

Annual Report 2008



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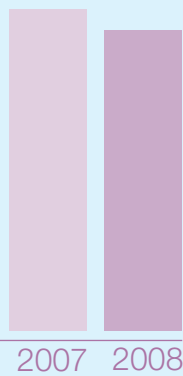
Scottish Friendly prides itself on offering a friendly and effective service. As a mutual organisation, the Group provides value for our members, investors and corporate partners through a combination of innovative investment product design, value for money administration and effective investment management.

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Key figures

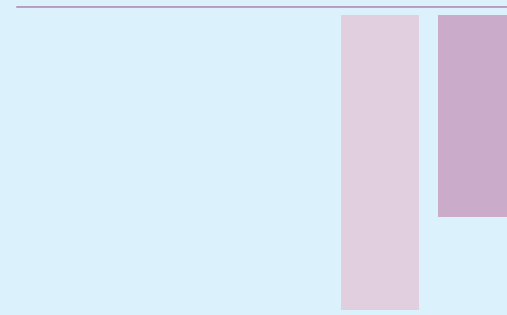
Number of members

2007 = 525,000
2008 = 489,000



2008 investment performance

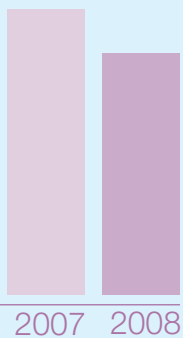
-28.3% -19.6%



■ FTSE 100
■ Scottish Friendly with-profits fund

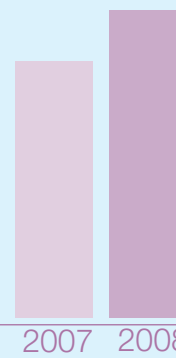
Assets under management

2007 = £834m
2008 = £704m



Sales – APE

2007 = £8.3m
2008 = £9.9m



APE – Annual Premium Equivalent

Chairman's Statement



Michael Walker / Chairman

I have great pleasure in presenting my first report as Chairman of Scottish Friendly.

I have been very impressed with the Scottish Friendly management and its strategy for growth, both of which have helped the Group to meet unprecedented economic challenges in 2008 and which will, I am sure, continue to do so throughout 2009 as similar market conditions persist.

The Group's current strategy, in place since 2006, led Scottish Friendly into the economic downturn strongly capitalised with funds under management increased by more than one third over 2006 and 2007, and with diversified distribution channels and additional sources of income which have proved to be of significant value in these extremely volatile times.

While our asset values have been significantly impacted by the economic conditions, we have nevertheless been able to continue to pay policyholder bonuses, albeit sharply reduced in line with the fall in investment returns across the market. Our capital position remains sound, in excess of the regulatory requirements. We recognise however that there is no room for complacency and we continue to ensure that prudent management of policyholders' capital is paramount.

Strategy

The Group's three-strand strategy for growth remains in place.

Organic growth: Despite difficult investment conditions in 2008, particularly in the latter part of the year, the strategy of diversifying distribution channels through high profile partnerships has produced

strong results. Total sales of life and pensions business were £9.9m on the industry measure of annual premium equivalent (being regular premiums plus one tenth of single premiums), an increase of 20% over 2007.

Business process outsourcing: The Scottish Friendly wrap administration business launched in 2006 continues to expand in line with the underlying growth in funds under administration. This generates an additional income stream for the members of Scottish Friendly.

In addition to the existing contract to administer a wrap platform for Nucleus Financial Group, in July 2008 Scottish Friendly announced that it had secured the contract to administer a wrap platform in 2009 for Norwich Union, shortly to be known as Aviva.

Following on from a series of major projects at Scottish Friendly, most notably launching the Nucleus wrap in 2006 and integrating the funds of Scottish Legal Life in 2007, the scale and complexity of the Aviva project over the latter part of 2008 was perhaps the most ambitious to date, particularly given the timescale. Again Scottish Friendly, with its IT partner Bravura Solutions Limited, rose to the challenge and the new platform was duly launched in January.

Mergers and consolidation: The five transfers completed over 2006 and 2007 continue to benefit both the policyholders transferred from other life offices, primarily by way of reduced administration expenses, and the main Scottish Friendly fund, by way of an administration income stream.

The impact of recent economic conditions on capital across the sector has reduced the number of targets which Scottish Friendly would judge to be of interest, capital strength being a key consideration in accepting new funds. However mergers and consolidation remain part of our strategy for growth given successes to date; we continue to be open to new opportunities and to consider each on its own merit.

Corporate recognition

Increasing market awareness of Scottish Friendly has continued apace during the year, as measured in part by securing new partnerships – in distribution and in

business process outsourcing – and in part by press coverage. The success of the business process outsourcing business in particular is judged to have increased Scottish Friendly's profile and stature in the financial services arena. This in turn is expected to help in securing additional benefits for policyholders through new partnerships in the future and to attract new policyholders to our products.

In addition the Group received further recognition in 2008 when Chief Executive, Fiona McBain, was awarded Business Leader of the Year at the Glasgow Business Awards, a rightful recognition of success in a very difficult economic climate. Most recently, in March 2009 Fiona McBain was short listed for Director of the Year at the Institute of Directors (Scotland). Scottish Friendly also won a Highly Commended Award as Child Trust Fund provider in the Moneyfacts annual awards and was short listed for Insurer of the Year at the British Insurance Awards 2008.

Investment and with-profits business

The level of the FTSE 100 capital values fell by 31% over 2008. This fall combined with downturns in other equity and property markets plus historic cuts in interest rates has produced an economic environment with which no-one is familiar. Against this background Scottish Friendly could not be expected to be unaffected and although the Board took significant steps to reduce the risk of the with-profits fund throughout the year, over 2008 the Scottish Friendly with-profits fund recorded losses of 19.6%.

Corporate governance

The Financial Services Authority Treating Customers Fairly (TCF) initiative is designed to ensure that each company in the financial services industry puts customers at the heart of its organisation. Scottish Friendly has always been committed to treating its members and policyholders fairly and so has warmly welcomed the principles underlying TCF. It has measures in place to ensure TCF is embedded within the Scottish Friendly culture, and to effect action where appropriate as a result of those measures; recent enhancements include refinements to product terms and correspondence as well as developments of staff training plans and discussion groups.

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 to improve corporate governance across the mutual sector.

Focus on service

Scottish Friendly's customer services team has risen to the challenges of an increasingly diversified portfolio of business.

I am pleased to report that despite the considerable changes in the nature of the Group's business, the focus continues to be on delivering ever higher standards of customer satisfaction. The 2008 Association of British Insurers Customer Impact Survey shows that the Group has maintained an industry ranking well above average for customer service. Further details of this survey can be found on page 14. At the same time, we continue to maintain tight control over costs and our administrative renewal expenses remain extremely competitive in the industry.

As announced last year, the Group successfully introduced online applications for the majority of our products. Increasingly customers prefer to apply online for their investments and Scottish Friendly's back office capability in this respect provides a strong competitive edge. Online application processing ability also allows Scottish Friendly to boost its e-commerce activity, an increasingly popular form of marketing that delivers cost-efficient results.

The Board

Graham Webster, former Chairman, retired from the Board in December 2008 after 15 years committed service to Scottish Friendly. I know I speak for the Board of Scottish Friendly when I wish him well in his retirement and thank him for his invaluable support, wisdom and dedication. We shall miss him.

Management and staff

On behalf of the Board, I should also like to thank the management team and the staff of Scottish Friendly for their continued focus, effort and performance in 2008.

Outlook

Despite the economic downturn in 2008, Scottish Friendly increased sales over the previous year and reaped the benefits of the diversification delivered through the Group's three-part growth strategy. The addition of the wrap for Norwich Union, shortly to be known as Aviva, has significantly increased the scale of Scottish Friendly and I have every confidence that the staff, management team and Board will continue to meet the challenges in 2009.

The year ahead is expected to continue to be a difficult one in light of the prevailing economic conditions. The management team will, as always, adopt a flexible but cautious approach to new business acquisition, investment strategy and business developments over the next 12 months. Additionally the Board will continue to adopt a prudent and careful approach to managing the business in the interests of all our members.



Michael J Walker
Chairman
25 March 2009

Chief Executive's Review



Fiona McBain / Chief Executive

2008 has been one of the most difficult years in recent history for the financial services industry. With major high street banks nationalised or under shared state ownership, turmoil on the stock, property and currency markets and interest rates falling to unheard of levels, the challenges have been, and continue to be, significant.

Asset values have fallen across the financial sector, by over a third in some asset classes, with resulting cuts in policyholder bonuses. However, since 2006 Scottish Friendly's three-part growth strategy has delivered diversification in addition to increases in assets under management and administration. These have been key factors, along with ongoing prudential capital management, in mitigating somewhat the impact on policyholders in 2008.

Despite the background of highly volatile and uncertain financial markets, in 2008 we have been able to secure a significant increase in sales, primarily through partnerships, and, with effect from the start of 2009, a major expansion in our wrap administration business. We have also been able to reduce our costs as a percentage of income.

Scottish Friendly has continued to develop valuable relationships with partners such as Royal London, Pearl Group (previously Resolution) and Forces Financial. In 2008 we also secured an important new partnership with Soccer Savings through which we promote our bespoke savings plans to major football clubs that currently include Rangers, Celtic, Portsmouth and Birmingham City. As with all our carefully selected partnerships, their substantial and loyal customer bases offer significant business growth opportunities.

In the difficult conditions expected in 2009, we anticipate placing greater emphasis on our partnership distribution channel as this should provide a cost effective method of reaching our new business targets and will assist us in diversifying our product range.

We will also continue to take a flexible and cautious approach to seeking new business. There is increasingly a general recognition of the need to start saving and borrow less but individuals' willingness to commit to regular savings is affected by fear of reduced household income in the current economic environment.

Organic growth plus the five transfers of other organisations to Scottish Friendly effected in 2006 and 2007 have expanded our policyholder base to almost 1.3 million; the Scottish Legal Life takeover, for example, added over 500,000 policies. In the coming 12 months we will continue to review and improve our levels of customer service and communication for all of our customers.

The addition of Scottish Legal Life, coupled with an increase in maturities of Scottish Friendly 10 year policies written in the late nineteen nineties, has changed our overall claims profile (£105m in 2008, £59m in 2007). For both those reasons, this level of claims is expected to continue over the next few years.

Performance for the year

In the difficult markets of 2008, our core life and pensions sales fell by only 3% from 2007; the reduction was more than offset by sales of single premium Appropriate Personal Pension (APP) business. Based on the industry standard of annual premium equivalent – regular premiums plus one tenth of single premiums – Scottish Friendly recorded total sales of £9.9m in 2008, as compared to £8.3m in 2007, an increase of 20%. Total gross premium income increased from £79m in 2007 to £102m in 2008. A change in the regulations with effect from October 2008 means that much of the potential APP business is now sold through non-insured contracts and so we do not expect to match these levels of sales or premium income in 2009.

As well as new business and total premium income, Scottish Friendly's other key performance indicators relate primarily to expense management. In previous years total administrative expenses were expressed as a percentage of gross premium income; however, as the scale of the wrap administration business increases, it becomes misleading to include those expenses as there is no related premium income.

Excluding expenses relating to wrap administration, administrative expenses were 5.0% of gross premium income, an improvement of 0.6% from 5.6% on an equivalent basis for 2007. The cost of acquiring new business also improved, with a significant decrease from 105% of the first year's premium in 2007 to 81%. The biggest impact on this reduction was the APP business; as discussed above, we do not expect this to apply in future years and so we do not expect to match this ratio in 2009.

Investment Performance

Scottish Friendly invests in low cost tracker funds with active asset allocation between asset classes, combined with actively managed portfolios.

The main with-profits fund suffered a substantial fall over the year due to the dramatic falls in the stock markets and property markets. Against a fall of an investment in the FTSE 100 of 28.3% including income, the with-profits fund suffered a fall of 19.6% over the year. It is clearly a significant fall and we remain cautious in our outlook for the short and medium term.

Principal risks and uncertainties

Notwithstanding the measures taken over 2008 to reduce risk in the investment portfolio, this continues to be the main area of risk and uncertainty in the business.

We were proactive in aiming to limit the extent of the fall and our policyholders' exposure to risk by moving investments from equities to cash, especially during the second half of the year. The percentage of funds under management held in equities was reduced from just under a half at the end of 2007 to less than a quarter at the end of 2008.

Our exposure to liquidity risk is managed by broadly matching the expected timing of payments to the liquidity of our investments. As an insurance organisation, our contracts will typically have a known maturity or withdrawal date so future cash requirements can be accurately predicted. Significant claims outwith these contractual dates are not common, due to the longer-term nature of insurance business. Claim payments in 2008 were £105m; as at 31/12/2008 £98m was held in cash and a further £444m of assets was invested in liquid, daily priced and traded unit funds.

Friendly and effective

In an exceptionally poor year for the economy, the financial markets and the financial services industry, the Scottish Friendly Group has continued to achieve sales growth, premium growth and an expansion in its business process outsourcing business.

Despite the prevailing conditions, there are areas that we expect will continue to deliver results in 2009; the Child Trust Fund and e-commerce markets are likely to provide some stability and the addition of further distribution partnerships in 2009 will help to support new business.

In the longer term, despite the credit crunch, we are likely to witness an increase in the demand for saving, protection and pension products and this should afford Scottish Friendly further sales growth opportunities. However in the short term the effect will clearly be negative and we continue to make every effort to maximise our flexibility in these changing markets.

The management team neither underestimate the gravity of the current climate nor are we complacent about the potential for even greater turmoil in the coming months. Our with-profits fund fell significantly in value over the year despite being protected from the worst excesses of these falls by our decisions during the year to reduce our exposure to equity type assets.

The management team will remain ever vigilant for further signs of financial market turmoil. We will continue to exercise caution over the next twelve months, whilst seeking to further improve our levels of customer service and to ensure our members continue to reap the benefits and security of our increasingly diverse income stream.

Finally, I would like to thank my colleagues on the Board and throughout Scottish Friendly for their ongoing commitment, and the members and partners of Scottish Friendly for their continued support.



Fiona McBain

Chief Executive
25 March 2009

M J Walker LLB**Chairman**

Appointed as a Director and as Chairman in January 2009. Chairman of the Nomination Committee and a member of the Remuneration Committee. Director of the Scottish Friendly Assurance subsidiary companies Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited, Scottish Friendly Trustee Company Limited and S.L. Insurance Services Limited. Former Chairman of legal firm Maclay Murray & Spens. Holds various other Non-Executive Directorships including Scottish Amicable.

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 & Life Assurance Scheme. Former Group Chief Executive of the logistics company Arbuckle Smith Group. 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, Darnaway Venture Capital plc and Spark Energy Limited, and a Non-Executive Director of Flexitricity Limited. 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 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.

Executive

F C McBain MA, ACA	Chief Executive
J Galbraith BSc, MBA, FFA	Deputy Chief Executive
N E Lovatt ACII, BA, MSc(Dip)	Sales and Marketing Director
K Grant BSc, FFA, MBA	Head of Customer Services
C E Saxby BAcc(Hons), CA	Finance Director
J Wilson BSc, BEng, MSc	Head of IT

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. Also a Non-Executive Director of Lincoln Assurance Life Company and H&T Group.

F C McBain MA, ACA**Chief Executive**

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. Member of the Nomination Committee. Director of the Scottish Friendly Assurance subsidiary companies Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited, Scottish Friendly Trustee Company Limited and S.L. Insurance Services Limited. Director of the Association of Friendly Societies and a Director of the Association of Mutual Insurers. Chair of the ABI Life Insurance Committee members' forum. Non-Executive Director of Scottish Mortgage Investment Trust PLC.

J Galbraith BSc, MBA, FFA**Deputy Chief Executive**

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 Scottish Friendly Assurance subsidiary companies Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited, Scottish Friendly Trustee Company Limited and S.L. Insurance Services Limited. Trustee of the Scottish Legal Life Pension Scheme.

The Directors have pleasure in submitting their annual report and accounts for the year ended 31 December 2008. This report should be read in conjunction with the Chairman's Statement and the Chief Executive's Review on pages 2 to 5.

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 four wholly owned subsidiaries: Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited, Scottish Friendly Trustee Company Limited and S.L. Insurance Services 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. S.L. Insurance Services Limited conducted the business of agents for the transaction of general branch insurance.

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.

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 4 to 5.

Directors and Chief Executive

The current Directors of the Society, including the Chief Executive, are listed on page 6. On 7 January 2009, G H Webster retired as a Director. M J Walker was appointed as a Director and as Chairman on 1 January 2009.

Further information on the Board is set out in the Report on Corporate Governance on pages 9 to 10.

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 2008.

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 2008, the Society had 1,296,000 (2007 – 1,344,000) policyholders and estimated the number of members to be 489,000 (2007 – 525,000).

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.

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 have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

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

25 March 2009

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).

The Board

The Board met on nine occasions during 2008 – 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 B I Wood and M L Berryman 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 regularly receives reports from internal and external audit regarding the company's system of controls. The Audit Committee reviews the internal audit plan annually and all directors receive copies of all internal audit reports upon finalisation. In 2008 a specific internal audit review was undertaken on Accounting & Finance covering financial controls.

The operational risk register is reviewed by the Audit Committee on a six-monthly basis and was last reviewed by the Audit Committee in October 2008. This sets out the key operational risks facing the Society, the likelihood of occurrence and the potential impact.

The Individual Capital Assessment (ICA) was presented to the Board in June 2008 and March 2009. This document reviews the key financial risks facing the Society.

The Board receives a monthly compliance report from the Compliance Officer. A detailed annual review was presented to the October 2008 Audit Committee along with the compliance plan for 2009.

The Board has overall responsibility for this system of internal control and, through a combination of the above reports, is able to annually review its effectiveness, including 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 6.

In addition to the Chairman and Vice-Chairman, the Board comprised, as at 31 December 2008, 2 Executive Directors, being the Chief Executive and the Deputy Chief Executive, and 4 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.

In assessing the composition of Board membership, M J Walker 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 judgement to his role. Accordingly, during 2008 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 12 to 13.

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 12 to 13.

Audit Committee

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

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 2008 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 be satisfactory.

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) (resigned 7 January 2009)
M J Walker (appointed 1 January 2009)
T P Noble
G E F Johnston
F C McBain (appointed 28 May 2008)

The Committee met on seven 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 (resigned 7 January 2009)
M J Walker (appointed 1 January 2009)

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 two 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 appraised of these factors and of best practice, taking external advice where appropriate.

The remuneration package for Executive Directors now incorporates a bonus element which is directly linked to specific financial targets. In 2008, 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)

	Salary and fees £000	Bonus ⁽¹⁾ £000	Benefits ⁽²⁾ £000	Total year ended 31 Dec 2008 £000	Total year ended 31 Dec 2007 £000
Chairman					
G H Webster	42			42	38
Executive Directors					
F C McBain	275	20	9	304	314
J Galbraith	224	25	12	261	261
Non-Executive Directors					
M L Berryman ⁽³⁾	22		1	23	7
J W Jack	23		1	24	22
G E F Johnston	28			28	27
T P Noble	24			24	22
Dr B I Wood	23			23	22

1. The bonus shown was declared in 2008 in recognition of performance in 2007. The Executive Directors have waived their entitlement to the contractual element of the bonus for 2008 (Ms McBain £21,000, Mr Galbraith £17,000).
2. For Executive Directors, benefits comprise the provision of a company car and healthcare insurance and, for Mr Galbraith, provision of a house purchase loan at a subsidised interest rate. Benefits for Non-Executive Directors comprise reimbursement of travel and accommodation costs.
3. Appointed 1 September 2007

Pensions (audited)

	Accrued pension at 31 Dec 2008 ⁽¹⁾ £000	Increase in accrued pension during 2008 £000	Transfer value at 31 Dec 2007 ⁽²⁾ £000	Transfer value at 31 Dec 2008 ⁽²⁾ £000	Increase/ (decrease) in transfer value less Director's contri- butions £000
Executive Directors					
F C McBain	47	8	504	439	(68)
J Galbraith	77	6	703	565	(140)

1. Accrued pension represents the amount to which the Directors would have been entitled had they left service on 31 December 2008.
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. The 30 delegates are elected to represent geographic constituencies and delegate positions are advertised annually.

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.

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 transfers of business.

Report on Customer Impact Scheme

Scottish Friendly is one of 32 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 2008 Customer Impact Survey showed that, in terms of whether our products are 'easy to understand', 39% of customers rated Scottish Friendly as 'very good' or 'excellent'. This placed us well above average and in the top quartile of this rating.
2. *Providing customers with clear information and good service when they buy products.* In the 2008 survey 61% 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 2008 survey 53% 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 2008 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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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 2008 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 2008.

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 8.

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 2008 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

25 March 2009

Technical Account – Long Term Business For year ended 31 December 2008	Note	Group 2008 £000	Group 2007 £000	Society 2008 £000	Society 2007 £000
Earned Premiums	3	102,034	79,183	102,034	79,183
Reinsurance Premiums		(428)	(491)	(428)	(491)
Earned Premiums, Net of Reinsurance		101,606	78,692	101,606	78,692
Investment Income	4	43,794	23,054	45,066	23,618
Unrealised Losses on Investments		(164,882)	(1,518)	(164,198)	(1,486)
Other Technical Income		12,984	2,943	8,146	1,326
		(6,498)	103,171	(9,380)	102,150
Claims Incurred	5	104,843	58,969	104,843	58,969
Change in Other Technical Provisions	14	(103,579)	11,038	(103,579)	11,038
Net Operating Expenses					
Acquisition Costs	6	7,097	7,179	7,097	7,179
Administrative Expenses	7	6,206	4,782	6,206	4,782
Investment Expenses & Charges	8	49	52	49	52
Other Technical Charges		2,832	1,021	0	0
Tax attributable to Long Term Business	10	593	394	543	394
Actuarial loss/(gain) re pension scheme		1,882	(419)	1,882	(419)
Transfer (from)/to the Fund for Future Appropriations	14	(26,421)	20,155	(26,421)	20,155
		(6,498)	103,171	(9,380)	102,150
Balance on the Technical Account – Long Term Business		0	0	0	0

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 20 to 34 form an integral part of these accounts.

Balance Sheet

Annual Report 2008

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Assets		Group 2008 £000	Group 2007 £000	Society 2008 £000	Society 2007 £000
As at 31 December 2008	Note				
<i>Investments</i>					
	11				
Land & Buildings		5,750	5,750	5,750	5,750
Other Financial Investments		510,513	684,409	510,440	684,342
Investments in Group Undertakings		–	–	1,545	739
<i>Assets Held to Cover Linked Liabilities</i>					
	12	69,922	62,567	69,922	62,567
<i>Reinsurers' Share of Technical Provisions</i>					
Long Term Business Provision		7,067	6,503	7,067	6,503
<i>Debtors</i>					
Debtors arising out of Direct Insurance Operations		247	193	247	193
Taxation Recoverable		5,565	3,755	5,565	3,755
Deferred Taxation		64	64	64	64
Other Debtors		7,570	1,327	7,085	1,897
<i>Other Assets</i>					
Tangible Assets	13	447	229	447	229
Cash at Bank & in Hand		93,667	65,538	91,941	63,839
<i>Prepayments & Accrued Income</i>					
Accrued Interest, Dividends & Rents		2,123	2,345	2,123	2,345
<i>Pension scheme surplus</i>					
	17	1,648	1,577	1,648	1,577
		704,583	834,257	703,844	833,800
Liabilities					
As at 31 December 2008					
<i>Fund for Future Appropriations</i>					
	14	71,218	99,145	71,218	99,145
<i>Technical Provisions</i>					
	14				
Long Term Business Provision		557,191	666,881	557,191	666,881
Claims Outstanding		8,571	7,055	8,571	7,055
Technical Provision for Linked Liabilities	14	64,671	57,996	64,671	57,996
<i>Provision for Other Risks & Charges</i>					
	15	361	295	361	295
<i>Creditors</i>					
Creditors arising out of Direct Insurance Operations		220	3	84	3
Other Creditors including Taxation & Social Security		1,389	1,552	786	1,095
<i>Accruals and Deferred Income</i>					
		962	1,330	962	1,330
		704,583	834,257	703,844	833,800

Approved by the Directors and signed on 25 March 2009 on their behalf by:



J W Jack
Director



F C McBain
Director and Chief Executive



C E Saxby
Secretary

The notes on pages 20 to 34 form an integral part of these accounts.

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).

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

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.

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.

2. Accounting policies continued

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 & 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.

Long term business provision

Insurance contracts and participating investment contracts

In accordance with FRS27, 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.

2. Accounting policies continued

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.

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	
	2008 £000	2007 £000	2008 £000	2007 £000	2008 £000	2007 £000
Annual	67,192	64,600	3,546	2,184	70,738	66,784
Single	31,296	12,399	–	–	31,296	12,399
	98,488	76,999	3,546	2,184	102,034	79,183

Comprising:

Premiums from participating contracts	67,930	66,402
Premiums from non-participating contracts	2,575	2,400
Premiums from linked contracts	31,529	10,381
Gross Earned Premiums	102,034	79,183
Reinsurance Premiums	(428)	(491)
Earned Premiums, net of reinsurance	101,606	78,692

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.

Gross new business premiums	Society 2008		Society 2007	
	Annual £000	Single £000	Annual £000	Single £000
New business premiums	5,514	32,062	5,635	12,657

Contributions received for Child Trust Funds, non-insurance ISAs and direct OEIC investments

	Group		Society	
	2008 £000	2007 £000	2008 £000	2007 £000
Annual contributions	2,591	2,162	–	–
Single contributions	6,617	6,920	–	–

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

4. Investment income

	Group		Society	
	2008 £000	2007 £000	2008 £000	2007 £000
Income from land & buildings	175	152	175	152
Income from other investments	32,108	22,385	33,380	22,949
Gains (net of applicable losses) on the realisation of investments	11,576	543	11,576	543
Net return on pension scheme under FRS 17	(65)	(26)	(65)	(26)
	43,794	23,054	45,066	23,618

5. Claims incurred

	Ordinary Assurance		Industrial Assurance		Total	
	2008 £000	2007 £000	2008 £000	2007 £000	2008 £000	2007 £000
Deaths	2,964	1,649	7,421	2,324	10,385	3,973
Maturities	59,781	32,357	5,659	4,759	65,440	37,116
Surrenders	26,218	16,755	2,623	982	28,841	17,737
	88,963	50,761	15,703	8,065	104,666	58,826
Claims handling expenses					177	143
					104,843	58,969

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 £26,000 (2007 – £13,000).

6. Acquisition costs

	Group and Society	
	2008 £000	2007 £000
Acquisition costs incurred	7,097	7,179
Net change in deferred acquisition costs	–	8,870
Amount transferred from Fund for Future Appropriations	–	(8,870)
Net charge included in technical account	7,097	7,179

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 was 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 82 (2007 – 71).

The aggregate payroll costs of these persons were as follows:

	2008 £000	2007 £000
Wages and salaries	2,387	1,790
Social security costs	216	174
Other pension costs	220	212
	2,823	2,176

Remuneration of Directors

Details of Directors' remuneration are included in the Directors' Remuneration Report on pages 12 to 13.

	2008 £000	2007 £000
<i>Remuneration of Auditors</i>		
Fees payable to the auditor for audit of annual accounts	81	75
Fees payable to the auditor for other services:		
The audit of subsidiary companies pursuant to legislation	9	9
Other services pursuant to legislation	2	2
Other services	–	26
Fees in respect of the Scottish Friendly Pension & Life Assurance Scheme Audit	2	2

8. Investment expenses & charges

	2008 £000	2007 £000
<i>Group and Society</i>		
Investment management expenses	49	52

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 £1,028,000 (2007 – £579,000).

10. Taxation

	2008	Group	2008	Society
	£000	2007	£000	2007
		£000		£000
Corporation Tax and irrecoverable income tax	749	366	699	366
Adjustment in respect of previous years	(61)	28	(61)	28
Deferred tax charge/(credit)	(95)	(850)	(95)	(850)
Amount transferred to Fund for Future Appropriations	–	850	–	850
	593	394	543	394

Following the release at 31 December 2007 of the deferred acquisition cost asset under FRS 27 (see Note 6), the related deferred tax liability was also released with a corresponding amount transferred to the Fund for Future Appropriations (see Note 14).

11. Investments

Group and Society	2008	2007
<i>Land and buildings</i>	£000	£000
At 1 January	5,750	5,750
Revaluation	–	–
At 31 December	5,750	5,750

As at 31 December 2008, 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 2008 was £5,003,000 (2007 – £5,003,000).

	2008	2008	2007	2007
	Market	Historical	Market	Historical
	value	cost	value	cost
<i>Other financial investments</i>	£000	£000	£000	£000
<i>Group</i>				
Shares and other variable-yield securities and units in unit trusts:				
UK Listed Investments	735	2,965	1,743	2,965
Overseas	581	1,960	9,115	9,118
Unit Trusts and OEICs	490,559	487,902	646,599	513,304
UK and Government Fixed Interest Securities	–	–	9,906	10,253
Other Fixed Income Securities	18,122	17,161	16,512	17,764
Loans secured by Mortgages	409	409	409	409
Loans secured by Insurance Policies	107	107	125	125
	510,513	510,504	684,409	553,938

11. Investments continued

<i>Society</i>	2008 Market value £000	2008 Historical cost £000	2007 Market value £000	2007 Historical cost £000
Shares and other variable-yield securities and units in unit trusts:				
UK Listed Investments	735	2,965	1,743	2,965
Overseas	581	1,960	9,115	9,118
Unit Trusts and OEICs	490,486	487,824	646,532	513,247
UK and Government Fixed Interest Securities	–	–	9,906	10,253
Other Fixed Income Securities	18,122	17,161	16,512	17,764
Loans secured by Mortgages	409	409	409	409
Loans secured by Insurance Policies	107	107	125	125
	510,440	510,426	684,342	553,881

<i>Investments in Group undertakings</i> <i>Society</i>	2008 Net asset value £000	2008 Historical cost £000	2007 Net asset value £000	2007 Historical cost £000
Scottish Friendly Asset Managers Limited	783	1,600	457	1,600

Principal activity: managers of Scottish Friendly ISAs, PEPs and Child Trust Funds.
100% shares held.

Scottish Friendly Insurance Services Limited	730	600	281	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.

S.L. Insurance Services Limited	31	–	–	–
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Principal activity: agents for the transaction of general Branch insurance.
100% shares held.

12. Assets held to cover linked liabilities

<i>Group and Society</i>	2008 £000	2007 £000
Market value of assets held to cover linked liabilities	69,922	62,567
Historical cost of assets held to cover linked liabilities	81,450	56,978

12. Assets held to cover linked liabilities continued

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.

13. Tangible assets

Group and Society	Computer equipment £000	Motor vehicles £000	Fixtures & fittings £000	Total £000
<i>Cost</i>				
At 1 January 2008	1,483	125	390	1,998
Additions	185	–	199	384
Disposals	(27)	(10)	(2)	(39)
At 31 December 2008	1,641	115	587	2,343
<i>Depreciation</i>				
At 1 January 2008	1,347	89	333	1,769
Charge for year	104	21	34	159
On disposals	(27)	(3)	(2)	(32)
At 31 December 2008	1,424	107	365	1,896
Net Book Value at 31 December 2008	217	8	222	447
Net Book Value at 31 December 2007	136	36	57	229

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 2008	99,145	666,881	7,055	57,996	831,077
Change in other technical provisions	–	(110,254)	–	6,675	(103,579)
Movement in provision for outstanding claims	–	–	1,516	–	1,516
Transfer (to)/from technical account	(26,421)	–	–	–	(26,421)
Exchange rate adjustment	(1,506)	–	–	–	(1,506)
Change in reinsurers' share of long term business provision	–	564	–	–	564
At 31 December 2008	71,218	557,191	8,571	64,671	701,651

14. Funds and technical provisions continued

The principal assumptions underlying the calculation of the long term business provision is that future interest earnings will be 3.25% 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 Appropriations is determined after taking account of a pension scheme surplus of £1,648,000.

15. Provisions for other risks and charges

(a) Deferred taxation

The provision for deferred taxation comprised:

	2008 £000	2007 £000
Unrealised investment gains	–	196
Deferred acquisition costs	–	(73)
Other timing differences	–	(28)
Undiscounted provision for deferred tax	–	95
Attributable to assets held to cover linked liabilities	194	–
At 31 December	194	95

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 £7,323,000 (2007 – £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.

	2008 £000	2007 £000
At 1 January	200	–
Transferred from Scottish Legal Life	–	218
Utilised in period	(33)	(18)
At 31 December	167	200

16. Costs of bonuses*Group and Society*

Total bonuses attributable to the year are as follows:

	2008 £000	2007 £000
Year end reversionary bonus declared (included in change in other technical provisions)	5,189	5,534
Reversionary and terminal bonuses paid (included in claims)	15,394	6,312
Total bonuses dealt with in the technical account	20,583	11,846

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 2008, the charge included in the technical account relating to the employer's contributions to this scheme was £123,000 (2007 – £116,000). There were no outstanding or prepaid contributions at the balance sheet date.

*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 ('the Scheme'), that is closed to new entrants. The Scheme provides benefits on a defined benefit basis. The FRS 17 liability value includes allowance for the following discretionary increases given to pensions in payment.

The Society expects to contribute £124,000 to the Scheme during the year to 31 December 2009, excluding the cost of any discretionary increase granted to pensioners.

The principal assumptions used to calculate Scheme liabilities include:

	2008 %	2007 %
Discount rate	6.3	5.7
Inflation	2.85	3.5
Rate of increase in salaries	4.85	5.5
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)	2.85	3.5
Rate of revaluation for deferred pensions	2.85	3.5
Post retirement mortality assumption	2000 series Medium cohort Minimum improvement: 1.5% males, 1.0% females	PA92 Medium cohort C2020

Under the mortality tables adopted, the assumed future life expectancy at age 65 is as follows:

	2008	2007
Males currently aged 65	22.8	21.9
Females currently aged 65	24.6	24.8

17. Pensions continued

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 2008	6.30%	7,368
31 December 2007	5.70%	8,161
31 December 2006	5.00%	8,629

The fair value of 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 2008 (£1,223,000, 2007 – £784,000) and experience losses during the year of £162,000 (2007 – £94,000), were fully offset by a reduction in the value of the policy and there are therefore no actuarial gains or losses to report.

	2008 £000	2007 £000
<i>Analysis of amount charged to net operating expenses</i>		
Current service cost (including expenses and life assurance)	151	165
Past service cost	97	82
Total operating charge	248	247

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.

A full actuarial valuation was carried out at 1 January 2008 and, for the purpose of this disclosure, updated to 31 December 2008 by a qualified independent actuary. The Scheme is closed to new entrants. Scheme assets are stated at their market value at 31 December 2008 and the present value of the Scheme liabilities has been calculated at the same date.

The amounts recognised in the balance sheet are as follows:

	2008 £'000	2007 £'000
Fair value of scheme assets	30,273	26,168
Present value of funded liabilities	(25,035)	(24,527)
Surplus	5,238	1,641
Restriction on recognition of surplus	(3,526)	–
Recognised surplus	1,712	1,641
Related deferred tax liability	(64)	(64)
Net surplus	1,648	1,577

17. Pensions continued

The amounts recognised in the technical account are as follows:

	2008 £'000	2007 £'000
Current service cost	–	–
Interest cost	1,366	316
Expected return on scheme assets	(1,366)	(327)
Scheme expenses	65	37
	65	26
Actuarial gains/(losses)	1,644	419
Effect of the restriction on recognition of surplus	(3,526)	–
Total	(1,882)	419

Changes in the present value of the defined benefit liabilities are as follows:

	2008 £'000	2007 £'000
Opening defined benefit liability	24,527	24,906
Interest cost	1,366	316
Actuarial losses/(gains)	255	(349)
Benefits paid	(1,113)	(346)
	25,035	24,527

Changes in the fair value of the scheme assets are as follows:

	2008 £'000	2007 £'000
Opening fair value of scheme assets	26,168	26,154
Expected return	1,366	327
Actuarial gains/(losses)	1,899	70
Contributions by employer	2,018	–
Scheme expenses	(65)	(37)
Benefits paid	(1,113)	(346)
	30,273	26,168

The fair value of the scheme assets as a percentage of total scheme assets and target allocations are set out below:

	2008	2007
Equities	6.3%	10.0%
Bonds	92.9%	90.2%
Cash	0.8%	-0.2%

17. Pensions continued

Disclosure of principal assumptions	2008	2007
Discount rate	6.30%	5.70%
Expected return on scheme assets	4.59%	5.23%
Future salary increases	n/a	n/a
Rate of increase of pensions in payment	3.30%	3.60%
Rate of increase of deferred pensions	2.85%	3.30%
Post retirement mortality	PNXA2000 birth year tables with medium cohort and underpin 1.5%/1.0% for males/females	PXA92 birth year tables with medium cohort
The expected return on assets is derived from the assumptions of long term expected returns on each asset class, these are shown below:		
Equities	7.50%	7.25%
Bonds	4.40%	5.00%
Cash	4.40%	5.00%
Historical pension scheme information:	2008 £'000	2007 £'000
Defined benefit liability	(25,035)	(24,527)
Scheme assets	30,273	26,168
Surplus	5,238	1,641
Experience adjustments on scheme liabilities	(316)	53
Experience adjustments on scheme assets	1,899	70

18. With-profits actuary

Mr G Beamer of OAC plc served as the With-profits Actuary throughout the financial year. 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 Beamer has confirmed that neither he nor his family were members of the Society, nor had they any financial or pecuniary interest in the Society, with the exception of fees paid to OAC plc for professional services which amounted to £97,000 (2007 – £65,000).

19. Transactions with Related Parties

The aggregate premiums payable for the year by 5 Directors and 6 other members of the Executive in respect of the Society's products amounted to £20,294 (2007 – £19,930).

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

20. Capital statement

<i>Available capital resources</i>	2008 £000	2007 £000
Fund for Future Appropriations	71,218	99,145
Adjustments to assets onto regulatory basis	21,857	98,194
Total available capital resources	93,075	197,339
<hr/>		
<i>Analysis of liabilities</i>	2008 £000	2007 £000
Options and guarantees	40,979	37,238
Other policyholder obligations	454,130	567,682
Unit-linked business	64,671	57,996
Other life assurance business	62,082	61,961
Technical Provisions in Balance Sheet	621,862	724,877

The Society calculates capital based on the FSA realistic 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.

<i>Analysis of Movement</i>	2008 £000	2007 £000
Opening capital resources	197,339	152,844
Change in assumptions	–	–
Change in management policies	–	–
Change in regulatory requirements	–	97,805
New business and other factors	(104,264)	(53,310)
Closing capital resources	93,075	197,339

21. Operating lease commitments

Annual commitments under non-cancellable operating leases for property are as follows:

<i>Operating leases which expire</i>	2008 £000	2007 £000
After five years	86	–

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