

Annual Report
& Accounts 2010



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Scottish Friendly's diversification strategy has continued to deliver growth despite the difficult environment.

Despite the slowdown in the economy, reduced consumer confidence and increased personal taxes, Scottish Friendly achieved growth in total group sales, core life and pensions sales and assets under management. 2010 witnessed a small reduction in members as the group continues to administer the run off of recently acquired older books of business.

Key Figures

Sales (APE)¹



2010 – £12.9m
2009 – £9.1m

¹ Annual Premium Equivalent

Sales – Core Life and Pensions (APE)



2010 – £11.4m
2009 – £7.6m

Assets under management



2010 – £805m
2009 – £752m

Number of members



2010 – 439,000
2009 – 465,000

Chairman's Statement



After the difficulties of 2008 and 2009, in particular the economic fallout of the banking crisis, many hoped that 2010 would prove to be a more stable year. Unfortunately challenges in the Eurozone economies put paid to these hopes and, despite a partial recovery in stock market levels, confidence remains weak.

Notwithstanding these difficulties, Scottish Friendly has weathered the financial storm well, with sales and assets under management and administration continuing to grow.

Even so, the group remains cautious about ongoing market conditions given the uncertainty over the UK and global economies, and continues to place faith in its 'diversification and growth' strategy.

Strategy

Scottish Friendly's three-part strategy has been in operation for five years. It is based on developing organic growth opportunities, working with business process outsourcing partners and identifying merger and consolidation partners in the life and friendly society sector. The group has consistently had significant success in each aspect, and the Board is confident that the current strategy remains appropriate as a means of building overall assets under management and administration, increasing the group's income stream and helping to reduce the impact of fixed costs.

The value of such diverse distribution is expected to increase significantly as the Retail Distribution Review comes into effect in 2012 with substantial ramifications for the Independent Financial Adviser sector.

Corporate recognition

Awareness of Scottish Friendly within the financial services arena increased in 2010. This is a direct result of media coverage arising from the group's success in sales of new business, as well as partnership and distribution developments. In the 2010 Business Insider Scotland's Top 500 Company league table, the group leapt to 68th place from 349th position the year before. Increased profile helps secure additional benefits for members through new growth and further partnerships in the future.

Scottish Friendly has a strong record for corporate responsibility and its members can take pride in the group's long-standing promotion of children's literacy in Scotland in partnership with Scottish Book Trust. In 2010 Scottish Friendly helped reach over 250,000 children through an innovative online initiative called Meet Our Authors. This state-of-the-art programme won the Arts & Business Scotland Young People Award in September 2010.

Corporate governance

Scottish Friendly firmly believes customers are at the heart of the business. The group fully supports the Financial Services Authority's (FSA) 'Treating Customers Fairly' (TCF) initiative. Examples of Scottish Friendly commitment to TCF in 2010 include the ongoing development of products aimed at specific customer groups following detailed focus group research.

It is expected that there will be an increasing focus on corporate governance by the FSA, particularly in respect of client asset protection. Looking after people's savings and investments is a significant responsibility which Scottish Friendly takes seriously. To this end the group has continued to invest in new resources with additional skilled staff and further development in technology.

Scottish Friendly plays an active role in the Association of Financial Mutuals which was launched in 2010 following the merger of the Association of Friendly Societies and the Association of Mutual Insurers.

The FSA is keen to ensure that the interests of with-profits members are protected. Scottish Friendly continues to work closely with other organisations in developing proposals in this area, with specific emphasis on mutual organisations. Importantly, while there has been a general decline in the amount of new with-profits business written across the life assurance industry, Scottish Friendly continues to write material volumes and this supports the strength of the fund for all members.

Solvency II is due to be fully implemented by the end of 2012 and is an important EU programme for insurers. Its aim is to deliver improved risk-based regulatory supervision of firms and to set capital requirements that better reflect the actual economic risks being taken. Scottish Friendly is well prepared for these changes.

In 2012 the FSA will be abolished and two new regulatory bodies will be formed: the Prudential Regulatory Authority and the Financial Conduct Authority. Scottish Friendly will be regulated by both bodies. While we welcome initiatives to address regulatory failings identified in the course of the banking crisis, we are concerned about the ever increasing cost of regulation. Although the details have yet to be confirmed, it is clear that the

combined cost of the two new regulators will be more expensive in total than the one being replaced; there will also inevitably be increased indirect costs for organisations such as Scottish Friendly required to support two separate bodies. This cost burden falls on the end consumer at a time when we in the UK need to be encouraging more people to make provision for their future financial needs. Scottish Friendly continues to try to support people in savings and protection products against this background of increasing costs by continually striving to maximise efficiencies and reduce the related charges, whilst actively lobbying the FSA and the Government for more support to encourage low cost savings.

Principal risks and uncertainties

Uncertainty continues in the UK and global financial markets. While investment markets have improved of late this is no guide to the future. In the UK, inflation is a constant threat, exacerbated by the rise in the rate of VAT at the start of 2011 and rising transport and energy costs. The full impact of public sector job cuts, due to be implemented, has still to be felt. Globally, there are concerns for the Euro and European sovereign debt and the wider effects this will have.

While the impact of economic uncertainty remains unclear, Scottish Friendly is cautious about the immediate future and management and investment decisions will continue to reflect that caution.

The Board

Barry Wood, Vice Chairman, has been a director of Scottish Friendly since 2001 and will retire at the forthcoming AGM. I have greatly appreciated his support and advice. We are delighted to welcome Simon Miller who joined the Board as a new non-executive director in June 2010 and as chair of the Investment Committee. Simon has many years of experience in the financial sector as executive director, non-executive director and chairman, in a range of financial organisations including private equity firms and investment trusts. His experience and counsel have already been a great asset to the Board.

Scottish Friendly's people

Scottish Friendly's business has increased and staff numbers have risen to around 200 to facilitate the group's growth in assets and new business. Investment in the skills and development of staff is important to maintain high levels of customer service. I should like to thank the management team and staff of Scottish Friendly for their commitment to the interests of all members and customers.

Outlook

Thus far Scottish Friendly is emerging from the recent economic turbulence in a relatively strong position, but there are further difficulties ahead.

There is no doubt that 2011 will be a challenging year. With public sector cuts, recovery may be dependent on the ability of the private sector to create domestic jobs and grow exports. This will ultimately depend on whether sufficient business and consumer confidence can be maintained to encourage large companies to exploit investment and employment opportunities. A confident economy is vital for a flourishing savings and investment market.

I believe that Scottish Friendly's financial strength, strategy and the commitment of its staff place the group in a strong position to take advantage of an economic upturn. In the meantime, the group is actively seeking ways to promote the value of long-term savings habits with the general public. Savings and investments need to be made simple, trusted and popular.

Scottish Friendly's strategy remains consistent and I am confident that it will deliver long-term value to members and customers.

Finally I wish to offer my personal congratulations to the group's Chief Executive, Fiona McBain, for winning the Female Director of the Year and the Director of the Year (Glasgow & West of Scotland) at the recent Institute of Directors (Scotland) Awards. This reflects the achievements of Fiona as an individual and leader, and of all at Scottish Friendly.



Michael J Walker
Chairman
23 March 2011

Chief Executive's Review



2010 witnessed some improvement in the financial markets but saw continued fragility in the economy and in consumer and business confidence. Despite these conditions, Scottish Friendly delivered strong results, achieving sales in excess of forecast whilst constraining costs and increasing assets under management and administration. This was a period of continued economic and political uncertainty and these results demonstrate the tangible value of the group's strategy for diversification and growth.

With the current squeeze on public services, further pressures on international sovereign debt and the possibility of a double-dip recession, Scottish Friendly remains cautious for the future in both its business and investment outlooks. It is important therefore that we remain flexible and maximise opportunities whilst minimising risk wherever possible.

Strategic implementation

Organic growth

Scottish Friendly has developed its relationships with key partners including Phoenix group (previously Pearl), Royal London and Forces Financial, whilst forging new partnerships, such as that with the Eui Group, best known for its Admiral and elephant.co.uk brands. The group's e-business strategy made sound progress over 2010, with substantial growth in cost-effective sales of Scottish Friendly's core product range. Sales of single premium products also grew strongly in 2010.

Business process outsourcing

The Scottish Friendly wrap administration, launched in 2006, has been a significant success story for the group, with assets under administration now in excess of £3bn. Demonstrating confidence in the service Scottish Friendly provides, the partnership with Aviva expanded in 2010 with Scottish Friendly now also providing the contact centre for the Aviva wrap platform from Glasgow.

Mergers and consolidation

The transfer of business from the five acquisitions completed since 2006 has continued to make a positive contribution to the group.

A number of technical changes in the market, as well as the continuing slowdown in the economy, means it is likely other friendly societies and small life companies will seek partners over the next year. Where Scottish Friendly feels it is to the benefit of members, opportunities in this field will be explored.

Results

Scottish Friendly's flexible strategy for new business acquisition allowed the group to grow in 2010, even though the overall market for savings and investments declined.

Scottish Friendly has developed a diverse approach to sales, including selling via direct mail and advertising, e-business, partners and telephony as well as face-to-face. This flexibility enabled Scottish Friendly to comfortably exceed annual target whilst keeping costs under budget, resulting in a sharp reduction in the group's overall cost-to-sales ratio.

Core life and pensions sales were £11.4m APE (the industry standard measure of annual premium equivalent – regular premiums plus one tenth of single premiums); the corresponding amount in 2009 was £7.6m – an increase of 50% in 2010. This reflects strong sales of the Scottish Friendly onshore bond plus continued growth through our partnership and e-commerce channels.

Total group sales were £12.9m (£9.1m in 2009).

Total gross premium income was £119m (£91m in 2009). This increase reflects the strong sales performance during the year through our diverse distribution channels, compensating for the 10-year natural maturity of Scottish Friendly policies and the scheduled 'run off' of books of business taken over from other providers.

The ratio of administrative expenses to premium income APE was 6.9% (2009: 7.2%) reflecting effective control over expenditure, notwithstanding increasing regulatory costs. Marketing expenditure has been reduced by developing lower cost routes to market; on sales of core products this has reduced the cost-to-sales ratio from 112.8% in 2009 to 84.8%.

Investment performance

The main with-profits fund continued to recover some of the ground lost in 2008, helped by continuing growth in the stock markets through 2009 and 2010. The return on the Scottish Friendly with-profits fund for 2010 was 11.3% (2009: 15.8%).

The continued recovery in asset values allowed a further uplift in final bonuses. At the end of 2010, we were again able to increase final bonuses, following the increase at the end of 2009.

Scottish Friendly's capital position remains sound and in excess of the regulatory requirements. The group continues to focus on a conservative balance sheet structure and robust risk management framework in order to maintain the strength of the capital position and to generate strong and diverse cash flows.

Focus on service

Scottish Friendly recognises that focusing on customer service provides a distinct competitive advantage and that an understanding of the evolving needs of customers during their lifetime is vital to the future success of the business. The group is active in continuing to get to know customers better in order to develop innovative products and services.

The results of the ABI Customer Impact Scheme, which independently compares customer service ratings with a number of participating competitors, are reported on page 14 of this report and in more detail on the group's website www.scottishfriendly.co.uk.

The partial recovery in final bonuses at the end of 2009 led, as expected, to an improvement in customer satisfaction in the course of 2010. Scottish Friendly strives to build on those areas where it has strong ratings and to learn from and improve upon any noted areas of concern.

The group will continue to focus on delivering good customer service while maintaining tight control over costs and ensuring that our administrative renewal expenses remain competitive.

Outlook

Scottish Friendly's outlook is cautious in 2011. The group aims to increase new business and assets under administration across a variety of channels including continuing to develop its partnership distribution network, with an emphasis on e-business.

The abolition of the Child Trust Fund will result in some loss of new business income to the group in 2011, but Scottish Friendly is not reliant on this relatively low-margin product. The group aims to compensate in part for this loss of business through the promotion of its Child Bond and further diversification of the product range. We will also continue to closely monitor Government policy on a 'Junior ISA'.

The UK and world economies in 2011 are, if anything, even more uncertain than 2010. In such times, the group's ability to be flexible and respond rapidly to changing circumstances will be more valuable than ever. The effectiveness of such an approach has served Scottish Friendly well for each of the past two difficult years, allowing the group to grow whilst others were contracting.

I noted last year the group's determination to emerge from this downturn in a stronger position and in 2010 we made important progress but I am not complacent about the future. I have no doubt that 2011 will present a number of difficulties but Scottish Friendly shall seek to make the most of the flexibility afforded by its strategy to continue to derive tangible value for members.

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
23 March 2011

Directors

MJ 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. Trustee of both the Scottish Friendly Assurance Society Limited Pension and Life Assurance Scheme and the Scottish Legal Life Assurance Scheme.

Dr BI 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 Turnkey Group Limited and a Director of Core Australia Pty Limited.

JW 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.

ML 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.

Executive

FC McBain MA, ACA

J Galbraith BSc, MBA, FFA

NE Lovatt ACII, BA, MSc (Dip)

I Neilson

J Wilson BSc, BEng, MSc

L Gilmore BA (Econ), ACA

SEC Miller

Appointed as a Director in June 2010. Chairman of the Investment Committee. Currently Chairman of Dunedin Capital Partners Limited, which he joined in 1994, and has many years of financial services experience. Also Chairman of Artemis Alpha Trust, Amati VCT, JPMorgan Elect and a Non-Executive Director of Dunedin Enterprise Investment Trust and Brewin Dolphin Holdings.

FC McBain MA, ACA

Chief Executive

A chartered accountant with over 25 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. Member of the ABI Life Insurance Committee. 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

Head of IT

Head of Finance

Directors' Report

The Directors have pleasure in submitting their annual report and accounts for the year ended 31 December 2010. This report should be read in conjunction with the Chairman's Statement and the Chief Executive's Review on pages 2 to 5.

Business objectives and activities

The principal activity of the Scottish Friendly Assurance Society Limited (Scottish Friendly) 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 Scottish Friendly are believed to have been carried on within its powers.

Scottish Friendly 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 (collectively 'the Group'). 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 and the future outlook, including key performance indicators and 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 Scottish Friendly, including the Chief Executive, are listed on page 6. On 28 April 2010, GEF Johnston retired as a Non-Executive Director. SEC Miller was appointed as a Non-Executive Director on 1 June 2010 and will offer himself for election at the forthcoming Annual General Meeting.

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 Scottish Friendly's Head of Actuarial Function, Scottish Friendly 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 2010. Accordingly, the directors confirm that these accounts are prepared on a going concern basis.

Employees

Scottish Friendly 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, sexual orientation or disability. If employees become disabled during the period of employment, Scottish Friendly will endeavour to retrain or redeploy individuals to enable their employment to continue.

Scottish Friendly has an established system of communication utilising a clearly defined line management structure both to convey information concerning Scottish Friendly's performance to staff and to receive from staff input relative to Scottish Friendly and their part in its operation. Regular meetings are held by managerial staff for this purpose, reinforced by intranet updates, annual reports and other written communications. In addition, a Staff Committee acts as a mechanism through which matters, both formal and informal, can be communicated between staff and the Executive.

Policy on complaints by members

Scottish Friendly's complaints procedures, detailing the action to be taken in the event of a complaint being received from a member, are documented in Scottish Friendly's Memorandum and Rules, Complaints Manual and Compliance Manual. There is provision for an arbiter to be appointed. In the event that we are unable to resolve a complaint to the member's satisfaction, they are made aware of the option to refer to the Financial Ombudsman Service.

Policyholders and members

As at 31 December 2010, Scottish Friendly had 1,226,000 (2009: 1,256,000) policyholders and estimated the number of members to be 439,000 (2009: 465,000).

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 Scottish Friendly'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 Scottish Friendly'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 Scottish Friendly as at the end of the financial year and of the income and expenditure of the Group and of Scottish Friendly 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 Scottish Friendly 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 Scottish Friendly 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 Scottish Friendly's website. Legislation in the United Kingdom governing the preparation and dissemination of accounts may differ from legislation in other jurisdictions.

Having reviewed the financial position and the projections for the next 12 months, the directors believe that it is appropriate to continue to apply the going concern basis in preparing the financial statements.

Auditors

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

Corporate Governance

The Report on Corporate Governance set out on pages 9 to 11 is included in the directors' report by reference.

By order of the Directors



Fiona McBain
Chief Executive
23 March 2011

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 formally on 9 occasions in 2010; 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 MJ Walker, GEF Johnston, ML Berryman and SEC Miller on one occasion each. Board and Committee attendance are set out in the following table (figures in brackets are total meetings held):

	Board	Audit & Risk Committee	Remuneration Committee	Nomination Committee	Investment Committee
MJ Walker	8 (9)	–	2 (2)	2 (2)	2 (2)
BI Wood	9 (9)	4 (4)	2 (2)	2 (2)	–
JW Jack	9 (9)	4 (4)	–	–	–
ML Berryman	8 (9)	4 (4)	–	–	–
SEC Miller (from 1 June)	4 (5)	–	–	–	2 (2)
GEF Johnston (to 28 April)	3 (4)	2 (2)	2 (2)	2 (2)	–
FC McBain	9 (9)	–	–	–	2 (2)
J Galbraith	9 (9)	–	–	–	2 (2)

In addition, in November, the Non-Executive Directors met with Executive Management to review strategic objectives and 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.

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 2011.

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 Scottish Friendly's system of controls.

The operational risk register is reviewed by the Audit & Risk Committee at each meeting and was last reviewed in March 2011. 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 review was presented to the October 2010 Audit Committee along with the compliance plan for 2011.

The Board has overall responsibility for the 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 2010, 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.

BI Wood was appointed as the Senior Independent Director following Mr Johnston's retirement on 28 April 2010. Mr Wood has served over nine years, however the Board has concluded that he continues to bring independent judgement to his role. Accordingly, during 2010 the Board, excluding the Chairman, had a majority of independent Non-Executive Directors.

As Senior Independent Director, Mr Wood 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 and 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, Nomination and Investment – 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, Nomination and Investment 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 and 13.

Audit & Risk Committee

JW Jack (Chairman)
Dr BI Wood
ML Berryman
GEF Johnston (retired 28 April 2010)

This Committee consists entirely of Non-Executive Directors and is chaired by JW Jack.

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

During 2010 the Committee met on four occasions, with all members present, 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 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 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 professional and regulatory requirements and current best practice in order to maintain its independence.

Nomination Committee

MJ Walker (Chairman)
JW Jack
FC McBain
GEF Johnston (retired 28 April 2010)

During 2010 the Committee met on 2 occasions, 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.

Investment Committee

SEC Miller (Chairman)
MJ Walker
FC McBain
J Galbraith

The Investment Committee was established in 2010 to oversee Scottish Friendly's investment holdings and performance on behalf of the Board. The terms of reference of the Committee include making decisions on asset allocation and strategy of the Scottish Friendly funds in line with the liabilities, relevant risk appetite and parameters established by the Board or by the relevant fund objective, and also monitoring risk appetite, investment parameters and fund objectives, making recommendations to the Board as appropriate.

During 2010 the Committee met on two occasions, with all members present. Fund managers and investment advisors are routinely invited to present to the Committee. Prior to the formation of the Committee, matters covered by the terms of reference here, were routinely considered by the Board.

Directors' Remuneration Report

Remuneration Committee

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

Dr BI Wood (Chairman)
MJ Walker
GEF Johnston (retired 28 April 2010)

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 2 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 performance element which is targeted at increasing growth and cost efficiencies. Payments are capped at 30% of salary.

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, other than reimbursement of travel and accommodation costs for attending meetings.

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, subject to relevant legislation.

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	Performance Pay £000	Benefits ¹ £000	Total year ended 31 Dec 2010 £000	Total year ended 31 Dec 2009 £000
Chairman					
MJ Walker	46	–	4	50	45
Executive Directors					
FC McBain	283	57	9	349	346
J Galbraith	231	47	11	289	287
Non-Executive Directors					
ML Berryman	23	–	1	24	28
JW Jack	24	–	1	25	25
GEF Johnston ²	9	–	–	9	29
SEC Miller ³	16	–	–	16	–
Dr BI Wood ⁴	27	–	–	27	25

¹ For Executive Directors, benefits comprise the provision of a company car and healthcare insurance. Benefits for Non-Executive Directors comprise reimbursement of travel and accommodation costs for attending meetings.

² Retired 28 April 2010

³ Appointed 1 June 2010

⁴ Appointed as Vice-Chairman with effect from 28 April 2010

Pensions (audited)

	Accrued pension at 31 Dec 2010 ¹ £000	Increase in accrued pension during 2010 £000	Transfer value at 31 Dec 2009 ² £000	Transfer value at 31 Dec 2010 ² £000	Increase in transfer value less Director's contributions £000
Executive Directors					
FC McBain	58	5	710	903	190
J Galbraith	87	5	880	1,145	203

¹ Accrued pension represents the amount to which the Directors would have been entitled had they left service on 31 December 2010.

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

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 is the last year of the scheme, as currently constituted, however we intend to work closely with the ABI on other methods of consistently measuring customer satisfaction.

In 2009 the group's ratings fell largely as a result of concerns following plan payouts at one of the worst points of the recent economic turmoil. A change in the rating system between 2010 and 2009 means that it is not possible to make a direct comparison between the ratings for 2010 and 2009, however it is clear that our overall results have improved with the increase in plan payouts.

The Group was able to achieve results which were within 5% of the industry average for all the main Customer Impact ratings:

- Developing and promoting products and services – 74%
- Giving clear information at the point of sale – 91%
- Maintaining effective relationships between the customer and the organisation – 67%

Within the detailed questions of the report the group scored strongly in all aspects of service and written communications. However the survey did note that Scottish Friendly customers have concerns over the flexibility of our product range and that we need to improve our management of customers' expectations during periods of increased market volatility. Both of these concerns are being taken on board by the group and will be reflected in our new product development process and reviews of customer communications 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 (Scottish Friendly) for the year ended 31 December 2010 set out on pages 18 to 35. The financial reporting framework that has been applied in their preparation is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

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 Scottish Friendly 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 Scottish Friendly members, as a body, in accordance with section 73 of the Friendly Societies Act 1992 and, in respect of the separate opinion in relation to the Directors' Remuneration Report and reporting on corporate governance, on terms that have been agreed. Our audit work has been undertaken so that we might state to Scottish Friendly's members those matters we are required to state to them in an auditor's report and, in respect of the separate opinion in relation to the Directors' Remuneration Report and reporting on corporate governance, those matters that we have agreed to state to them in our report, and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than Scottish Friendly and Scottish Friendly'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 auditor

As explained more fully in the Statement of Responsibilities of the Directors set out on page 8, the Directors' are responsible for preparing financial statements which give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the APB's website at www.frc.org.uk/apb/scope/private.cfm.

Opinion on financial statements

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 Scottish Friendly as at 31 December 2010 and of the income and expenditure of the group and of Scottish Friendly for the year then ended; and
- have been properly prepared in accordance with the Friendly Societies Act 1992 and the regulations made under it.

Opinion on other matters prescribed by the Friendly Societies Act 1992 and under the terms of our engagement

In our opinion:

- the Report of the Directors 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 accounting records and the financial statements for the financial year.
- 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 Scottish Friendly.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters:

Under the Friendly Societies Act 1992 we are required to report to you if, in our opinion:

- proper accounting records have not been kept;
- the financial statements are not in agreement with the accounting records; or
- we have not received all the information and explanations and access to documents that we require for our audit.

In addition to our audit of the financial statements, the Directors have engaged us to review their Report on Corporate Governance as regards Scottish Friendly's compliance with the 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 (now jointly the Association of Financial Mutuals) ('the Annotated Code'). Under the terms of our engagement we are required to review whether the Report on Corporate Governance Statement reflects Scottish Friendly's compliance with the eight provisions of the Annotated Code specified for our review.



Simon Pashby (Senior Statutory Auditor)
for and on behalf of KPMG Audit Plc,
Statutory Auditor
Chartered Accountants
Glasgow

23 March 2011

Income and Expenditure

Technical Account – Long Term Business

For year ended 31 December

	Note	Group 2010 £000	Group 2009 £000	Scottish Friendly 2010 £000	Scottish Friendly 2009 £000
Earned Premiums	3	118,621	90,553	118,621	90,553
Reinsurance Premiums		(407)	(373)	(407)	(373)
Earned Premiums, Net of Reinsurance		118,214	90,180	118,214	90,180
Investment Income	4	29,677	25,924	34,182	28,769
Unrealised Gains on Investments		39,840	53,935	41,624	54,592
Other Technical Income		8,693	6,070	(704)	(1,764)
		196,424	176,109	193,316	171,777
Claims Incurred	5	126,422	108,294	126,422	108,294
Change in Other Technical Provisions	12	35,001	25,933	35,001	25,933
Net Operating Expenses					
Acquisition Costs	6	5,045	6,575	5,045	6,575
Administrative Expenses	7	9,158	7,885	9,158	7,885
Investment Expenses & Charges		50	44	50	44
Other Technical Charges		3,703	3,107	–	–
Tax attributable to Long Term Business	8	285	701	(48)	404
Actuarial loss re pension scheme		2,920	1,639	2,920	1,639
Transfer to the Fund for Future Appropriations	12	13,840	21,931	14,768	21,003
		196,424	176,109	193,316	171,777
Balance on the Technical Account – Long Term Business		–	–	–	–

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

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

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

Balance Sheet

Assets

As at 31 December

	Note	Group 2010 £000	Group 2009 £000	Scottish Friendly 2010 £000	Scottish Friendly 2009 £000
<i>Investments</i>	9				
Land & Buildings		4,215	4,215	4,215	4,215
Other Financial Investments		569,061	563,548	568,941	563,475
Investments in Group Undertakings		–	–	3,984	2,201
<i>Assets Held to Cover Linked Liabilities</i>	10	152,997	95,460	152,997	95,460
<i>Reinsurers' Share of Technical Provisions</i>					
Long Term Business Provision		6,695	6,857	6,695	6,857
<i>Debtors</i>					
Debtors arising out of Direct Insurance Operations		36	316	36	316
Taxation Recoverable		8,182	6,735	8,182	6,735
Deferred Taxation		–	223	–	83
Other Debtors		6,480	4,961	3,571	2,755
<i>Other Assets</i>					
Tangible Assets	11	899	465	899	465
Cash at Bank & in Hand		56,341	68,903	53,460	65,807
<i>Prepayments & Accrued Income</i>					
Accrued Interest, Dividends & Rents		1,687	1,659	1,687	1,659
<i>Pension scheme surplus</i>	15	–	1,760	–	1,760
		806,593	755,102	804,667	751,788

Liabilities

As at 31 December

<i>Fund for Future Appropriations</i>	12	106,989	93,155	106,989	92,227
<i>Technical Provisions</i>	12				
Long Term Business Provision		532,797	557,406	532,797	557,406
Claims Outstanding		11,856	9,506	11,856	9,506
<i>Technical Provision for Linked Liabilities</i>	12	149,627	90,179	149,627	90,179
<i>Provision for Other Risks & Charges</i>	13	6	95	6	95
<i>Creditors</i>					
Creditors arising out of Direct Insurance Operations		81	41	81	41
Other Creditors including Taxation & Social Security		2,769	3,416	840	1,030
Deferred Taxation		9	0	12	0
<i>Accruals and Deferred Income</i>		1,574	1,304	1,574	1,304
<i>Pension scheme deficit</i>	15	885	–	885	–
		806,593	755,102	804,667	751,788

Approved by the Directors and signed on 23 March 2011 on their behalf by:



MJ Walker
Chairman



FC McBain
Director and Chief Executive

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

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, Scottish Friendly 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 Scottish Friendly 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 include 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 Scottish Friendly 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 Scottish Friendly are valued in accordance with generally recognised methods of valuation. The aggregate unrealised surplus or deficit is included in the technical account.

It is Scottish Friendly'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 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

Scottish Friendly 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.

Scottish Friendly 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 Scottish Friendly's long term business provision.

In addition, following the transfer of engagements in 2007, Scottish Friendly 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 Scottish Friendly

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

	Ordinary Assurance		Industrial Assurance		Total	
	2010	2009	2010	2009	2010	2009
	£000	£000	£000	£000	£000	£000
Annual	58,630	64,026	2,276	2,528	60,906	66,554
Single	57,715	23,999	–	–	57,715	23,999
	116,345	88,025	2,276	2,528	118,621	90,553

Comprising:

Premiums from participating contracts	57,361	64,009
Premiums from non-participating contracts	2,182	2,171
Premiums from linked contracts	59,078	24,373
Gross Earned Premiums	118,621	90,553
Reinsurance Premiums	(407)	(373)
Earned Premiums, net of reinsurance	118,214	90,180

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

	Scottish Friendly 2010		Scottish Friendly 2009	
	Annual	Single	Annual	Single
	£000	£000	£000	£000
New business premiums	5,694	58,331	5,666	24,252

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

	Group		Scottish Friendly	
	2010	2009	2010	2009
	£000	£000	£000	£000
Annual contributions	5,646	2,264	–	–
Single contributions	4,500	4,249	–	–

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

4. Investment income

	Group		Scottish Friendly	
	2010 £000	2009 £000	2010 £000	2009 £000
Income from land & buildings	147	156	147	156
Income from other investments	23,945	26,264	28,450	29,109
Net gains/(losses) on the realisation of investments	5,637	(275)	5,637	(275)
Net (loss) on pension scheme under FRS 17	(52)	(221)	(52)	(221)
	29,677	25,924	34,182	28,769

5. Claims incurred

Group and Scottish Friendly

	Ordinary Assurance		Industrial Assurance		Total	
	2010 £000	2009 £000	2010 £000	2009 £000	2010 £000	2009 £000
Deaths	2,392	2,665	4,108	4,979	6,500	7,644
Maturities	89,414	69,006	4,188	5,022	93,602	74,028
Surrenders	24,827	25,056	1,198	1,362	26,025	26,418
	116,633	96,727	9,494	11,363	126,127	108,090
Claims handling expenses					295	204
					126,422	108,294

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 £33,000 (2009: £26,000).

6. Acquisition costs

Group and Scottish Friendly

The total amount of commission payable, comprising acquisition and renewal commission for direct insurance business in the year was £1,048,000 (2009: £1,497,000).

7. Administrative expenses

Group and Scottish Friendly

Staff numbers and costs

The average number of persons, excluding directors, employed by Scottish Friendly during the year was 189 (2009: 152). The aggregate payroll costs of these persons were as follows:

	2010 £000	2009 £000
Wages and salaries	4,333	3,971
Social security costs	402	359
Other pension costs	347	195
	5,082	4,525

Remuneration of Directors

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

Remuneration of Auditors

	2010 £000	2009 £000
Fees payable to the auditor for audit of annual accounts	66	64
Fees payable to the auditor for other services:		
The audit of subsidiary companies pursuant to legislation	11	11
Other services pursuant to legislation	25	24
Other services	15	–
Fees in respect of the Scottish Friendly Pension & Life Assurance Scheme audit	3	3

8. Taxation

	Group		Scottish Friendly	
	2010 £000	2009 £000	2010 £000	2009 £000
Corporation Tax and irrecoverable income tax	201	848	6	411
Adjustment in respect of previous years	(54)	(7)	(54)	(7)
Deferred tax charge (credit)	138	(140)	–	–
	285	701	(48)	404

There is a deferred tax liability of £12,000 attributable to assets held to cover linked liabilities.

At group level, Scottish Friendly Asset Managers Limited has recognised a deferred tax asset of £3,000 (2009: £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.

Scottish Friendly also has an unrecognised deferred tax asset of £10,808,000 (2009: £4,507,000) with regards to carried forward excess management expenses, unrealised capital losses and other items, that is not considered likely to be recoverable.

9. Investments

Group and Scottish Friendly

	2010 £000	2009 £000
<i>Land and buildings</i>		
At 1 January	4,215	5,750
Revaluation	–	(1,535)
At 31 December	4,215	4,215

As at 31 December 2010, land and buildings occupied by Scottish Friendly for its own use are included at Director's valuation on an open market value basis. Land and buildings were independently valued as at 31 December 2009 by GVA Grimley at existing use value, for those parts of the property occupied by Scottish Friendly, and market value for the remainder. The valuation was carried out in accordance with the RICS Valuation Standards. 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 2010 was £5,003,000 (2009: £5,003,000).

Group

Other financial investments

	2010 Market Value £000	2010 Historical Cost £000	2009 Market Value £000	2009 Historical Cost £000
Shares and other variable-yield securities and units in unit trusts:				
UK Listed Investments	1,121	2,965	1,124	2,965
Overseas	1,785	4,026	1,352	3,500
Unit Trusts and OEIC	555,414	450,391	543,511	483,503
Other Fixed Income Securities	10,455	10,524	17,124	16,658
Loans secured by Mortgages	220	220	350	350
Loans secured by Insurance Policies	66	66	87	87
	569,061	468,192	563,548	507,063

Scottish Friendly

	2010 Market Value £000	2010 Historical Cost £000	2009 Market Value £000	2009 Historical Cost £000
Shares and other variable-yield securities and units in unit trusts:				
UK Listed Investments	1,121	2,965	1,124	2,965
Overseas	1,785	4,026	1,352	3,500
Unit Trusts and OEIC	555,294	450,322	543,438	483,453
Other Fixed Income Securities	10,455	10,524	17,124	16,658
Loans secured by Mortgages	220	220	350	350
Loans secured by Insurance Policies	66	66	87	87
	568,941	468,123	563,475	507,013

9. Investments *continued*

Investments in Group undertakings

Scottish Friendly

	2010 Net asset Value £000	2010 Historical Cost £000	2009 Net asset Value £000	2009 Historical Cost £000
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Scottish Friendly Asset Managers Limited	1,593	1,600	1,240	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	2,343	600	1,848	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	47	–	40	–
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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 Scottish Friendly

	2010 £000	2009 £000
Market value of assets held to cover linked liabilities	152,997	95,460
Historical cost of assets held to cover linked liabilities	132,025	84,594

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 Scottish Friendly'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 Scottish Friendly

	Computer equipment £000	Motor vehicles £000	Fixtures & fittings £000	Total £000
<i>Cost</i>				
At 1 January 2010	1,815	120	590	2,525
Additions	236	27	440	703
Disposals	(11)	(24)	–	(35)
At 31 December 2010	2,040	123	1,030	3,193
<i>Depreciation</i>				
At 1 January 2010	1,566	95	399	2,060
Charge for year	177	15	77	269
On disposals	(11)	(24)	–	(35)
At 31 December 2010	1,732	86	476	2,294
Net Book Value at 31 December 2010	308	37	554	899
Net Book Value at 31 December 2009	249	25	191	465

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 2010	93,155	557,406	9,506	90,179	750,246
Change in other technical provisions		(24,447)		59,448	35,001
Movement in provision for outstanding claims			2,350		2,350
Transfer from technical account	13,840				13,840
Exchange rate adjustment	(6)				(6)
Change in reinsurers' share of long term business provision		(162)			(162)
At 31 December 2010	106,989	532,797	11,856	149,627	801,269

Scottish Friendly

	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 2010	92,227	557,406	9,506	90,179	749,318
Change in other technical provisions		(24,449)		59,448	35,001
Movement in provision for outstanding claims			2,350		2,350
Transfer from technical account	14,768				14,768
Exchange rate adjustment	(6)				(6)
Change in reinsurers' share of long term business provision		(162)			(162)
At 31 December 2010	106,989	532,797	11,856	149,627	801,269

The principal assumption 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 deficit of £885,000.

13. Provisions for other risks and charges

Pension review

	2010 £000	2009 £000
As 1 January	95	167
Provision released in year	(89)	–
Utilised in period	–	(72)
At 31 December	6	95

14. Costs of bonuses

Group and Scottish Friendly

Total bonuses attributable to the year are as follows:

	2010 £000	2009 £000
Year end reversionary bonus declared (included in change in other technical provisions)	2,442	2,004
Reversionary and terminal bonuses paid (included in claims)	15,729	4,361
Total bonuses dealt with in the technical account	18,171	6,365

15. Pensions

Group and Scottish Friendly

Money purchase Group personal pension scheme

Scottish Friendly operates a money purchase group personal pension scheme. For the year ended 31 December 2010, the charge included in the technical account relating to the employer's contributions to this scheme was £172,000 (2009: £143,000). 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

Scottish Friendly 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 given to pensions in payment but makes no allowance for future discretionary increases.

Scottish Friendly expects to contribute £223,000 to the Scheme during the year to 31 December 2011 in respect of retirement benefits for the active members.

The principal assumptions used to calculate Scheme liabilities include:

	2010 %	2009 %
Discount rate	5.4	5.7
Inflation	3.5	3.5
Revaluation in deferment (CPI)	3.0	3.5
Rate of increase in salaries	5.5	5.5
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% females

15. Pensions *continued*

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

	2010	2009
Males currently aged 45	26.2	26.0
Females currently aged 45	26.7	26.6
Males currently aged 65	23.1	23.0
Females currently aged 65	24.8	24.7

The assets of the Scheme are secured by means of an insurance policy with Scottish Friendly. 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 2010	5.40	9,641
31 December 2009	5.70	8,924
31 December 2008	6.30	7,368

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

	2010 £000	2009 £000
Current service cost (including expenses and life assurance)	197	132
Past service cost	110	52
Total operating charge (included in Administrative expenses)	307	184

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.

	2010 £000	2009 £000	2008 £000	2007 £000	2006 £000
Experience gains/(losses) on Scheme liabilities	170	71	176	(94)	(255)
Changes in assumptions used to value Scheme liabilities	(522)	(1,430)	899	784	135
Experience adjustments on Scheme assets	352	1,359	(1,075)	(690)	120

15. Pensions *continued*

The Scottish Legal Life Pension Scheme

Following the transfer of Scottish Legal Life, Scottish Friendly 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 Scottish Friendly, being invested in Managed Fund contracts as well as annuity policies to back the UK pensioner and UK deferred member liabilities. 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 2010 by a qualified independent actuary. The Scheme is closed to new entrants. Scheme assets are stated at their market value at 31 December 2010 and the present value of the Scheme liabilities has been calculated at the same date.

The amounts recognised in the balances sheet are as follows:

	2010 £000	2009 £000
Fair value of scheme assets	26,321	31,164
Present value of funded liabilities	(27,206)	(26,899)
(Deficit)/surplus	(885)	4,265
Restriction on recognition of surplus	–	(2,438)
Recognised (deficit)/surplus	(885)	1,827
Related deferred tax liability	–	(64)
Net (deficit)/surplus	(885)	1,763

The amounts recognised in the technical account are as follows:

	2010 £000	2009 £000
Interest cost	1,483	1,530
Expected return on scheme assets	(1,662)	(1,576)
Scheme expenses	231	267
	52	221
Actuarial (losses)/gains	(5,358)	(2,727)
Effect of the restriction on recognition of surplus	2,438	1,088
Total	(2,920)	(1,639)

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

	2010 £000	2009 £000
Opening defined benefit liability	26,899	25,035
Interest cost	1,483	1,530
Actuarial losses/(gains)	570	1,836
Benefits paid	(1,746)	(1,502)
	27,206	26,899

15. Pensions *continued*

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

	2010 £000	2009 £000
Opening fair value of scheme assets	31,164	30,273
Expected return	1,662	1,576
Actuarial losses	(4,788)	(891)
Contributions by employer	260	1,975
Scheme expenses	(231)	(267)
Benefits paid	(1,746)	(1,502)
	26,321	31,164

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

	2010 %	2009 %
Bonds	36.9	65.7
Cash	0.0	3.1
Annuity policies	63.1	31.2

Disclosure of principal assumptions

	2010 %	2009 %
Discount rate	5.40	5.70
Expected return on scheme assets	5.03	5.46
Future salary increases	n/a	n/a
Rate of increase in pensions in payment	3.80	3.80
Rate of increase of deferred pensions	3.50	3.50
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:

	2010 %	2009 %
Bonds	4.40	5.40
Cash	4.40	4.40
Annuity policies	5.40	5.70

15. Pensions *continued*

Historical pension scheme information:

	2010 £000	2009 £000
Defined benefit liability	(27,206)	(26,899)
Scheme assets	26,321	31,164
Surplus	(885)	4,265
Experience adjustments on scheme liabilities	328	671
Experience adjustments on scheme assets	(4,788)	(891)

16. With-profits actuary

Mr G Beamer of OAC plc served as the With-profits Actuary from 1st January 2010 to 14th March 2010. Mr DJ Lechmere of OAC plc served the remainder of the financial year from 15th March 2010. The following information has been provided in response to a request made by Scottish Friendly as required by section 77 of the Friendly Societies Act 1992.

Mr Beamer and Mr Lechmere have confirmed that neither they nor their families were members of Scottish Friendly, nor had they any financial or pecuniary interest in Scottish Friendly, with the exception of fees paid to OAC plc for professional services which amounted to £97,475 (2009: £62,000).

17. Transactions with related parties

The aggregate premiums payable for the year by six Directors and five other members of the Executive in respect of Scottish Friendly's products amounted to £26,974 (2009: £23,722).

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

18. Capital statement

Available capital resources

	2010 £000	2009 £000
Fund for Future Appropriations	106,989	92,227
Adjustments to assets onto regulatory basis	96,230	76,034
Total available capital resources	203,219	168,261

Analysis of liabilities

	2010 £000	2009 £000
Options and guarantees	23,719	28,141
Other policyholder obligations	455,023	472,472
Unit-linked business	149,627	90,179
Other life assurance business	54,055	56,793
Technical Provisions in Balance Sheet	682,424	647,585

18. Capital statement *continued*

Scottish Friendly 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.

Scottish Friendly 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

	2010 £000	2009 £000
Opening capital resources	168,261	93,075
Change in assumptions	19,228	–
Change in management policies	(459)	–
Change in regulatory requirements	–	–
New business and other factors	16,189	75,186
Closing capital resources	203,219	168,261

19. Operating lease commitments

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

	2010 £000	2009 £000
Operating leases which expire		
After five years	220	86

20. Capital commitments

There were outstanding capital commitments of £1.7m (2009: £1.8m) in respect of investments at the end of the year (representing €2m in both periods).



Head Office: Scottish Friendly Assurance Society Limited

Scottish Friendly House, 16 Blythswood Square, Glasgow G2 4HJ. Telephone: 08456 00 54 33
Fax: 0141 221 4864. Email: enquiries@scottishfriendly.co.uk Web: www.scottishfriendly.co.uk

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