilities in respect of the Directors' Report and the Accounts

The Directors are responsible for preparing the Directors' Report and the annual report and accounts in accordance with applicable law and regulations.

Friendly Society law requires the Directors to prepare accounts for each financial year. Under that law, the Directors have elected to prepare the accounts in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law).

The accounts are required by law to give a true and fair view of the state of affairs of the Society and of the Group as at the end of the financial year and of the income and expenditure of the Society and of the Group for that financial year.

In preparing these accounts, the Directors are required to:

- (a) select suitable accounting policies and then apply them consistently;
- (b) make judgments and estimates that are reasonable and prudent;
- (c) state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the accounts; and
- (d) prepare the accounts on the going concern basis unless it is inappropriate to presume that the Group will continue in business.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Group and enable them to ensure that its accounts comply with the Friendly Societies Act 1992 and the regulations made under it. They are also responsible for safeguarding the assets of the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are also responsible for preparing a Directors' Report in accordance with the Friendly Societies Act 1992 and the regulations made under it.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Society's website. Legislation in the United Kingdom governing the preparation and dissemination of accounts may differ from legislation in other jurisdictions.

## Auditors

The retiring auditors, KPMG Audit Plc, offer themselves for re-appointment at the forthcoming Annual General Meeting.

By order of the Directors



C E Saxby  
Secretary  
26 March 2008

As a mutual organisation, Scottish Friendly is committed to maintaining accountability to its members. As part of that commitment, we continue to embrace best practice in corporate governance and are committed to the principles of the Annotated Combined Code for Mutual Insurers ('the Code').

In line with the principle of "comply or explain" set out in the Code, this report describes Scottish Friendly's compliance throughout the period with the principles and provisions of the Code.

The Directors consider that, throughout the period under review, Scottish Friendly has applied the relevant principles and complied with the relevant provisions of the Code as amplified by Corporate Governance for Mutual Insurers – Guidance published by the AMI and AFS in response to the requests contained in the Myners Report (Dec 2004).

Executive Directors' remuneration does not include a contractual element which is explicitly performance-related. For the reasons set out in the Directors' Remuneration Report, the Directors do not regard this exception as a material departure from the Code.

## The Board

The Board met monthly during 2007 other than in November – there is a schedule of regular reports which the Board considers at these meetings and which is agreed annually. Reports are provided to Board members in advance of the meetings. All Directors were present at the meetings except for apologies from J W Jack and T P Noble on one occasion each. In November, the Non-Executive Directors met with Executive Management to review the business plan for the forthcoming year.

The matters considered by the Board, and on which it receives regular reports, cover financial, operational and risk matters, including:

- financial performance against budget, data and analysis relating to business volumes, and reports on investment strategy and performance;
- operational reports on customer service and staff matters;
- compliance reports detailing developments in the regulatory environment and Scottish Friendly's management of compliance exposures.

Although many of the powers regarding operational management and day-to-day activities of Scottish Friendly are delegated to Executive Management, through the Chief Executive, there is a formal schedule of matters reserved to the Board for approval which includes: the authorisation regime for bank accounts; changes to investment parameters and deals outwith those parameters; transfers of engagement; the budget and the distribution of surpluses and bonuses. The Board also retains responsibility for a number of statutory duties relating to the prudent management of Scottish Friendly's activities: these include responsibility for maintaining required solvency and liquidity levels as well as maintenance of requisite accounting records and systems of control. The powers retained by the Board, and those delegated to Executive Management and Board Committees, are reviewed at least annually by the Board.

The roles of the Chairman and Chief Executive are separate and their respective responsibilities have been agreed and documented.

Scottish Friendly has established a framework of internal controls for the management of risk within its business and to safeguard the interests of members. The system is designed to manage the risk of failure to achieve business objectives, and provide reasonable assurance against material misstatement or loss. The Board has overall responsibility for this system of internal control and annually reviews its effectiveness, including a review of financial, operational and compliance controls and risk management systems. Its effectiveness has also been reviewed by the Board specifically for the purposes of this statement.

## Directors

Brief biographies of the current Directors are set out on page 8.

In addition to the Chairman and Vice-Chairman, the Board comprised, as at 31 December 2007, two Executive Directors, being the Chief Executive and the Actuary and Director of Strategy, and four other Non-Executive Directors. This composition is considered to provide an effective and balanced mix of skills and experience to meet the Board's remit.

G H Webster is presumed not to be independent by virtue of his role as Chairman. G E F Johnston, the Senior Independent Director, has served over nine years, however the Board has concluded that he continues to bring independent character and judgement to his role. Accordingly, during 2007 the Board, excluding the Chairman, had a majority of independent Non-Executive Directors.

As Senior Independent Director, Mr Johnston may, as necessary, lead meetings of the independent Non-Executive Directors (without the Executive Directors and/or the Chairman being present); be available to members through the member relations function to understand their concerns (in the event that contacts with the Chairman, Chief Executive or Secretary are inappropriate or have failed) and to present these views to the Board as a whole; and to lead the performance evaluation of the Chairman.

Scottish Friendly's Rules provide for all Directors to stand for re-election at least once every three years. All Directors who have been a member of the Board for nine years from date of election are subject to annual re-election at the AGM.

Particulars of Directors' remuneration are given in the Directors' Remuneration Report on pages 14 to 15.

## Performance evaluation

On an annual basis, the Chairman conducts a performance evaluation of each Director in order to verify that each continues to contribute effectively and demonstrate commitment, including time commitment, to the role. Any feedback from the evaluation is communicated individually to the Director by the Chairman. The performance of the Chairman is reviewed by the Non-Executive Directors, led by the Senior Independent Director, taking into account the views of the Executive Directors. Executive Directors are appraised in respect of their directorial duties.

The performance of the Board and its Committees is also considered on an annual basis and the results shared with the Board as a whole.

## Board Committees

The terms of reference of the principal Committees of the Board – Audit, Remuneration and Nomination – are available on Scottish Friendly's website. Membership of the Committees of the Board is intended to make best use of the skills and experience of the Directors. The work carried out by the Audit and Nomination Committees in discharging their responsibilities is summarised below. The work carried out by the Remuneration Committee is described within the Directors' Remuneration Report on pages 14 to 15.

### Audit Committee

J W Jack (Chairman)  
 G E F Johnston  
 T P Noble  
 Dr B I Wood  
 M L Berryman (appointed 26 September 2007)

This Committee consists entirely of Non-Executive Directors and is chaired by J W Jack. The Terms of Reference of the Audit Committee include all matters indicated by the Annotated Code. The Finance Director acts as Secretary to the Committee.

During 2007 the Committee met twice, with all members present, and met privately with the external auditor. The Committee:

- discussed with the external auditor, before the audit commenced, the nature and scope of the audit and, on completion of their work, reviewed the external auditor's highlights memorandum;
- reviewed the annual financial statements before submission to the Board, focusing particularly on major judgmental areas and compliance with accounting standards and legal requirements, including the regulations and guidance of the Financial Services Authority;
- reviewed the internal audit programme, ensured co-ordination between the internal and external auditors, and ensured that the internal audit function was adequately resourced and had appropriate standing within the organisation;
- reviewed Scottish Friendly's systems and controls, as required by the Financial Services Authority, and took such action as was necessary to ensure compliance; reviewed the operational risks applicable to Scottish Friendly and ensured that procedures continued to improve.

Both the Board and the external auditor have safeguards in place to prevent the auditor's independence and objectivity being compromised. The external auditor reports regularly to the Committee on the actions that it has taken to comply with professional and regulatory requirements and current best practice in order to maintain its independence.

### Nomination Committee

G H Webster (Chairman)  
 T P Noble  
 G E F Johnston

The Committee met on two occasions during the past year with all members present. The Committee ensures that plans are in place for orderly succession for appointments to the Board. The Committee leads the process for such appointments and makes recommendations to the Board, taking into consideration the time commitments required of Non-Executive Directors and their independence. It considers the overall balance of skills, experience and knowledge to ensure that Directors bring informed and independent judgement to the Board.

## Remuneration Committee

The following were members of the Remuneration Committee during the year:

T P Noble (Chairman)  
G E F Johnston  
Dr B I Wood  
G H Webster (appointed 28 March 2007)

This Committee consists entirely of Non-Executive Directors. The Terms of Reference of the Remuneration Committee include reviewing the remuneration of the Board and of Executive Management, and recommending any changes in remuneration to the Board. The Chief Executive acts as Secretary to the Committee.

The Committee met on 6 occasions during the past year with all members present.

Scottish Friendly's policy is to provide a competitive remuneration package which will attract and retain the appropriate calibre of Executive and Non-Executive Directors.

Executive Director salaries are reviewed annually by reference to comparable positions in other organisations and any change to salary is effective from 1 January. In reviewing salaries, the Committee takes into account remuneration trends in the financial services sector, as well as considering wider economic influences. The Remuneration Committee ensures that it remains apprised of these factors and of best practice, taking external advice where appropriate. In 2007 external consultants were engaged to benchmark Executive Directors' salaries and advise on potential bonus structures. The consultants had no other connection with the Scottish Friendly Group.

Although none of the elements of Executive Directors' remuneration is directly linked to a performance measure, the success of the business overall and the individual's contribution to that performance will be contributory factors to each Director's annual remuneration review. In 2007, a discretionary bonus was paid to the Executive Directors in recognition of performance in the preceding year.

Both current Executive Directors are members of the Scottish Friendly Pension and Life Assurance Scheme. This is a defined benefit retirement plan which provides, at normal retirement date, a lump sum benefit and a pension based on salary and length of service. The scheme provides a lump sum death in service benefit for Executive Directors of four times basic salary based on the scheme year preceding date of death.

The Executive Directors are also entitled to a company car and healthcare insurance.

Non-Executive Directors have letters of appointment which set out their duties and responsibilities by reference to the Society's Governance and Control Procedures Manual. Non-Executive Directors initially hold office until the conclusion of the Annual General Meeting following their appointment, at which they are eligible for election without nomination. The circumstances in which a Board member would be required to vacate office are set out in the Rules of the Society.

Fees for Non-Executive Directors are determined by the Remuneration Committee and are reviewed annually with changes effective from 1 May. They are designed to recognise the responsibilities of Non-Executive Directors and to attract individuals with the necessary skills and experience to contribute to the future development of the Group.

Fees are made up of a basic annual fee together with fees for chairmanship and membership of Board Committees. Additional fees are payable to the Chairman and Vice-Chairman in respect of the additional responsibilities relating to those roles. Fees are neither performance-related nor pensionable and Non-Executive Directors do not receive any additional benefits.

## Service contracts

The Executive Directors have service agreements with a notice period of less than 12 months. The service agreements do not have a fixed term and provide for retirement at age 65.

In the event of termination, any payments made would be based on individual circumstances including the reason for termination and contractual obligations.

**Directors' emoluments (audited)**

	Notes	Salary and fees £000	Bonus <sup>(6)</sup> £000	Taxable benefits £000	Total year ended 31 Dec 2007 £000	Total year ended 31 Dec 2006 £000
<b>Chairman</b>						
G H Webster		38	–	–	38	30
<b>Executive Directors</b>						
F C McBain	1	255	50	9	314	244
J Galbraith	1,2	215	35	11	261	143
<b>Non-Executive Directors</b>						
M L Berryman	3	7	–	–	7	–
A D Forbes	4	7	–	–	7	19
J W Jack	1,5	21	–	1	22	10
G E F Johnston		27	–	–	27	23
T P Noble		22	–	–	22	19
Dr B I Wood		22	–	–	22	19

1. Taxable benefits comprise, for Executive Directors, the provision of a company car and healthcare insurance and, for Mr Galbraith, provision of a house purchase loan at a subsidised interest rate. Taxable benefits for Non-Executive Directors comprise travel and accommodation expenditure.
2. Appointed 26 April 2006.
3. Appointed 1 September 2007.
4. Resigned 25 April 2007.
5. Appointed 3 July 2006.
6. Bonus declared in 2007 in recognition of performance in 2006.

**Pensions (audited)**

	Accrued pension at 31 Dec 2007 <sup>(1)</sup> £000	Increase in accrued pension during 2007 £000	Transfer value at 31 Dec 2006 <sup>(2)</sup> £000	Transfer value at 31 Dec 2007 <sup>(2)</sup> £000	Increase in transfer value less Director's contri- butions £000
<b>Executive Directors</b>					
F C McBain	39	7	462	504	39
J Galbraith	71	8	686	703	15

1. Accrued pension represents the amount to which the Directors would have been entitled had they left service on 31 December 2007.
2. The transfer values have been calculated in accordance with the Actuarial Guidance Note GN11.

Scottish Friendly's delegate system has proven to be an effective model for communicating with members and will continue to be the cornerstone around which Scottish Friendly fulfils its responsibilities to engage with, and be accountable to, its members. Following the transfer of Scottish Legal Life, the number of delegates was increased from 24 to 30. These delegates are elected to represent geographic constituencies and delegate positions are advertised annually. One of the new delegates has been appointed to represent Republic of Ireland members transferred from Scottish Legal Life.

The Annual General Meeting, held in April, provides an opportunity to inform the delegates on business performance and future strategy. This is supplemented by additional delegates' meetings held at least annually. Delegate attendance at meetings has traditionally been very good.

During 2007 two Special General Meetings were also held, in July and October, to obtain the approval of the delegates to the proposed transfers of business from Scottish Legal Life and LANMAS respectively.

Scottish Friendly's member relations strategy includes hosting a dedicated members' area on the Scottish Friendly website which promotes two-way communication by providing access to information of particular relevance to members and through a dedicated eMail link which members can use to provide feedback. This members' area also includes dedicated areas for those members joining as a result of the transfers of business. Following each transfer, welcome packs were issued to members to introduce them to Scottish Friendly and to provide contact information in the event of queries.

## Report on Customer Impact Scheme

Scottish Friendly is one of 31 life and general insurance companies supporting the Association of British Insurers' initiative known as the Customer Impact Scheme. The Scheme includes an annual Customer Impact Survey which takes feedback from customers who used the services of the participating companies during the previous 12 months. The overall objective is to improve the service delivered to customers of the insurance industry by focusing on three specific Customer Commitments.

These are as follows:

1. *Developing and promoting products and services, which meet the needs of customers.* The results of the 2007 Customer Impact Survey showed that, in terms of whether our products are 'easy to understand', 40% of customers rated Scottish Friendly as 'very good' or 'excellent'. This placed us well above average and in the second quartile of this rating.
2. *Providing customers with clear information and good service when they buy products.* In the 2007 survey 60% of Scottish Friendly customers interviewed said that Scottish Friendly was easy to do business with. Once again this placed us comfortably above industry average and in the second quartile.
3. *Maintaining appropriate and effective relationships with customers, providing them with a good service after they have bought a product.* In the 2007 survey 50% of customers participating in the survey rated Scottish Friendly's customer service centre as 'very good' or 'excellent'. This placed Scottish Friendly in the top quartile.

As in 2007 Scottish Friendly has published the full details of the latest survey on its website with comments by the Group on how Scottish Friendly intends to improve on its ratings over the next 12 months.

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# Income and Expenditure

Technical Account – Long Term Business For year ended 31 December 2007	Note	Group 2007 £000	Group 2006 £000	Society 2007 £000	Society 2006 £000
Earned Premiums	3	79,183	67,898	79,183	67,898
Reinsurance Premiums		(491)	(414)	(491)	(414)
Earned Premiums, Net of Reinsurance		78,692	67,484	78,692	67,484
Investment Income	4	23,054	26,534	23,618	26,763
Unrealised Gains/(Losses) on Investments		(1,518)	29,662	(1,486)	29,538
Other Technical Income		2,943	739	1,326	–
		103,171	124,419	102,150	123,785
Claims Incurred	5	58,969	37,851	58,969	37,851
Change in Other Technical Provisions	14	11,038	31,941	11,038	31,941
Net Operating Expenses					
Acquisition Costs	6	7,179	5,712	7,179	5,712
Administrative Expenses	7	4,782	4,787	4,782	4,787
Investment Expenses and Charges	8	52	45	52	45
Other Technical Charges		1,021	634	–	–
Tax attributable to Long Term Business	10	394	995	394	995
Actuarial gain re pension scheme		(419)	–	(419)	–
Transfer to the Fund for Future Appropriations	14	20,155	42,454	20,155	42,454
		103,171	124,419	102,150	123,785
Balance on the Technical Account – Long Term Business		–	–	–	–

Except as disclosed above, there are no recognised gains or losses for the year.

The inclusion of unrealised gains and losses reflects the marking to market of investments in the balance sheet; as this is not deemed to be a departure from the unmodified historical cost basis of accounting, a separate note of historical cost profits and losses is not given.

The notes on pages 22 to 36 form an integral part of these accounts.

# Balance Sheet

Assets		Group 2007 £000	Group 2006 £000	Society 2007 £000	Society 2006 £000
As at 31 December 2007	Note				
<i>Investments</i>					
	11				
Land and Buildings		5,750	5,750	5,750	5,750
Other Financial Investments		684,409	511,726	684,342	511,672
Investments in Group Undertakings		–	–	739	707
<i>Assets Held to Cover Linked Liabilities</i>					
	12	62,567	11,924	62,567	11,924
<i>Reinsurers' Share of Technical Provisions</i>					
Long Term Business Provision		6,503	6,139	6,503	6,139
<i>Debtors</i>					
Debtors arising out of Direct Insurance Operations		193	176	193	176
Taxation Recoverable		3,755	1,934	3,755	1,934
Deferred Taxation	15	64	–	64	–
Other Debtors		1,327	510	1,897	567
<i>Other Assets</i>					
Tangible Assets	13	229	162	229	162
Cash at Bank and in Hand		65,538	56,892	63,839	56,091
<i>Prepayments and Accrued Income</i>					
Accrued Interest, Dividends and Rents		2,345	766	2,345	766
Deferred Acquisition Costs	6	–	8,870	–	8,870
<i>Pension scheme surplus</i>					
	17	1,577	–	1,577	–
		<b>834,257</b>	<b>604,849</b>	<b>833,800</b>	<b>604,758</b>
<i>Liabilities</i>					
As at 31 December 2007					
<i>Fund for Future Appropriations</i>					
	2, 14	99,145	152,455	99,145	152,455
<i>Technical Provisions</i>					
	14				
Long Term Business Provision	2	666,881	437,407	666,881	437,407
Claims Outstanding		7,055	2,247	7,055	2,247
<i>Technical Provision for Linked Liabilities</i>					
	14	57,996	10,941	57,996	10,941
<i>Provision for Other Risks and Charges</i>					
	15	295	543	295	543
<i>Creditors</i>					
Creditors arising out of Direct Insurance Operations		3	155	3	155
Other Creditors including Taxation and Social Security		1,552	444	1,095	353
<i>Accruals and Deferred Income</i>					
		1,330	657	1,330	657
		<b>834,257</b>	<b>604,849</b>	<b>833,800</b>	<b>604,758</b>

Approved by the Directors and signed on 26 March 2008 on their behalf by:



G E F Johnston  
Director



F C McBain  
Director and Chief Executive



C E Saxby  
Secretary

The notes on pages 22 to 36 form an integral part of these accounts.

# Independent Auditors' Report to the members of Scottish Friendly Assurance Society Limited

We have audited the Group and Society financial statements of Scottish Friendly Assurance Society Limited for the year ended 31 December 2007 which comprise the Group and Society Income and Expenditure Account, the Group and Society Balance Sheet and the related notes. These financial statements have been prepared under the accounting policies set out therein. We are also required to report on the Directors' Report for the year ended 31 December 2007.

In addition to our audit of the Group and Society financial statements, the Directors have engaged us to audit the information in the Directors' Remuneration Report that is described as having been audited, which the Directors have decided to prepare as if the Society were required to comply with the requirements of Schedule 7A to the Companies Act 1985.

This report is made solely to the Society's members, as a body, in accordance with section 73 of the Friendly Societies Act 1992 and the terms of our engagement. Our audit work has been undertaken so that we might state to the Society's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Society and the Society's members as a body, for our audit work, for this report, or for the opinions we have formed.

## Respective responsibilities of the Directors and auditors

The Directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and UK accounting standards (UK Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities on page 10.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Friendly Societies Act 1992 and the regulations made under it. In addition we report to you if, in our opinion, the Society has not kept proper accounting records, or if we have not received all the information, explanations and access to documents that we require for our audit.

We also report to you our opinion as to whether the Directors' Report has been prepared in accordance with the Friendly Societies Act 1992 and the regulations made under it, and as to whether the information given therein is consistent with the financial statements. The information given in the Directors' Report includes that specific information presented in the Chief Executive's Review that is cross referred from the Business Review section of the Directors' Report.

In addition to our audit of the financial statements, the Directors have engaged us to review their Report on Corporate Governance as regards the Society's compliance with provisions C1.1, C2.1, C3.1, C3.2, C3.3, C3.4, C3.5, and C3.6 of the Annotated Combined Code for Mutual Insurers published in July 2005 jointly by the Association of Mutual Insurers and the Association of Friendly Societies ("the Annotated Code"). We review whether the Report on Corporate Governance reflects the Society's compliance with the eight provisions of the Annotated Code specified for our review and we report if it does not. We are not required by the terms of our engagement to consider whether the statements of the Directors on internal control cover all risks and controls, or to form an opinion on the effectiveness of the Society's corporate governance procedures or its risk and control procedures.

We read the other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

### Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Society's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

### Opinion

In our opinion:

- the financial statements give a true and fair view, in accordance with UK Generally Accepted Accounting Practice, of the state of affairs of the Group and of the Society as at 31 December 2007 and of the income and expenditure of the Group and of the Society for the year then ended, and have been properly prepared in accordance with the Friendly Societies Act 1992 and the regulations made under it;
- the Directors' Report has been prepared in accordance with the Friendly Societies Act 1992 and the regulations made under it and the information given therein is consistent with the financial statements for the financial year; and
- the part of the Directors' Remuneration Report which we were engaged to audit has been properly prepared in accordance with Schedule 7A to the Companies Act 1985, as if those requirements were to apply to the Society.

*KPMG Audit Plc*

KPMG Audit Plc  
Chartered Accountants  
Registered Auditor  
191 West George Street  
Glasgow  
G2 2LJ

26 March 2008

## 1. Basis of preparation

The Accounts have been prepared in accordance with applicable accounting standards and under the historical cost accounting rules, modified to include the revaluation of investments. They have also been prepared in accordance with The Friendly Societies Act 1992, The Friendly Societies (Accounts and Related Provisions) Regulations 1994 and the Statement of Recommended Practice on Accounting for Insurance Business issued by the Association of British Insurers (the 'ABI SORP', as revised in 2005).

On 30 June 2007, a book of life insurance engagements of Pioneer Friendly Society Limited, a friendly society, was transferred to the Society in accordance with section 86 of the Friendly Societies Act 1992.

On 1 October 2007, the long-term business engagements of Scottish Legal Life Assurance Society Limited, a friendly society, were transferred to the Society in accordance with section 86 of the Friendly Societies Act 1992.

On 31 December 2007, the long-term business engagements of London Aberdeen and Northern Mutual Assurance Society Limited (LANMAS), a mutual insurance company, were transferred to the Society following approval by the High Court.

As a mutual life assurance society, under Financial Reporting Standard 1, the Society is exempt from the requirement to prepare a cash flow statement.

## 2. Accounting policies

### Change in accounting policy

The with-profits fund of the Society now falls within the FSA realistic capital regime. As a result, the related requirements of FRS 27 'Life Assurance' have been adopted in the accounts this year. This impacts on the basis of valuation of the long term business provision, which is now calculated on the 'realistic' basis. In addition, FRS 27 does not permit the deferral of acquisition costs. As permitted by FRS 27, the technical account for year ended 31 December 2006 has not been restated. The impact of the change on the closing long term business provision is set out in Note 14. The balance of deferred acquisition costs at 31 December 2006 has been released to the technical account and the related deferred tax liability released. Corresponding amounts have been transferred from the Fund for Future Appropriations to offset the impact on the current year technical account.

### Basis of consolidation

The Group accounts consolidate the assets, liabilities and income and expenditure account transactions of Scottish Friendly Assurance Society Limited together with its subsidiary undertakings. The ongoing results of subsidiary undertakings are included within Investment Income, Other Technical Income and Other Technical Charges. The net results are included in the Fund for Future Appropriations for the Group. The activities of the Society and Group are accounted for in the Income and Expenditure Technical Account – Long Term Business.

### Premiums

Earned premiums are accounted for when the policy liability is set up and the premiums become due for payment; reinsurance premiums are accounted for when they become payable.

### Investment income and expenses

Investment income and expenses includes dividends, interest, rents, gains and losses on the realisation of investments and the related expenses. Dividends are included as investment income on the date on which the shares are quoted "ex-dividend". Interest, rents and expenses are accounted for on an accruals basis. Realised gains and losses on investments are calculated as the difference between net sales proceeds and the original cost. The movement in unrealised gains and losses recognised in the year also includes the reversal of unrealised gains and losses recognised in earlier years in respect of investment disposals in the current period.

## 2. Accounting policies continued

### Unrealised investment gains and losses

Unrealised investment gains and losses are calculated as the difference between the valuation at the balance sheet date and the valuation at the last balance sheet date or purchase price, if acquired during the year. All unrealised gains and losses are included in the long term business technical account.

### Claims

Claims incurred, which include related claims handling expenses, are accounted for, in the case of death claims and surrenders, when they are notified to the Society and, in the case of maturities and annuities, when they become due. Claims on participating business include bonuses payable. Reinsurance recoveries are credited to match the relevant gross amounts.

### Acquisition costs

Acquisition costs comprise all direct and indirect costs arising from the conclusion of insurance contracts.

### Taxation

The charge for taxation in respect of business that falls outside the tax-exempt limit is based on the rules for the taxation of friendly societies, as applied to items included in the long term business technical account for the year. It also takes into account deferred taxation arising from timing differences between the recognition of gains, losses and certain items of expenditure in the financial statements and recognition for tax purposes. Deferred tax assets are recognised to the extent that they are judged to be recoverable in future periods.

### Valuation of investments

Investments, including those held to cover linked liabilities, are stated at the current market value as described below.

Land and buildings occupied by the Society are valued in accordance with generally recognised methods of valuation. The aggregate unrealised surplus or deficit is included in the technical account.

It is the Society's practice to maintain these assets in a continual state of sound repair and to extend and make improvement thereto from time to time; accordingly, the Directors consider that the lives of these assets are so long and residual values, based on prices prevailing at the time of acquisition or subsequent valuation, are so high that any depreciation would be insignificant.

Shares and other variable-yield securities and units in unit trusts and OEICs are shown in the balance sheet at mid-market value at the balance sheet date and mortgages and loans at book value, net of any provision for irrecoverable amounts as considered necessary by the Directors.

Fixed income securities are valued at the current market value at the balance sheet date.

Investments in Group undertakings are valued at the net asset value.

### Tangible assets

Depreciation is provided so as to write off the cost less the estimated residual value of tangible assets by equal instalments over the estimated useful economic lives as follows:

Computer Equipment	4 years
Motor Vehicles	4 years
Fixtures and Fittings	10 years

### Fund for Future Appropriations

The balance on this account represents funds that have not been allocated to specific policyholders. Transfers to and from the fund reflect the excess of income over outgoings in each accounting year arising from participating business.

## 2. Accounting policies continued

### Long term business provision

#### *Insurance contracts and participating investment contracts*

In accordance with FRS 27, liabilities relating to participating contracts are calculated on a realistic basis. Consistent with the Principles and Practices of Financial Management, provision is made for all bonus payments (declared and future, reversionary, terminal and planned enhancements). An explicit allowance is made for the time and intrinsic value of options and guarantees granted to policyholders and for possible future management actions.

The realistic liabilities are based on the aggregate value of policy asset shares reflecting the premiums, investment return, expenses and charges applied to each policy. Allowance is made for policy-related liabilities such as guarantees and future bonuses, typically calculated using a stochastic model simulating future investment returns, asset mix and bonuses.

In line with FRS 27 guidelines, the present value of future profits (PVFP) for non-participating business is deducted from the participating liabilities; the PVFP is determined in accordance with the Financial Services Authority's realistic capital regime.

Unit-linked liability calculations are based on the fund value at the valuation date plus a reserve where, on a prudent basis, it is estimated that future cash outflows cannot be covered by future cash inflows.

For conventional non-profit business, a net premium valuation method is used, which makes an allowance for expenses.

### *Guarantees*

Some participating contracts contain guarantees that can increase the benefits payable to the policyholder. A market consistent stochastic model is used to determine the potential liability for the following guarantees:

- The sum assured and declared reversionary bonuses on with-profits policies.
- Unitised with-profits plans containing guarantees that the market adjustments will not be applied at specific times.

### **Bonuses**

Vested reversionary bonuses, including the current declaration, are dealt with in the technical account under 'change in other technical provisions'. Terminal bonuses paid during the year are included as part of claims incurred.

### **Pensions**

The Society operates a money purchase Group personal pension scheme. Employer's contributions in respect of eligible employees are charged to the technical account (administrative expenses) based upon a fixed percentage of pensionable remuneration.

The Society also operates a non-contributory pension scheme, closed to new entrants. This scheme provides benefits for staff based upon final pensionable earnings, with voluntary contributions from staff to provide enhanced benefits. The pension scheme assets are secured by an insurance policy which is valued at its surrender value, which matches the liabilities under the scheme. The pension scheme liabilities are measured using a projected unit method and discounted at the current rate of return on a high quality corporate bond of equivalent term and currency to the liability.

The cost of providing staff pensions in respect of employees eligible to participate in this scheme is charged to the long-term business technical account with the related policy liability forming part of the Society's long term business provision.

## 2. Accounting policies continued

In addition, following the transfer of engagements, the Society provides retirement benefits, in the form of pensions, through the Scottish Legal Life Pension Scheme, a defined benefit scheme closed to new entrants. Liabilities are measured on an actuarial basis using the projected unit method and discounted at a rate that equals the current rate of return on a high quality corporate bond of equivalent term and currency to the scheme liabilities. Scheme assets are measured at their fair value. Any surplus or deficit of scheme assets over liabilities is recognised in the balance sheet as an asset (surplus) or liability (deficit), net of related notional deferred tax. An asset is only recognised to the extent that the surplus can be recovered through reduced contributions in the future or through refunds from the scheme. The expected return on scheme assets less the unwinding of the discount on the scheme liabilities is included in investment income. Actuarial gains and losses are recognised in the technical account where they are separately disclosed.

### Foreign currencies

Transactions in foreign currencies are recorded at the average rate for the period. Monetary assets and liabilities denominated in foreign currencies are translated at the rate ruling at the balance sheet date. All differences are taken to the technical account.

## 3. Earned premiums

### Group and Society

Earned premiums, all of which relate to direct insurance on individual contracts, can be analysed as follows:

	Ordinary assurance		Industrial assurance		Total	
	2007 £000	2006 £000	2007 £000	2006 £000	2007 £000	2006 £000
Annual	64,600	62,813	2,184	2,310	66,784	65,123
Single	12,399	2,775	–	–	12,399	2,775
	<b>76,999</b>	<b>65,588</b>	<b>2,184</b>	<b>2,310</b>	<b>79,183</b>	<b>67,898</b>

### Comprising:

Premiums from participating contracts	66,402	65,306
Premiums from non-participating contracts	2,400	2,198
Premiums from linked contracts	10,381	394
Gross Earned Premiums	79,183	67,898
Reinsurance Premiums	(491)	(414)
Earned Premiums, net of reinsurance	78,692	67,484

Where policy holders have the option of investing premiums in either linked funds or accumulating with-profits funds, these premiums are included above as premiums from linked contracts.

## Notes to the Accounts continued

### 3. Earned premiums continued

	Society 2007		Society 2006	
	Annual £000	Single £000	Annual £000	Single £000
Gross new business premiums				
New business premiums	5,635	12,657	5,236	3,353
	Group		Society	
Contributions received for Child Trust Funds, non-insurance ISAs and direct OEIC investments	2007 £000	2006 £000	2007 £000	2006 £000
Annual contributions	2,162	1,621	–	–
Single contributions	6,920	15,918	–	–

Contributions relate to business conducted by the Society's subsidiary, Scottish Friendly Asset Managers Limited.

### 4. Investment income

	Group		Society	
	2007 £000	2006 £000	2007 £000	2006 £000
Income from land and buildings	152	163	152	163
Income from other investments	22,385	20,701	22,949	20,930
Gains (net of applicable losses) on the realisation of investments	543	5,670	543	5,670
Net return on pension scheme under FRS 17	(26)	–	(26)	–
	23,054	26,534	23,618	26,763

### 5. Claims incurred

Group and Society	Ordinary assurance		Industrial assurance		Total	
	2007 £000	2006 £000	2007 £000	2006 £000	2007 £000	2006 £000
Deaths	1,649	1,479	2,324	1,027	3,972	2,506
Maturities	32,357	18,787	4,759	3,852	37,117	22,639
Surrenders	16,755	11,888	983	666	17,737	12,554
	50,761	32,154	8,066	5,545	58,826	37,699
Claims handling expenses					143	152
					58,969	37,851

The above figures are stated after taking into account the movement in the provision for outstanding claims (see Note 14). They are also stated net of aggregate recoveries received from reinsurers amounting to £13,000 (2006 – £84,000).

## 6. Acquisition costs

Group and Society	2007 £000	2006 £000
Acquisition costs incurred	7,179	6,542
Net change in deferred acquisition costs	8,870	(830)
Amount transferred from Fund for Future Appropriations	(8,870)	–
Net charge included in technical account	7,179	5,712

For entities falling within the realistic capital regime, FRS 27 does not permit the deferral of acquisition costs. Accordingly the balance at 31 December 2006 has been released to the Technical Account with a corresponding amount transferred from the Fund for Future Appropriations (see Note 14).

## 7. Administrative expenses

### Group and Society

#### *Staff numbers and costs*

The average number of persons, excluding Directors, employed by the Society during the year was 71 (2006 – 58).

The aggregate payroll costs of these persons were as follows:

	2007 £000	2006 £000
Wages and salaries	1,790	1,528
Social security costs	174	159
Other pension costs	212	266
	2,176	1,953

#### *Remuneration of Directors*

Detail of Directors' remuneration is included in the Directors' Remuneration Report on pages 14 to 15.

<i>Remuneration of auditors</i>	2007 £000	2006 £000
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Fees payable to the auditor for the audit of the annual accounts	75	59
Fees payable to the auditor for other services:		
The audit of subsidiary companies pursuant to legislation	9	5
Other services pursuant to legislation	2	12
Other services	26	–
 Fees in respect of the Scottish Friendly Pension & Life Assurance Scheme		
Audit	2	2

## 8. Investment expenses and charges

Group and Society	2007 £000	2006 £000
Investment management expenses	52	45

## 9. Commission payable

### Group and Society

The total amount of commission payable, comprising acquisition and renewal commission for direct insurance business in the year was £579,000 (2006 – £272,000).

## 10. Taxation

	Group		Society	
	2007 £000	2006 £000	2007 £000	2006 £000
Corporation Tax and irrecoverable income tax	366	369	366	369
Adjustment in respect of previous years	28	–	28	–
Deferred tax charge/(credit)	(850)	626	(850)	626
Amount transferred to Fund for Future Appropriations	850	–	850	–
	<b>394</b>	<b>995</b>	<b>394</b>	<b>995</b>

Following the release of the deferred acquisition cost asset under FRS 27 (see Note 6), the related deferred tax liability has also been released with a corresponding amount transferred to the Fund for Future Appropriations (see Note 14).

## 11. Investments

Group and Society <i>Land and buildings</i>	2007 £000	2006 £000
At 1 January	5,750	4,200
Revaluation	–	1,550
At 31 December	<b>5,750</b>	<b>5,750</b>

As at 31 December 2007, land and buildings occupied by the Society for its own use are included at Directors' valuation on an open market value basis. Land and buildings were independently valued as at 31 December 2006 by Alan Watt Consulting at open market value for existing use. The valuation was carried out in accordance with the RICS Appraisal and Valuation Manual. The property is freehold; it is partially let to third parties, income from which is reflected in investment income in Note 4. The historical cost of land and buildings at 31 December 2007 was £5,003,000 (2006 – £5,003,000).

	2007 Market value £000	2007 Historical cost £000	2006 Market value £000	2006 Historical cost £000
<b>Other financial investments</b>				
<i>Group</i>				
Shares and other variable-yield securities and units in unit trusts:				
UK Listed Investments	1,743	2,965	7,619	5,965
Overseas	9,115	9,118	–	–
Unit Trusts and OEIC	646,599	513,304	503,654	383,357
UK and Government Fixed Interest Securities	9,906	10,253	–	–
Other Fixed Income Securities	16,512	17,764	–	–
Loans secured by Mortgages	409	409	409	409
Loans secured by Insurance Policies	125	125	44	44
	<b>684,409</b>	<b>553,938</b>	<b>511,726</b>	<b>389,775</b>

## 11. Investments continued

<i>Society</i>	2007 Market value £000	2007 Historical cost £000	2006 Market value £000	2006 Historical cost £000
Shares and other variable-yield securities and units in unit trusts:				
UK Listed Investments	1,743	2,965	7,619	5,965
Overseas	9,115	9,118	–	–
Unit Trusts and OEIC	646,532	513,247	503,600	383,304
UK and Government Fixed Interest Securities	9,906	10,253	–	–
Other Fixed Income Securities	16,512	17,764	–	–
Loans secured by Mortgages	409	409	409	409
Loans secured by Insurance Policies	125	125	44	44
	684,342	553,881	511,672	389,722

<i>Investments in Group undertakings</i> <i>Society</i>	2007 Net asset value £000	2007 Historical cost £000	2006 Net asset value £000	2006 Historical cost £000
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Scottish Friendly Asset Managers Limited	457	1,600	206	1,600
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Principal activity: managers of Scottish Friendly ISAs, PEPs and Child Trust Funds.  
100% shares held.

Scottish Friendly Insurance Services Limited	281	500	500	500
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Principal activity: providers of wrap administration services.  
100% shares held.

Scottish Friendly Trustee Company Limited	1	1	1	1
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Principal activity: trustee for the Scottish Friendly SIPP.  
100% shares held.

## 12. Assets held to cover linked liabilities

<i>Group and Society</i>	2007 £000	2006 £000
Market value of assets held to cover linked liabilities	62,567	11,924
Historical cost of assets held to cover linked liabilities	56,978	7,099

Assets held to cover linked liabilities comprise investments, cash at bank, accrued income, taxation balances and accrued expenditure. The excess of assets over the technical provision for linked liabilities arises from the Society's policy of creating units in linked funds in excess of the immediate requirement to allocate such to policies in issue.

## Notes to the Accounts continued

### 13. Tangible assets

Group and Society	Computer equipment £000	Motor vehicles £000	Fixtures and fittings £000	Total £000
<i>Cost</i>				
At 1 January 2007	1,373	115	350	1,838
Additions	35	–	–	35
Transfers in	88	10	41	139
Disposals	(13)	–	(1)	(14)
At 31 December 2007	1,483	125	390	1,998
<i>Depreciation</i>				
At 1 January 2007	1,293	66	317	1,676
Charge for year	66	23	16	105
On disposals	(12)	–	–	(12)
At 31 December 2007	1,347	89	333	1,769
Net Book Value at 31 December 2007	136	36	57	229
Net Book Value at 31 December 2006	80	49	33	162

### 14. Funds and technical provisions

#### Group and Society

The movements on funds and technical provisions during the year are as follows:

	Fund for Future Appropriations £000	Long term business provision £000	Provision for outstanding claims £000	Technical provision for linked liabilities £000	Total £000
At 1 January 2007	152,455	437,407	2,247	10,941	603,050
Transfers of engagements	53,927	106,452	3,746	39,343	203,468
Change in other technical provisions	–	3,326	–	7,712	11,038
Change in accounting policy					
Long Term Business Provision	(119,332)	119,332	–	–	–
Deferred Acquisition Costs	(8,870)	–	–	–	(8,870)
Deferred taxation	850	–	–	–	850
Movement in provision for outstanding claims	–	–	1,062	–	1,062
Transfer from technical account	20,155	–	–	–	20,155
Exchange rate adjustment	(40)	–	–	–	(40)
Change in reinsurers' share of long term business provision	–	364	–	–	364
At 31 December 2007	99,145	666,881	7,055	57,996	831,077

The principal assumption underlying the calculation of the long-term business provision is that future interest earnings will be 2½% for all assurance business. The mortality table used for ordinary assurance was the AM92ult and the Table English Life No. 15 (Males) was used for industrial assurance.

The Fund for Future Appropriations is determined after taking account of a pension scheme surplus of £1,577,000.

## 15. Provision for other risks and charges

### (a) Deferred taxation

The provision for deferred taxation comprised:

	2007 £000	2006 £000
Unrealised investment gains	196	1,962
Deferred acquisition costs	(73)	(759)
Other timing differences	(28)	(577)
Undiscounted provision for deferred tax	95	626
Attributable to assets held to cover linked liabilities	–	(83)
At 31 December	95	543

The deferred taxation on other timing differences is in respect of management expenses and capital allowances.

A deferred tax asset of £64,000 has been recognised, being the amount recoverable against the deferred tax liability arising on the pension scheme surplus (Note 17).

The Society also has an unrecognised deferred tax asset of £793,000 in respect of unrealised investment gains, deferred acquisition costs, management expenses and other items, that is not considered likely to be recoverable in future periods.

	2007 £000	2006 £000
(b) Pensions review		
Transferred from Scottish Legal Life	218	–
Utilised in period	(18)	–
At 31 December	200	–

## 16. Costs of bonuses

### Group and Society

Total bonuses attributable to the year are as follows:

	2007 £000	2006 £000
Year end reversionary bonus declared (included in change in other technical provisions)	5,534	4,995
Reversionary and terminal bonuses paid (included in claims)	6,312	2,603
Total bonuses dealt with in the technical account	11,846	7,598

## 17. Pensions

### Group and Society

#### Money purchase Group personal pension scheme

The Society operates a money purchase Group personal pension scheme. For the year ended 31 December 2007, the charge included in the technical account relating to the employer's contributions to this scheme was £116,000 (2006 – £105,000). There were no outstanding or prepaid contributions at the balance sheet date.

## 17. Pensions continued

### Defined benefit schemes

#### *Scottish Friendly Assurance Society Limited Pension and Life Assurance Scheme*

The Society operates a defined benefit scheme, the Scottish Friendly Assurance Society Limited Pension and Life Assurance Scheme, that is closed to new entrants. An actuarial valuation of the scheme was undertaken as at 31 December 2005 by the Scheme's actuary, Paul Hamilton FIA of Barnett Waddingham LLP. The charge for the year has been determined by updating the actuarial valuation on an FRS 17 basis to assess the assets and liabilities as at 31 December 2007, using the following assumptions:

	2007 %	2006 %	2005 %
Discount rate	5.7	5	4.75
Rate of increase in salaries	5.5	5.25	5
Rate of increase for pensions in payment – post 1997 service (future increases for service pre 1997 are discretionary and for valuation purposes are assumed to be nil)	3.5	3.25	3
Rate of revaluation for deferred pensions	3.5	3.25	3

The assets of the scheme are secured by means of an insurance policy with the Society. The market values of the policy and the expected rates of return were:

	Long-term expected rate of return %	Value at 31 December £000
31 December 2007	5.70%	8,161
31 December 2006	5.00%	8,629
31 December 2005	4.75%	8,312

This policy matches the present value of the scheme liabilities and there is therefore neither a surplus nor a deficit in the scheme.

The reduction in scheme liabilities due to assumption changes at 31 December 2007 (£784,000, 2006 – £135,000) and experience losses during the year of £94,000 (2006 – £255,000), were fully offset by a reduction in the value of the policy and there are therefore no actuarial gains or losses to report.

	2007 £000	2006 £000
<i>Analysis of amount charged to net operating expenses</i>		
Current service cost	151	121
Expenses and life assurance	14	24
Past service cost	82	117
Total operating charge	247	262

#### *The Scottish Legal Life Pension Scheme*

Following the transfer of Scottish Legal Life, the Society operates The Scottish Legal Life Pension Scheme, a funded defined benefits pension scheme, providing benefits to members based on final pensionable salary. The assets of the scheme are held separately from those of the Society, being invested in Managed Fund contracts. The contributions are determined by the Scheme Actuary on the basis of triennial valuations.

## 17. Pensions continued

A full actuarial valuation was carried out at 1 January 2005 and, for the purpose of this disclosure, updated to 31 December 2007 by a qualified independent actuary. The Scheme is closed to new entrants. This means that, under the Projected Unit Method, the service cost will increase as the remaining members approach retirement. Scheme assets are stated at their market value at 31 December 2007 and the present value of the Scheme liabilities has been calculated at the same date. The major assumptions used by the actuary to calculate Scheme liabilities are set out below:

	2007
Rate of increase in pensions in payment*	3.60%
Rate of increase in deferred pensions	3.30%
Discount rate	5.70%
* on pension accrued after 5 April 1997	

### Mortality assumption

2007: PXA92, projected by member's year of birth with allowance for the medium cohort effect

The assets in the scheme and the expected rate of return were:

	Long-term rate of return expected at 31 December 2007
Equities	7.25%
Bonds	5.00%
Other	5.00%

	Value at 31 December 2007 £000
Equities	2,628
Bonds	23,603
Other	(63)
Total market value of assets	26,168
Present value of scheme liabilities	24,527
Surplus in scheme	1,641
Related deferred tax liability	(64)
Net pension asset	1,577

	2007 £000
<i>(i) Movements in surplus/deficit during the year</i>	
Surplus in Scheme at the date of transfer	1,248
Movement in period since transfer:	
Other finance income	(26)
Actuarial gain/(loss)	419
Surplus in Scheme at the end of the year	1,641

# Notes to the Accounts continued

## 17. Pensions continued

<i>(ii) Analysis of the technical account charge under FRS 17</i>	£000	
Current service cost		–
Past service cost		–
Gain on curtailment		–
Total charge to operating expenses		–
<i>(iii) Analysis of net return on pension scheme under FRS 17</i>	£000	
Expected return on pension scheme assets		327
Scheme expenses		(316)
Interest on pension scheme liabilities		(37)
Net return		(26)
<i>(iv) Analysis of actuarial gains and losses</i>	£000	
Actual return less expected return on pension scheme assets		70
Experience gains and losses arising on the scheme liabilities		53
Change in financial assumptions underlying the scheme liabilities		296
Actuarial gain		419
<i>(v) History of experience gains and losses</i>	2007	2007
	£000	%
Difference between the expected and actual return on scheme assets		
Amount	70	
Percentage of the scheme assets at the end of the year (annualised)		1%
Experience gain/(loss) arising on the scheme liabilities		
Amount	53	
Percentage of the present value of scheme liabilities (annualised)		1%
Total amount of actuarial gain/(loss)		
Amount	296	
Percentage of the present value of scheme liabilities (annualised)		7%

## 18. With-profits actuary

Mr P Drury of Oxford Actuaries and Consultants served as the With-profits Actuary until 9 March 2007. On 20 April 2007, Mr G Beamer of Oxford Actuaries and Consultants was appointed With-profits Actuary of the Society. The following information has been provided in response to a request made by the Society as required by section 77 of the Friendly Societies Act 1992.

Mr Drury and Mr Beamer have confirmed that neither they nor their families were members of the Society, nor had they any financial or pecuniary interest in the Society, with the exception of fees paid to Oxford Actuaries and Consultants for professional services which amounted to £65,000 (2006 – £12,000).

## 19. Transactions with related parties

The aggregate premiums payable for the year by seven Directors and four other members of the Executive in respect of the Society's products amounted to £19,930 (2006 – £20,875).

At the year end, no Director of the Society had any beneficial interest in shares of the Society's subsidiary companies.

## 20. Transfer of engagements

On 1st October 2007, the long term business engagements of Scottish Legal Life Assurance Society Limited, an incorporated friendly society, were transferred to Scottish Friendly Assurance Society Limited.

The value of the assets and liabilities at the date of transfer is set out below:

	Value on acquisition £000
Investments	125,904
Assets held to cover linked liabilities	28,209
Cash at bank	13,799
Other assets	3,980
Long term business provision	(84,957)
Technical provision for linked liabilities	(28,209)
Claims outstanding	(3,151)
Other liabilities	(1,648)
Fund for Future Appropriations	(53,927)
Net assets acquired	–

On 31st December 2007, the long term business engagements of London Aberdeen and Northern Mutual Assurance Society Limited, a mutual insurance company, were transferred to Scottish Friendly Assurance Society Limited.

The value of the assets and liabilities at the date of transfer is set out below:

	Value on acquisition £000
Investments	20,167
Assets held to cover linked liabilities	11,134
Other assets	1,410
Long term business provision	(20,731)
Technical provision for linked liabilities	(11,134)
Claims outstanding	(595)
Other liabilities	(251)
Net assets acquired	–

## 21. Capital statement

	2007	2006
	£000	£000
<i>Available capital resources</i>		
Fund for Future Appropriations	99,145	152,455
Adjustments to assets onto regulatory basis	98,194	389
<b>Total available capital resources</b>	<b>197,339</b>	<b>152,844</b>
<i>Analysis of liabilities</i>		
Options and guarantees	37,238	–
Other policyholder obligations	567,682	386,310
Unit-linked business	57,996	10,941
Other life assurance business	61,961	51,097
<b>Technical Provisions in Balance Sheet</b>	<b>724,877</b>	<b>448,348</b>

The Society calculates capital based on the FSA realistic regime. The comparative figures for 2006 are based on the FSA statutory regime.

Management intends to maintain an appropriate additional margin over regulatory capital to absorb changes in both capital and capital requirements.

### Capital resource sensitivities

The capital position is sensitive to changes in market conditions and to a lesser extent to assumptions and experience relating to mortality, expenses and persistency.

Economic assumptions are set consistent with market prices. Non-economic assumptions are set at best estimate levels based on historic experience.

The Society holds guarantees in respect of sums assured and reversionary bonus guarantees on with-profits contracts. Under the FSA realistic regime, these are explicitly calculated using a stochastic valuation model.

	2007	2006
	£000	£000
<i>Analysis of movement</i>		
Opening capital resources	152,844	113,851
Change in assumptions	–	(51)
Change in management policies	–	–
Change in regulatory requirements	97,805	–
New business and other factors	(53,310)	39,044
<b>Closing capital resources</b>	<b>197,339</b>	<b>152,844</b>



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