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# Annual Report & Accounts 2009



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

## Key Figures

### Sales (APE)<sup>1</sup>



2009 – £9.1m  
2008 – £9.9m

<sup>1</sup> Annual Premium Equivalent

### Sales – Core Life and Pensions (APE)<sup>2</sup>



2009 – £7.6m  
2008 – £6.5m

<sup>2</sup> Excluding sales of Appropriate Personal Pension

### Assets under management



2009 – £752m  
2008 – £704m

### Number of members



2009 – 465,000  
2008 – 489,000

# Chairman's Statement



Michael Walker  
*Chairman*

As we had anticipated, 2009 was a very difficult year for the entire financial services industry. The challenge was to continue to navigate the global recession on the back of a dismal year for investment returns, compounded by a general lack of confidence in the financial services industry due primarily to the banking crisis.

## Strategy

In that context, our three-part diversification strategy has reaped dividends for the group, maintaining stability and delivering growth in this difficult period.

The strategy is based on developing organic growth opportunities, working with new distribution and business process outsourcing partners as well as identifying merger and consolidation partners in the life and friendly society sector.

The aim of the strategy is to grow overall assets under management and administration, increase the group's income stream and help to reduce the impact of fixed costs. This benefits all members by lowering the overall risk within the organisation through diversification, as well as lowering per policy costs.

## Corporate recognition

Scottish Friendly has continued to increase market awareness of the group as it secures new partnerships, with the related press coverage. In particular the group's partnerships for distribution and business process outsourcing have increased Scottish Friendly's profile and stature in the financial services arena. This in turn is expected to help secure additional benefits for members through new growth and further partnerships in the future.

## Corporate governance

The Financial Services Authority's '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 is firmly committed to this initiative and to maintaining a TCF culture throughout the organisation in order to ensure that all staff are committed to reflecting TCF through all aspects of our operation. Through an ongoing programme of member and focus group research as well as customer feedback analysis, Scottish Friendly has continued to refine marketing and member communications and to adapt products to ensure that they are customer friendly and meet customer needs.

Scottish Friendly has also continued to play an active role supporting important initiatives promoted by the Association of Mutual Insurers (AMI), which, with effect from 1 January 2010, merged with the Association of Friendly Societies to become the Association of Financial Mutuals. In 2009 AMI launched a promotion "We're mutual, we only work for you" and Scottish Friendly was a leading player in the development of this campaign.

Additionally the Board was delighted when Scottish Friendly's Chief Executive, Fiona McBain, was appointed to the Financial Services Authority's Small Business Practitioners' Panel. This body exists to represent the views and interests of smaller regulated firms and to provide advice to the FSA on its policies and development of regulation.

The well-publicised change of emphasis at the FSA to, in their words, "an intrusive style" of regulation has been strongly felt, with an increase in associated costs. While Scottish Friendly has always focused on compliance, the costs of responding to more frequent and more detailed questioning has been significant, both in terms of direct expenses and management time. This is expected to continue for the foreseeable future, subject perhaps to a change of government policy.

## Principal risks and uncertainties

Uncertainties abound in the UK and global financial markets with the level of sovereign debt worldwide a significant market concern. Risks remain as the consequences of quantitative easing work through the real economy leading to the possibility of inflation at a time of slow economic activity.

Whilst the impact of this is judged likely to be less than that of the potential meltdown that the global economy faced in 2008 and 2009, it does pose downside risks to market and asset values. We therefore remain cautious about the immediate future and our management and investment decisions will continue to reflect that caution.

## The Board

After nine years Tim Noble, a Non-Executive Director of Scottish Friendly, retired from the Board in October 2009. In addition, Geoffrey Johnston, the vice-chairman of Scottish Friendly, is leaving the Board at the forthcoming AGM after 14 years of service.

On behalf of the Board, I wish them both well in the future and thank them for their enthusiastic and valuable contributions over so many years of dedicated service and in particular for the support each of them has given to me. We shall miss them.

The Board is looking to appoint a new Non-Executive Director during 2010.

## Management and Staff

I should also like to thank the management team and the staff of Scottish Friendly for their continued effort and focus on performance and service in 2009.

## Outlook

In addition to the uncertainties discussed above, there are known challenges ahead facing our industry, including the Retail Distribution Review (RDR) and the Solvency II regime. The RDR will not directly affect Scottish Friendly's own distribution channel, but is likely to change the shape of the provision of advice in financial services; the Scottish Friendly business process outsourcing services are already fully RDR compliant to support business there. We are well placed too for the challenges of Solvency II, having invested significantly over the years in our stochastic modelling to support capital and risk management, and we continue to develop this in line with the evolving requirements coming from the EU.

Despite the difficult economic background in 2009, Scottish Friendly increased core sales and assets under management and administration, and continued to reap the benefits of its growth strategy. I have every confidence that the staff, management team and Board will continue to meet the challenges in 2010.

We will continue to rely on our strategy of growth through diversification, seeking new partners and new product opportunities. The management team will, as always, adopt a flexible but cautious approach, a stance that has worked well through 2009 and will help to carry the group through the continued uncertainty of the next 12 months.



**Michael J Walker**

Chairman  
25 March 2010

# Chief Executive's Review



Fiona McBain  
Chief Executive

2009 began as a year likely to be marked by tremendous economic uncertainty. Following the near collapse of the worldwide banking sector in 2008, investors and financial services organisations were extremely nervous about prospects in the year ahead.

Over the course of 2009, whilst there has been a modest return of consumer confidence, the reputation of the financial services sector has shown little sign of recovery.

However the partial recovery in stock market and asset values did enable Scottish Friendly to increase final bonus rates, reversing some of the effect of the reductions in payouts required at the height of the crisis.

In the midst of continued economic uncertainty, the relatively stable income streams delivered by our strategy for growth and diversification in recent years proved invaluable, and the group has managed to produce healthy sales results and increase assets under management and administration.

## Strategic implementation

### Organic growth

Scottish Friendly has continued to develop its relationships with key partners like Pearl Group, Royal London and Forces Financial. The Soccer Savings partnership we began in 2008 grew strongly in 2009 as a result of sales from face-to-face promotional activity. The introduction of new distribution channels for our e-business route has also proved highly successful, helping us to further diversify our distribution risk as well as controlling acquisition costs.

We reported last year on a change in our overall claims profile, due to an increase in maturities of Scottish Friendly 10 year policies. In December 2008 we launched a new product, Scottish Bond Plus, to allow investors to keep their investment with Scottish Friendly and I am pleased to report strong sales of this option in 2009.

### Business process outsourcing

The Scottish Friendly wrap administration launched in 2006 has made excellent progress, and business with our wrap administration partners – Nucleus Financial and Aviva – has gone from strength to strength.

The Nucleus Financial Group achieved terrific progress in 2009, recording a sizeable increase

in assets under administration in what was a difficult year for any financial organisation, let alone for one that was a start up financial company as recently as 2006.

Similarly, we have worked closely with Aviva to smooth the transition of their proposition and continue to support our partner with their development plans.

We continue to build a strong working relationship with both of our partners, helping them craft and develop their propositions with the sort of flexibility and efficient customer service that we demand for our own members.

## Mergers and consolidation

The five transfers completed over 2006 and 2007 continue to benefit both the policyholders transferred and the Scottish Friendly members by way of reduced administration expenses and an administration income stream respectively.

## Results

Despite the difficult markets of 2009, core life and pensions sales excluding Appropriate Personal Pensions (APP) were £7.6m APE (the industry standard measure of annual premium equivalent – regular premiums plus one tenth of single premiums); the equivalent amount in 2008 was £6.5m – an increase of 18% in 2009.

Total sales were £9.1m (£9.9m in 2008); this reflects the change at the end of 2008 that we reported last year would mean lower sales in future years (as due to technical changes Appropriate Personal Pensions (APP) business is largely now no longer classified as life and pensions business).

Total gross premium income was £91m (£102m in 2008); the decrease here reflects the maturities of Scottish Friendly 10 year policies and the scheduled 'run off' of books of business taken over from other providers, in addition to the change with regard to APP business.

As well as new business and premium income, Scottish Friendly's other key performance indicators relate primarily to expense management.

The ratio of administrative expenses to premium income APE was 7.2% (2008 6.6%); while expenditure was maintained in line with 2008, the increase in the ratio reflects the reduction in premiums, discussed above. Despite the challenging sales environment, the cost of acquiring new business was maintained in line with the previous year at 81% (2008 81%).

## Investment Performance

Over 2009 the main with-profits fund recovered some of the ground lost in the previous twelve months, helped by a partial recovery in the stock markets. The return on the with-profits fund for the year was 15.8% (2008 minus 19.6%). This in part reverses the losses of 2008,

with the return over the two year period 2008/2009 now minus 6.9%; the FTSE 100 has fallen by 12.5% over that period.

The impact of the extreme falls in investment values led to reductions in bonuses early in the year, which in turn meant disappointing returns for a number of our members with policies maturing in 2009. However, the recovery in asset values has allowed us to increase final bonuses with effect from the end of the year.

Our capital position remains sound, in excess of the regulatory requirements and prudent management of members' capital remains paramount.

## Focus on service

Scottish Friendly recognises that efficient and effective customer service is as vital to the lifeblood of the organisation as strong new business results and good investment performance.

Clearly the past year has been a challenging one for the reputation of the financial services industry as a whole and Scottish Friendly has not been immune from this. As expected, the lower maturity returns for members in 2009 led to a reduction in our ABI Customer Impact Scheme rating, although importantly it still remains above the industry average.

We hope that the partial recovery in final bonuses at the end of 2009 will lead to an improvement in member experience ratings. We have also analysed the detailed results, as in the past, in order to determine any areas where our service and efficiency can be improved. The key theme from an analysis of the 2009 Customer Impact report relates to the claims process; while this has to be seen in the context of the impact of markets on performance and claim payouts, we do note that we need to continue to develop our client communications, especially those dealing with the management of risk and expectations and those to clients with products nearing maturity.

The Group will continue to focus on delivering good customer service at the same time as continuing to maintain tight control over costs, and to ensure that our administrative renewal expenses remain competitive.

## Outlook

In the midst of continuing difficulties in the UK economy, the financial markets and the financial services industry, the Scottish Friendly Group has continued to achieve sales growth and has consolidated the expansion in its business process outsourcing operation.

We greatly welcome the partial recovery in worldwide stock markets and the impact on our with-profits fund. Whilst we remain cautious about the immediate future, we are delighted that the recovery has enabled an increase in final bonuses to plans maturing from 19 December 2009.

Whatever the result of the forthcoming General Election, 2010 is likely to see changes in fiscal and possibly monetary policy. Additionally the potential for a change in government is likely to lead to other instabilities in the financial sector; the radical overhaul, or even abolition, of Child Trust Funds is a prime example. Furthermore, the possibility of further pension reform and, importantly, potential changes to the structure of financial regulation, could lead to significant change within the industry.

With such instability it will be those organisations demonstrating flexibility, short lines of communication and the ability to respond rapidly to changing circumstances that not only survive but also flourish. In 2009 we have proved that we can grow in these difficult times.

We will once again take a flexible stance towards new business acquisition and we anticipate continuing to place greater emphasis on our partnership distribution channel as a means of providing a cost effective method of reaching our new business targets. We will also continue to develop our e-commerce capability to take advantage of marketing opportunities in this arena.

The ongoing downbeat economic conditions persist in reducing the number of potential merger and acquisition targets that Scottish Friendly judges to be of beneficial interest to members. However we remain open to new opportunities and will consider each on its own merit.

We do not believe that the next 12 months will be any less uncertain than 2009 but, as we reap the dividends of the investment in our diversification and growth strategy, we have an unwavering determination to reward our members by emerging from this downturn in a stronger position than we entered it.

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 2010

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# Directors

## 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 & Risk, Remuneration and Nomination Committees. Trustee of the Staff Pension & Life Assurance Scheme. Former Group Chief Executive of the logistics company Arbutle 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.

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

Appointed as a Director in May 2001. Chairman of the Remuneration Committee and a member of the Audit & Risk Committee. Chairman of The Turnkey Group Limited and a Director of Core Australia Pty Limited.

## J W Jack MA, CA

Appointed as a Director in 2006. Chairman of the Audit & Risk Committee and a member of the Nomination 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

**J Galbraith** BSc, MBA, FFA

**N E Lovatt** ACII, BA, MSc (Dip)

**I Neilson**

**C E Saxby** BAAcc (Hons), CA

**J Wilson** BSc, BEng, MSc

## M L Berryman BSc, FIA

Appointed as a Director in September 2007. Member of the Audit & Risk 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 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 Financial Mutuals. Chair of the ABI Life Insurance Committee members' forum. Non-Executive Director of Scottish Mortgage Investment Trust PLC. Trustee of the Robertson Trust.

## 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.

Chief Executive

Deputy Chief Executive

Sales and Marketing Director

Head of Client Services

Finance Director

Head of IT

# Directors' Report

The Directors have pleasure in submitting their annual report and accounts for the year ended 31 December 2009. 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 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 28 October 2009, T P Noble retired as a Director.

Further information on the Board is set out in the Report on Corporate Governance on pages 9 to 11.

## 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 2009.

## 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 2009, the Society had 1,256,000 (2008 – 1,296,000) policyholders and estimated the number of members to be 465,000 (2008 – 489,000).

## 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 Annual Report, the Directors' Report and the accounts in accordance with applicable law and regulations.

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

The accounts are required by law to give a true and fair view of the state of affairs of the Group and of the Society as at the end of the financial year and of the income and expenditure of the Group and of the Society for the 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 and Society 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 Society 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 2010

# Report on Corporate Governance

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.

## The Board

The Board met on 11 occasions in 2009, including two non-routine meetings; 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 all the meetings except for apologies from B I Wood, M L Berryman and J Galbraith 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;
- information on performance against the six outcomes of the Treating Customers Fairly initiative;
- compliance reports detailing developments in the regulatory environment and Scottish Friendly's management of compliance exposures. With effect from 2010, compliance matters are reported through the restructured Audit & Risk Committee.

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.

Strategic risk is addressed within the annual Business Plan, approved by the board in December and reviewed formally in July.

The key financial risks facing Scottish Friendly are covered within the Individual Capital Assessment (ICA), which is presented to the Board on a six-monthly basis and was last reviewed by the Board in February 2010.

Consideration of operational and regulatory risk is delegated by the Board to the Audit & Risk Committee, which meets on a quarterly basis and which receives regular reports from internal and external audit regarding the company's system of controls.

The operational risk register is reviewed by the Audit & Risk Committee at each meeting and was last reviewed in March 2010. This sets out the key operational risks facing Scottish Friendly, the likelihood of occurrence and the potential impact.

The Audit & Risk Committee also receives a quarterly report on compliance matters. A detailed annual compliance review, together with the compliance plan for 2010, was presented at the October 2009 meeting of the Audit Committee.

The Board has overall responsibility for the system of internal control and, through a combination of the above processes, is able to review its effectiveness annually, 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 2009, two Executive Directors, being the Chief Executive and the Deputy Chief Executive, and three 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.

GEF 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 2009 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 & Risk, 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 & Risk 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.

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## Audit & Risk Committee

J W Jack (Chairman)  
G E F Johnston  
Dr B I Wood  
M L Berryman  
T P Noble (retired 28 October 2009)

This Committee consists entirely of Non-Executive Directors and is chaired by J W Jack. At its meeting in January 2010, the Board approved revisions to the terms of reference of the Committee. The extended remit is reflected in the change of name to the Audit & Risk Committee with quarterly meetings to cover operational and regulatory risk management, with escalation of significant matters to the Board. Current monthly compliance reports to the Board have been replaced by a quarterly report to the Audit & Risk Committee, which includes greater policy content.

The Terms of Reference of the Audit & Risk Committee continue to include all matters indicated by the Annotated Code. The Secretary acts as Secretary to the Committee.

During 2009 the Committee met twice, with apologies from Mr Johnston and Mr Berryman on one occasion, and met privately with the external auditor. The Committee:

- reviewed the operational and regulatory risks within Scottish Friendly and ensured that appropriate systems and controls were in place to manage these risks, as required by the Financial Services Authority, taking such action as was necessary to ensure compliance;
- discussed with the external auditor, before the audit commenced, the nature and scope of the audit and, on completion of his 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 outsourced internal audit function was adequately resourced and had appropriate standing within the organisation.

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

M J Walker (Chairman)  
G E F Johnston  
F C McBain  
J W Jack (appointed 16 December 2009)  
T P Noble (retired 28 October 2009)

The Committee did not formally meet during the past year with matters of succession being dealt with at Board level. 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.

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# Directors' Remuneration Report

## Remuneration Committee

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

Dr B I Wood (Chairman)  
G E F Johnston  
M J Walker  
T P Noble (Chairman until retirement  
on 28 October 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 incorporates a bonus element which is targeted at increasing growth and cost efficiencies. Payments are capped at 30% of salary. The bonus is in respect of performance in 2009.

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 Scottish Friendly'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 Scottish Friendly.

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 <sup>1</sup> £000	Benefits <sup>2</sup> £000	Total year ended 31 Dec 2009 £000	Total year ended 31 Dec 2008 £000
<b>Chairman</b>					
M J Walker <sup>3</sup>	45	–	–	45	–
<b>Executive Directors</b>					
F C McBain	281	56	9	346	304
J Galbraith	229	46	12	287	261
<b>Non-Executive Directors</b>					
M L Berryman	23	–	5	28	23
J W Jack	24	–	1	25	24
G E F Johnston	29	–	–	29	28
T P Noble <sup>4</sup>	22	–	1	23	24
Dr B I Wood	25	–	–	25	23

<sup>1</sup> The bonus is in respect of performance in 2009.

<sup>2</sup> 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.

<sup>3</sup> Appointed 1 January 2009

<sup>4</sup> Retired 28 October 2009

## Pensions (audited)

	Accrued pension at 31 Dec 2009 <sup>1</sup> £000	Increase in accrued pension during 2009 £000	Transfer value at 31 Dec 2008 <sup>2</sup> £000	Transfer value at 31 Dec 2009 <sup>2</sup> £000	Increase in transfer value less Director's contributions £000
<b>Executive Directors</b>					
F C McBain	53	6	439	710	268
J Galbraith	83	6	565	880	312

<sup>1</sup> Accrued pension represents the amount to which the Directors would have been entitled had they left service on 31 December 2009.

<sup>2</sup> The transfer values have been calculated in accordance with the Actuarial Guidance Note GN11.

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# Member Relations

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 35 life and general insurance brands 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.

This year's survey took place in the middle of a deep downturn in asset prices which had a negative effect on investment returns. Lower investment returns appear to have led to lower levels of customer satisfaction across the industry, including those of Scottish Friendly.

Fortunately the Group was able to maintain above average results for the important categories of the Customer Impact Index (52% and rated in the second quarter) and whether customers are likely to recommend Scottish Friendly (53% and rated in the second quarter).

Scottish Friendly's results on the Index's three sub-sections fell, again skewed by the strength of feeling from the one-third of customers surveyed who had experienced a maturity or claim in 2009. These sections and scores are:

- developing and promoting products and services (32%, second quarter);
- giving clear information at the point of sale (58%, third quarter); and
- maintaining effective relationships between the customer and the organisation (42%, third quarter).

Given the investment conditions at the time, this reduction in our scores and strength of feeling is understandable. The partial recovery in final bonus rates in 2010 is likely to have a positive impact on our ratings in the future and other, more recent, measures of customer satisfaction point to such a recovery of sentiment.

As in 2009 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.

## Accounts

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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 2009 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 2009.

In addition to our audit of the 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 8 to the Companies Act 2006 The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008 No. 410).

This report is made solely to the Society's members, as a body, in accordance with section 73 of the Friendly Societies Act 1992. 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 February 2008, 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.

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## 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 2009 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 8 to the Companies Act 2006 The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, as if those requirements were to apply to the Society.



**Thomas Wolfenden**  
**(Senior Statutory Auditor)**  
**for and on behalf of KPMG**  
**Audit Plc, Statutory Auditor**

Chartered Accountants  
191 West George Street  
Glasgow  
G2 2LJ

25 March 2010

# Income and Expenditure

## Technical Account – Long Term Business

For year ended 31 December

	Note	Group 2009 £000	Group 2008 £000	Society 2009 £000	Society 2008 £000
Earned Premiums	3	90,553	102,034	90,553	102,034
Reinsurance Premiums		(373)	(428)	(373)	(428)
Earned Premiums, Net of Reinsurance		90,180	101,606	90,180	101,606
Investment Income	4	25,924	43,794	28,769	45,066
Unrealised Gains/(Losses) on Investments		53,935	(164,882)	54,592	(164,198)
Other Technical Income/(Expenditure)		6,070	12,984	(1,764)	8,146
		176,109	(6,498)	171,777	(9,380)
Claims Incurred	5	108,294	104,843	108,294	104,843
Change in Other Technical Provisions	12	25,933	(103,579)	25,933	(103,579)
Net Operating Expenses					
Acquisition Costs	6	6,575	7,097	6,575	7,097
Administrative Expenses	7	7,885	6,206	7,885	6,206
Investment Expenses & Charges		44	49	44	49
Other Technical Charges		3,107	2,832	0	0
Taxation	8	701	593	404	543
Actuarial loss re pension scheme		1,639	1,882	1,639	1,882
Transfer to/(from) the Fund for Future Appropriations	12	21,931	(26,421)	21,003	(26,421)
		176,109	(6,498)	171,777	(9,380)
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 35 form an integral part of these accounts.

# Balance Sheet

## Assets

As at 31 December

	Note	Group 2009 £000	Group 2008 £000	Society 2009 £000	Society 2008 £000
<i>Investments</i>	9				
Land & Buildings		4,215	5,750	4,215	5,750
Other Financial Investments		563,548	510,513	563,475	510,440
Investments in Group Undertakings		–	–	2,201	1,545
<i>Assets Held to Cover Linked Liabilities</i>	10	95,460	69,922	95,460	69,922
<i>Reinsurers' Share of Technical Provisions</i>					
Long Term Business Provision		6,857	7,067	6,857	7,067
<i>Debtors</i>					
Debtors arising out of Direct Insurance Operations		316	247	316	247
Taxation Recoverable		6,735	5,565	6,735	5,565
Deferred Taxation		223	64	83	64
Other Debtors		4,961	7,570	2,755	7,085
<i>Other Assets</i>					
Tangible Assets	11	465	447	465	447
Cash at Bank & in Hand		68,903	93,667	65,807	91,941
<i>Prepayments &amp; Accrued Income</i>					
Accrued Interest, Dividends & Rents		1,659	2,123	1,659	2,123
<i>Pension scheme surplus</i>	15	1,760	1,648	1,760	1,648
		755,102	704,583	751,788	703,844

## Liabilities

As at 31 December

<i>Fund for Future Appropriations</i>	12	93,155	71,218	92,227	71,218
<i>Technical Provisions</i>	12				
Long Term Business Provision		557,406	557,191	557,406	557,191
Claims Outstanding		9,506	8,571	9,506	8,571
Technical Provision for Linked Liabilities	12	90,179	64,671	90,179	64,671
<i>Provision for Other Risks &amp; Charges</i>	13	95	361	95	361
<i>Creditors</i>					
Creditors arising out of Direct Insurance Operations		41	220	41	84
Other Creditors including Taxation & Social Security		3,416	1,389	1,030	786
<i>Accruals and Deferred Income</i>		1,304	962	1,304	962
		755,102	704,583	751,788	703,844

Approved by the Directors and signed on 25 March 2010 on their behalf by:



G E F Johnston  
Director



F C McBain  
Director and Chief Executive



C E Saxby  
Secretary

The notes on pages 20 to 35 form an integral part of these accounts.

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# Notes to the 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 cost unless there is considered to be a diminution in value, in which case the value is 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 gross premium valuation method is used with an explicit expense reserve.

## 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 in 2007, 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	
	2009 £000	2008 £000	2009 £000	2008 £000	2009 £000	2008 £000
Annual	64,026	67,192	2,528	3,546	66,554	70,738
Single	23,999	31,296	–	–	23,999	31,296
	88,025	98,488	2,528	3,546	90,553	102,034

#### Comprising:

Premiums from participating contracts	64,009	67,930
Premiums from non-participating contracts	2,171	2,575
Premiums from linked contracts	24,373	31,529
Gross Earned Premiums	90,553	102,034
Reinsurance Premiums	(373)	(428)
Earned Premiums, net of reinsurance	90,180	101,606

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 2009		Society 2008	
	Annual £000	Single £000	Annual £000	Single £000
New business premiums	5,666	24,252	5,514	32,062

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

	Group		Society	
	2009 £000	2008 £000	2009 £000	2008 £000
Annual contributions	2,264	2,591	–	–
Single contributions	4,249	6,617	–	–

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

**4. Investment income**

	Group		Society	
	2009 £000	2008 £000	2009 £000	2008 £000
Income from land & buildings	156	175	156	175
Income from other investments	26,264	32,108	29,109	33,380
Net (losses)/gains on the realisation of investments	(275)	11,576	(275)	11,576
Net loss on pension scheme under FRS 17	(221)	(65)	(221)	(65)
	25,924	43,794	28,769	45,066

**5. Claims incurred**

**Group and Society**

	Ordinary Assurance		Industrial Assurance		Total	
	2009 £000	2008 £000	2009 £000	2008 £000	2009 £000	2008 £000
Deaths	2,665	2,964	4,979	7,421	7,644	10,385
Maturities	69,006	59,781	5,022	5,659	74,028	65,440
Surrenders	25,056	26,218	1,362	2,623	26,418	28,841
	96,727	88,963	11,363	15,703	108,090	104,666
Claims handling expenses					204	177
					108,294	104,843

The above figures are stated after taking into account the movement in the provision for outstanding claims (see Note 12). They are also stated net of aggregate recoveries received from reinsurers amounting to £26,000 (2008 – £26,000).

**6. Acquisition costs – commission payable**

**Group and Society**

The total amount of commission payable, comprising acquisition and renewal commission for direct insurance business in the year was £1,497,000 (2008 – £1,028,000).

## 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 136 (2008 – 82). The aggregate payroll costs of these persons were as follows:

	2009 £000	2008 £000
Wages and salaries	3,971	2,387
Social security costs	359	216
Other pension costs	195	220
	4,525	2,823

#### Remuneration of Directors

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

#### Remuneration of Auditors

	2009 £000	2008 £000
Fees payable to the auditor for audit of annual accounts	84	81
Fees payable to the auditor for other services:		
The audit of subsidiary companies pursuant to legislation	10	9
Other services pursuant to legislation	–	2
Other services	12	–
Fees in respect of the Scottish Friendly Pension & Life Assurance Scheme audit	3	2

## 8. Taxation

	Group		Society	
	2009 £000	2008 £000	2009 £000	2008 £000
Corporation Tax and irrecoverable income tax	848	749	411	699
Adjustment in respect of previous years	(7)	(61)	(7)	(61)
Deferred tax credit	(140)	(95)	–	(95)
	701	593	404	543

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 15). In addition there is a deferred tax asset of £19,000 attributable to assets held to cover linked liabilities.

At Group level, Scottish Friendly Asset Managers Limited has recognised a deferred tax asset of £140,000 arising as a result of unutilised losses brought forward, as it is considered more likely than not that there will be suitable future taxable profits from which these can be deducted.

The Society also has an unrecognised deferred tax asset of £4,507,000 (2008: £7,323,000) 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.

## 9. Investments

### Group and Society

	2009 £000	2008 £000
<i>Land and buildings</i>		
At 1 January	5,750	5,750
Revaluation	(1,535)	–
At 31 December	4,215	5,750

Land and buildings were independently valued as at 31 December 2009 by GVA Grimley. The valuation was carried out in accordance with the RICS Valuation Standards. The basis of valuation was existing use value, for those parts of the property occupied by Scottish Friendly, and market value for the remainder. 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 2009 was £5,003,000 (2008 – £5,003,000).

### Group

#### *Other financial investments*

	2009 Market Value £000	2009 Historical Cost £000	2008 Market Value £000	2008 Historical Cost £000
Shares and other variable-yield securities and units in unit trusts:				
UK Listed Investments	1,124	2,965	735	2,965
Overseas	1,352	3,500	581	1,960
Unit Trusts and OEICs	543,511	483,503	490,559	487,902
Other Fixed Income Securities	17,124	16,658	18,122	17,161
Loans secured by Mortgages	350	350	409	409
Loans secured by Insurance Policies	87	87	107	107
	563,548	507,063	510,513	510,504

### Society

	2009 Market Value £000	2009 Historical Cost £000	2008 Market Value £000	2008 Historical Cost £000
Shares and other variable-yield securities and units in unit trusts:				
UK Listed Investments	1,124	2,965	735	2,965
Overseas	1,352	3,500	581	1,960
Unit Trusts and OEICs	543,438	483,453	490,486	487,824
Other Fixed Income Securities	17,124	16,658	18,122	17,161
Loans secured by Mortgages	350	350	409	409
Loans secured by Insurance Policies	87	87	107	107
	563,475	507,013	510,440	510,426

## 9. Investments *continued*

### *Investments in Group undertakings*

#### **Society**

	2009 Net asset Value £000	2009 Historical Cost £000	2008 Net asset Value £000	2008 Historical Cost £000
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Scottish Friendly Asset Managers Limited	1,240	1,600	783	1,600
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Principal activity: managers of Scottish Friendly ISAs and Child Trust Funds.  
100% shares held.

Scottish Friendly Insurance Services Limited	1,848	600	730	600
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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	40	–	31	–
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Principal activity: agents for the transaction of general Branch insurance.  
100% shares held.

## 10. Assets held to cover linked liabilities

### Group and Society

	2009 £000	2008 £000
Market value of assets held to cover linked liabilities	95,460	69,922
Historical cost of assets held to cover linked liabilities	84,594	81,450

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.

## 11. Tangible assets

### Group and Society

	Computer equipment £000	Motor vehicles £000	Fixtures & fittings £000	Total £000
<i>Cost</i>				
At 1 January 2009	1,641	115	587	2,343
Additions	174	34	3	211
Disposals	–	(29)	–	(29)
At 31 December 2009	1,815	120	590	2,525
<i>Depreciation</i>				
At 1 January 2009	1,424	107	365	1,896
Charge for year	142	17	34	193
On disposals	–	(29)	–	(29)
At 31 December 2009	1,566	95	399	2,060
Net Book Value at 31 December 2009	249	25	191	465
Net Book Value at 31 December 2008	217	8	222	447

## 12. Funds and technical provisions

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

### Group

	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 2009	71,218	557,191	8,571	64,671	701,651
Change in other technical provisions		425		25,508	25,933
Movement in provision for outstanding claims			935		935
Transfer from technical account	21,931				21,931
Exchange rate adjustment	6				6
Change in reinsurers' share of long term business provision		(210)			(210)
<b>At 31 December 2009</b>	<b>93,155</b>	<b>557,406</b>	<b>9,506</b>	<b>90,179</b>	<b>750,246</b>

### Society

	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 2009	71,218	557,191	8,571	64,671	701,651
Change in other technical provisions		425		25,508	25,933
Movement in provision for outstanding claims			935		935
Transfer from technical account	21,003				21,003
Exchange rate adjustment	6				6
Change in reinsurers' share of long term business provision		(210)			(210)
<b>At 31 December 2009</b>	<b>92,227</b>	<b>557,406</b>	<b>9,506</b>	<b>90,179</b>	<b>749,318</b>

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 Future Appropriations is determined after taking account of a pension scheme surplus of £1,763,000.

## 13. Provisions for other risks and charges

### Pension review

	2009 £000	2008 £000
At 1 January	167	200
Utilised in period	(72)	(33)
<b>At 31 December</b>	<b>95</b>	<b>167</b>

## 14. Costs of bonuses

### Group and Society

Total bonuses attributable to the year are as follows:

	2009 £000	2008 £000
Year end reversionary bonus declared (included in change in other technical provisions)	2,004	5,189
Reversionary and terminal bonuses paid (included in claims)	4,361	15,394
Total bonuses dealt with in the technical account	6,365	20,583

## 15. 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 2009, the charge included in the technical account relating to the employer's contributions to this scheme was £143,000 (2008 – £123,000). 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 pension arrangement called 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 an allowance for any discretionary increases given to pensions in payment but makes no allowance for future discretionary increases.

The Society expects to contribute £185,000 to the Scheme during the year to 31 December 2010 in respect of retirement benefits for the active members.

The principal assumptions used to calculate Scheme liabilities include:

	2009 %	2008 %
Discount rate	5.70	6.30
Inflation	3.50	2.85
Rate of increase in salaries	5.70	4.85
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)	3.50	2.85
Rate of revaluation for deferred pensions	3.50	2.85
Post retirement mortality assumption	2000 series Medium cohort Minimum improvement: 1.5% males, 1.0% females	2000 series Medium cohort Minimum improvement: 1.5% males, 1.0% female

## 15. Pensions *continued*

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

	2009	2008
Males currently aged 45	26.0	25.9
Females currently aged 45	26.6	26.5
Males currently aged 65	23.0	22.8
Females currently aged 65	24.7	24.6

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 2009	5.70	8,924
31 December 2008	6.30	7,368
31 December 2007	5.70	8,161

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. No amount is therefore recognised in the balance sheet.

### *Amounts recognised in the technical account – long term business*

	2009 £000	2008 £000
Current service cost (including expenses and life assurance)	132	151
Past service cost	52	97
Total operating charge (included in Administrative expenses)	184	248

### *Summary of prior year amounts*

The net change in scheme liabilities due to assumption changes and experience gains/losses during the year are fully offset by a change in the value of the policy and there are therefore no net actuarial gains or losses to report.

	2009 £000	2008 £000	2007 £000	2006 £000	2005 £000
Experience gains/(losses) on Scheme liabilities	71	176	(94)	(255)	461
Changes in assumptions used to value Scheme liabilities	(1,430)	899	784	135	(611)
Experience adjustments on Scheme assets	1,359	(1,075)	(690)	120	150

**15. Pensions** *continued*

*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 benefit 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 as well as an annuity policy to back the UK pensioner liability. 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 2009 by a qualified independent actuary. The Scheme is closed to new entrants. Scheme assets are stated at their market value at 31 December 2009 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:

	2009 £000	2008 £000
Fair value of scheme assets	31,164	30,273
Present value of funded liabilities	(26,899)	(25,035)
Surplus	4,265	5,238
Restriction on recognition of surplus	(2,438)	(3,526)
Recognised surplus	1,827	1,712
Related deferred tax liability	(64)	(64)
Net surplus	1,763	1,648

The amounts recognised in the technical account are as follows:

	2009 £000	2008 £000
Current service cost	–	–
Interest cost	1,530	1,366
Expected return on scheme assets	(1,576)	(1,366)
Scheme expenses	267	65
	221	65
Actuarial (losses)/gains	(2,727)	1,644
Effect of the restriction on recognition of surplus	1,088	(3,526)
Total	(1,639)	(1,882)

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

	2009 £000	2008 £000
Opening defined benefit liability	25,035	24,527
Interest cost	1,530	1,366
Actuarial losses	1,836	255
Benefits paid	(1,502)	(1,113)
	26,899	25,035

## 15. Pensions *continued*

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

	2009 £000	2008 £000
Opening fair value of scheme assets	30,273	26,168
Expected return	1,576	1,366
Actuarial (losses)/gains	(891)	1,899
Contributions by employer	1,975	2,018
Scheme expenses	(267)	(65)
Benefits paid	(1,502)	(1,113)
	<b>31,164</b>	<b>30,273</b>

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

	2009 %	2008 %
Equities	0.0	6.3
Bonds	65.7	62.8
Cash	3.1	0.8
Annuity policies	31.2	30.1

### *Disclosure of principal assumptions*

	2009 %	2008 %
Discount rate	5.70	6.30
Expected return on scheme assets	5.46	5.17
Future salary increases	n/a	n/a
Rate of increase in pensions in payment	3.80	3.30
Rate of increase of deferred pensions	3.50	2.85
Post retirement mortality	PNXA2000 birth year tables with medium cohort and underpin 1.5%/1.0% for males/ females	PNXA2000 birth year tables with medium cohort and underpin 1.5%/1.0% for males/ females

The expected return on assets is derived from the assumptions of long term expected returns on each asset class. These are shown below:

	2009 %	2008 %
Equities	n/a	7.50
Bonds	5.40	4.40
Cash	4.40	4.40
Annuity policies	5.70	6.30

## 15. Pensions *continued*

Historical pension scheme information:

	2009 £000	2008 £000
Defined benefit liability	(26,899)	(25,035)
Scheme assets	31,164	30,273
Surplus	4,265	5,238
Experience adjustments on scheme liabilities	671	(316)
Experience adjustments on scheme assets	(891)	1,899

## 16. With-profits actuary

Mr G Beamer of OAC plc served as the With-profits Actuary through 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 £62,000 (2008: £97,000).

## 17. Transactions with related parties

The aggregate premiums payable for the year by 6 Directors and 5 other members of the Executive in respect of the Society's products amounted to £23,722 (2008 – £20,294).

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

## 18. Capital statement

### Available capital resources

	2009 £000	2008 £000
Fund for Future Appropriations	92,227	71,218
Adjustments to assets onto regulatory basis	76,034	21,857
Total available capital resources	168,261	93,075

### Analysis of liabilities

	2009 £000	2008 £000
Options and guarantees	28,141	40,979
Other policyholder obligations	472,472	454,130
Unit-linked business	90,179	64,671
Other life assurance business	56,793	62,082
Technical Provisions in Balance Sheet	647,585	621,862

## 18. Capital statement *continued*

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.

### Analysis of Movement

	2009 £000	2008 £000
Opening capital resources	93,075	197,339
Change in assumptions	–	–
Change in management policies	–	–
Change in regulatory requirements	–	–
New business and other factors	75,186	(104,264)
Closing capital resources	168,261	93,075

## 19. Operating lease commitments

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

	2009 £000	2008 £000
<b>Operating leases which expire</b>		
After five years	86	86





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