Annual Report and Accounts 2016

Scottish Friendly

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2016 Financial Highlights

Scottish Friendly, Scotland's largest, and one of the UK's leading financial mutuals, enjoyed a highly successful 2016 with record levels of sales.

As a mutual, we reinvest profits back into our business as we are not driven by shareholder dividend needs. This helps us concentrate on improving products and services for members. We have been able to increase bonuses on with-profits policies from 31 December 2016.

Sales grew strongly in 2016 following what had itself been a record year in 2015, achieving the greatest results in Scottish Friendly's history. Whilst the main driver was sales of life protection through our partnerships, growth was also realised across our own branded product range.

These results are possible because we offer simple and effective products and services to our customers, helping secure the future for their families through saving, investing and protecting.

With the doubling of Scottish Friendly's assets under management to over £2.5 billion following our takeover of M&GM Assurance in 2015, assets grew to a record £2.9 billion in 2016, mainly on the back of a strong stock market in the second half of the year.

The global economic outlook is particularly uncertain in 2017 with political change underway in Europe and the US, but at Scottish Friendly we fully expect that our long term strategy and flexibility will let us successfully navigate the challenges ahead.

Sales (APE)[1]

£33.9m

The shaded section at the right of each of the bars refers to protection business sales with the remainder relating to Savings and other business sales.

Assets under management[2]

£2.9bn

Number of members

513,000

Notes

[1] Annual Premium Equivalent, gross of reinsurance.
[2] Assets under management include assets in the Scottish Friendly Investment Funds ICVC.

Chairman's Statement

Michael Walker
Chairman

Strategy

I am very pleased to report that 2016 has been another year of good progress for Scottish Friendly in each of the three key parts of our Diversify and Grow strategy:

- Organic growth through the development of our product range and distribution channels;
- Business process outsourcing for partners, leveraging our efficiencies; and
- Seeking mergers and consolidation in the life sector.

The highlight of the year was a strong increase in sales, which came on top of a record year in 2015. The Group's assets under management also reached record levels on the back of a strong rise in global stock markets, particularly in the second half of 2016.

Sales from our protection business partners were primarily responsible for the substantial rise in sales in 2015 and our solid collaborations with major financial companies is testament to the investment we have made in our business process outsourcing solutions.

Scottish Friendly is committed to improving customer service and, after a period of bedding-in, we are pleased that the policies of former M&GM clients, who became part of Scottish Friendly in June 2015, have been fully integrated into our operations.

The 2016 EU membership referendum outcome was unexpected and, at a minimum, the period before the UK leaves the EU is likely to be marked by economic, as well as political uncertainty. However, as I noted last year and in the past, Scottish Friendly has an established record of rapidly responding to political and economic change and we expect our flexibility to continue to serve our members well during this period.

The regulatory environment

Following their introduction in 2015, the main aspects of regulatory change during 2016 have been in relation to embedding the requirements of Solvency II and the subsequent introduction of the Senior Insurance Managers Regime (SIMR). The SIMR replaces the PRA's Approved Persons Regime and covers the assessment of fitness and propriety of senior insurance managers and directors, the allocation of key responsibilities and the application of relevant conduct rules to senior individuals.

Solvency II is the risk-based regulatory regime for insurance companies in the EU, affecting the way insurers' capital requirements are maintained and reported. The regime came into effect on 1 January 2016. Our risk management framework and internal reporting procedures have been designed to ensure compliance with the requirements of Solvency II.

Scottish Friendly has further enhanced its position as one of the UK's leading and progressive financial mutuals with another year of robust growth.

Our sustained growth and diversification enables us to create value for our customers and evidences the success of our long-term strategy.

Throughout 2016 the PRA continued to implement the requirements of SIMR. This new regulatory framework is designed to encourage individual accountability for decision making in Solvency II firms. A new whistleblowing regime was introduced alongside a new set of conduct rules that apply to senior managers with responsibilities for key business activities. Scottish Friendly has provided the PRA with details of the scope of responsibilities of these senior managers.

Scottish Friendly has continued to monitor closely all regulatory developments and make appropriate changes and enhancements to ensure that it complies with all relevant requirements.

Corporate governance

Scottish Friendly subscribes to the UK Corporate Governance Code, annotated for Mutual Insurers, in order to ensure compliance with all principles of strong corporate governance and to evidence this effectively. Our governance structure continues to respond to developments in best practice and regulatory changes such as those mentioned above. The corporate governance structure reflects the importance the Board attaches to its wider responsibilities to customers and members. Specific details are included in the Report on Corporate Governance on pages 9 to 14 of this Annual Report.

We have maintained our ISO 27001 and ISO 22301 certifications, the International Standards for Information Security Management and Business Continuity Management respectively, further examples of our commitment to best practice and to continuing improvement of our key processes wherever possible.

We play an active role in the Association of Financial Mutuals and support its governance standards, promoting the interests of our members and helping to sustain the value of mutuality in the UK.

Corporate social responsibility

Our sponsorship of the Scottish Friendly Children's Book Trust has now entered its twentieth year. The programme promotes literacy for young people throughout the UK, particularly in areas of social deprivation and geographically remote regions. In 2017 the Scottish Friendly Children's Book Tour will extend its reach even further by undertaking a first-ever tour in Northern Ireland. The tour is consistently enthusiastically received, attracting widespread media coverage.

Corporate recognition

Expanding our media profile has been a key objective for Scottish Friendly over the past few years. A strong profile highlights our credentials as a UK-wide organisation, while supporting our marketing and sales efforts in organic growth and promotes business process outsourcing as well as mergers and consolidation bids. Our quarterly Disposable Income Index nationwide survey continued to gain traction in the economic and personal finance sections of the national media. In particular in 2016, Scottish Friendly offered proactive support in principle for the forthcoming Lifetime ISA and also expressed concerns over its limitations. This gave rise to coverage in newspaper, online and broadcast media, in addition to Scottish Friendly giving evidence in person at a Westminster parliamentary committee.

The Board

2016 has been a time of planned change in the management at Scottish Friendly.

Fiona McBain, our Chief Executive for the last 11 years, and with a total of 18 years' service with Scottish Friendly, stepped down at the end of 2016. On behalf of the Board, I thank her for her outstanding stewardship of Scottish Friendly during an era marked by dramatic change for the financial services industry. Fiona, together with Deputy Chief Executive Jim Galbraith, was instrumental in modernising Scottish Friendly with a strategic vision that continues to serve the Group well. We wish Fiona well in all her future new ventures and challenges.

I am very pleased to welcome Jim Galbraith as Chief Executive. As Deputy Chief Executive of Scottish Friendly since 2009, and with 28 years' senior management service with Scottish Friendly, Jim has been integral to the Group's success. The Board has every confidence in Jim Galbraith and his team.

Furthermore I am pleased to welcome Neil Lovatt to the Board as Scottish Friendly's Commercial Director. Over the past decade Neil has been a key player in Scottish Friendly's outstanding success as Scottish Friendly's Sales and Marketing Director which has seen the Group evolve from a direct marketing operation to a multi-channel distributor and manufacturer of innovative financial products for leading UK brands.

Succession planning is one of the most important duties for any Chairman and Board and these internal appointments emphasise the pipeline of talent that has been developed at Scottish Friendly. It will continue to be a focus for the business.

Scottish Friendly's people

On behalf of the Board, I would like to recognise the contribution made by our employees. It is their commitment and endeavour that makes possible the delivery of Scottish Friendly's strategy. With their continued dedication to meeting the needs of our customers, I am certain that we can look to the future with confidence.

Chief Executive's Review

Jim Galbraith
Chief Executive

In this, my first review as Chief Executive of Scottish Friendly, I am pleased to report a first-class performance in 2016. Our strategy continues to serve us well, focusing on our three long-term objectives as set out below.

We have continued along our growth path with another year of record sales and assets under management.

Recognising that development in new technologies brings fresh opportunities to improve service and to lower costs, Scottish Friendly has invested in upgrading the IT infrastructure ensuring our members continue to benefit from the innovation this brings.

Scottish Friendly's strategy

Organic growth
Scottish Friendly's e-business and direct marketing figures in 2016 surpassed those of 2015 as we continued to drive sales through a 'website first' strategy.

The flexibility and innovation of Scottish Friendly's My Plans platform has positioned Scottish Friendly well for the launch of the Lifetime ISA (LISA) in April 2017. While this new investment has not been welcomed with open arms across the industry, Scottish Friendly has supported its introduction, believing the Lifetime ISA offers the potential to get people to save for retirement; particularly young people who have not engaged with the concept of 'pensions'.

We do recognise the Lifetime ISA's inflexibility – especially in the first year. We will therefore be introducing an innovative and unique ISA to LISA feeder concept to maximise flexibility and optionality, whilst ensuring clients continue to receive the maximum benefit of the associated tax relief.

Partnerships and business process outsourcing
Scottish Friendly's substantial circle of corporate partnerships, including leading brands such as Beagle Street and Smart Insurance, were the driving force behind Scottish Friendly's exceptionally strong results in 2016 and we are confident this trend will continue.

Scottish Friendly's investment in quality products, technology and customer service has attracted key business partners, and we in turn help them to build their business. We continue to invest in our product and service offerings to meet the needs of our partners' clients and to attract new partners.

Scottish Friendly achieved record results again in 2016, marking a further year of growth and demonstrating the progress that a modern, well-run and dynamic financial mutual can make.

Mergers and consolidation

The addition of transfers of engagements from other firms is a key component of our strategy that produces long term economies of scale. The seven transfers of engagements completed since 2006 continues to make a positive contribution to each set of policyholders.

Scottish Friendly's biggest takeover to date was that of M&GM in June 2015. Bedding in a substantial merger is a significant undertaking and whilst this was not without difficulties initially, during 2016 the group developed its offering to M&GM customers to ensure a high quality of service, fully integrated with our existing back office while increasing our head-count only modestly.

Results

Scottish Friendly delivered record results in 2016. Total sales increased by 33% to £33.9 million APE (the industry standard measure of annual premium equivalent – regular premiums plus one tenth of single premiums); the corresponding amount in 2015 was £25.5 million. Of this, protection sales were £21.5 million (2015: £14.7 million) and savings and investments amounted to £12.4 million (2015: £10.8 million). Statutory earned premiums increased to £75.7 million (2015: £70.9 million). Our overall acquisition cost-to-sales ratio decreased to 44% (2015: 55%) as a consequence of continuous efficiencies as the business grows.

Net premium income from insurance contract increased to £58.6 million from £55.4 million in 2015 and premiums earned on investment contracts increased to £20.6 million from £14.9 million. The ratio of administration expenses to total premium income APE was 8.9% (2015: 8.6%).

Scottish Friendly membership grew in 2016 to 513,000 (2015: 490,000). Scottish Friendly administers over one million policies across more than 150 product lines.

Investment performance

The return of the asset shares within the Scottish Friendly with-profits fund for 2016 was 14.5% (2015: 2.3%), reflecting a year where markets rose considerably, particularly in the second half of the year following the referendum outcome for the UK to leave the EU which boosted the UK stock market. This had the impact of boosting final bonus rates for most with-profits customers as at 31 December. Scottish Friendly assets under management rose to £2,868 million (2015: £2,660 million).

Scottish Friendly's capital position remains strong and is significantly in excess of the regulatory requirements. We continue to concentrate on a conservative balance sheet structure and robust risk management framework in order to preserve the capital position and diverse cash flows, allowing us to take advantage of future opportunities.

Scottish Friendly's Fund for Future Appropriations has increased from £147.6 million to £158.2 million. The Fund for Future Appropriations represents funds that have not been allocated to specific policyholders and free assets.

Outlook

For the last 30 years the liberal consensus around free trade and free movement has been the engine for aggregate economic growth. In the last few years it has become more apparent than ever that the rewards of this policy were not being distributed equitably amongst the electorate.

That tension has manifested itself in movements from Brexit and calls for a new Scottish independence referendum through to the election of the new president in the USA. It is therefore likely that the forces driving change will be very different over the next few decades, with an uncertain path towards protectionism perhaps the most likely.

Scottish Friendly has consistently proved its ability over recent years to respond positively in times of political and economic change. We are confident that Scottish Friendly's successes in 2016 position us favourably to respond to future challenges. In line with our proven strategy, we shall carry on seeking out opportunities that will benefit our members and partners, offering quality products and service.

The record results in 2016 and the tremendous progress made by Scottish Friendly over the past decade to become Scotland's largest financial mutual are a testament to the strategy forged in large part by my predecessor Fiona McBain. I look forward to working with Scottish Friendly's dedicated and professional management and staff to build and expand upon that progress.

Directors

Michael 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, Investment Committee and Risk Committee. Director of the Scottish Friendly Assurance subsidiary companies Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited, S.L. Insurance Services Limited, SFIS (Nominees) Limited, M&GM and MGM Assurance (Trustees) Limited. Former Chairman of legal firm Maclay Murray & Spens. Non-Executive Chairman of Walkers Shortbread Limited.

Simon EC Miller

Appointed as a Director in June 2010. Chairman of the Investment Committee and member of the Remuneration Committee. He has many years of experience in the financial services sector. He is Chairman of Brewin Dolphin Holdings, Blackrock North American Income Trust and JP Morgan Global Convertibles Income Fund. Member of STV Board.

Dermot J Jenkinson

Vice-Chairman and Senior Independent Director

Appointed as a Director in November 2011. Member of the Audit Committee and of the Nomination Committee. Appointed Vice Chairman and Senior Independent Director in April 2015. Over 30 years' commercial executive and non-executive experience in developing and managing a wide range of businesses in the UK, USA and EU, covering services, distribution, corporate finance and advice. Scottish Entrepreneur of the Year 2009. Currently Non-Executive Director of John Menzies plc and other private companies and Executive Chairman of Ascensos Limited.

David C Huntley BA, FIA

Appointed as a Director in January 2013. Chairman of the Remuneration Committee and the Risk Committee. Member of the Audit Committee. With over 30 years of experience across the life and pensions industry as well as in consulting and executive business coaching, has held senior positions in a number of businesses including Managing Director of Pearl Life Division and CEO of Swiss Re Life and Health Australia. Non-Executive Director of FIL Life Insurance Limited, and FIL Life (Ireland) Limited. Member of Board of Loughborough Building Society.

Kerr Luscombe BSc, FFA

Appointed as a Director in June 2015. Chairman of the Audit Committee and member of the Risk Committee and Remuneration Committee. Fellow of the Faculty of Actuaries with extensive experience at Board level in the life insurance industry. Previously a director of Royal London Group and also held finance directorships at both Lloyds Banking Group's and Santander's life insurance businesses. Currently also a Non-Executive Director of Clyde Valley Housing Association and Independent Member of the With Profits Committees at Aegon UK and Phoenix Group.

Fiona C McBain MA, ACA

Chief Executive until 31 December 2016

Appointed as a Director in April 2005 and as Chief Executive in January 2006. A chartered accountant with over 30 years' experience in the financial services sector. Joined Scottish Friendly in 1998. Member of the Nomination Committee, Investment Committee and Risk Committee. Director of the Scottish Friendly Assurance subsidiary companies Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited, S.L. Insurance Services Limited, SFIS (Nominees) Limited, M&GM and MGM Assurance (Trustees) Limited. Director of Scottish Mortgage Investment Trust PLC. Vice Chair of Save the Children, UK and Director of its subsidiary, Humanitarian Leadership Academy.

Jim Galbraith BSc, MBA, FFA

Chief Executive from 1 January 2017 (previously Deputy Chief Executive)

Appointed as a Director in April 2006. A qualified actuary with over 30 years' experience in the life insurance industry. Joined Scottish Friendly in 1988. Member of the Nomination Committee, Investment Committee and Risk Committee. Director of the Scottish Friendly Assurance subsidiary companies Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited, S.L. Insurance Services Limited, SFIS (Nominees) Limited, M&GM and MGM Assurance (Trustees) Limited. Trustee of the MGM Assurance Staff Pension Plan.

Neil E Lovatt BA (Hons), MSc(Dip), ACII

Commercial Director

Appointed as a Director in January 2017. A marketing professional with over 20 years' experience in the life, pensions and investments industry, including senior positions at Scottish Life and Royal London. Joined Scottish Friendly in June 2006.

Executive

FC McBain MA, ACA	Chief Executive (until December 2016)
J Galbraith BSc, MBA, FFA	Deputy Chief Executive (until December 2016)
NE Lovatt ACII, BA, Msc (Dip)	Commercial Director
M Pringle BSc, FCA	Finance Director and Company Secretary
D Macleod MSci, BAcc, FFA	Head of Actuarial
I Neilson	Head of Client Services
G Hardie MBCS, CITP	Head of IT
M Selves FCCA	Head of Risk

Directors' Report

The Directors have pleasure in submitting their Annual Report and Accounts for the year ended 31 December 2016. This report should be read in conjunction with the Strategic Report on pages 1 to 5.

Business objectives and activities

The principal activity of 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 is authorised by the Prudential Regulatory Authority and regulated by the Financial Conduct Authority and the Prudential Regulatory Authority. It has six wholly owned subsidiaries, (collectively with Scottish Friendly "the Group"): Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited, S.L. Insurance Services Limited, SFIS (Nominees) Limited, M&GM and MGM Assurance (Trustees) Limited. Scottish Friendly Asset Managers Limited is authorised and regulated by the Financial Conduct Authority and conducts the business of managers for transactions in Scottish Friendly ISAs, JISAs and Child Trust Funds. The principal activity of Scottish Friendly Insurance Services Limited is the provision of administration services and it is authorised and regulated by the Financial Conduct Authority. S.L. Insurance Services Limited conducts the business of agents for the transaction of general branch insurance. SFIS (Nominees) Limited is currently dormant. M&GM is currently dormant and MGM Assurance (Trustees) Limited is the trustee entity for the oversight of certain closed pensions schemes.

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, other than M&GM and MGM Assurance (Trustees) Limited which are registered in England.

Business review

A review of the performance of the business during the year and the future outlook, including key performance indicators is included in the Strategic Report on pages 1 to 5.

Directors and Chief Executive

The current Directors of Scottish Friendly, including the Chief Executive, are listed on page 6.

Further information on the Board is set out in the Report on Corporate Governance on pages 9 to 14.

Statement of solvency

In the opinion of Scottish Friendly's Chief Actuary, Scottish Friendly had the required margin of solvency as prescribed on the new Solvency II regulatory requirements as at 31 December 2016 and throughout the year.

Going concern basis

The Board is satisfied that it is appropriate for Scottish Friendly to draw up financial statements on the going concern basis. The Board considers that Scottish Friendly has adequate resources to continue in business for the foreseeable future. In making this assessment the Board has considered the above statement of solvency from the Actuarial Function Holder, which is further supported by actuarial valuation and market scenario reporting made to the Board on a regular basis, including the Own Risk and Solvency Assessment (ORSA). It is also noted that the Group maintains substantial cash reserves to cover anticipated policy outflows and further contingency is available in that the majority of the investments on both Balance Sheets are held in readily realisable unit funds.

Viability statement

The principal risks have been analysed and are disclosed in the Report on Corporate Governance, which also describes the sensitivity of the capital position to those risks.

The Risk Management Framework is integrated with the Solvency and Capital Management activity, in particular the ORSA. The ORSA requires Scottish Friendly to consider the risks arising from the agreed strategic priorities, how much capital is needed to protect the business against those risks in the context of the agreed risk appetite, and how resilient the Scottish Friendly business model is under stressed conditions. This analysis involves a range of projections of the capital position under a range of severe but plausible adverse stress and scenario tests covering a period of five years, Scottish Friendly's planning horizon.

Based on this robust assessment of the principal risks facing Scottish Friendly, the Directors have a reasonable expectation that Scottish Friendly will be able to continue in operation and meet its liabilities as they fall due over that five year period. The five year period reflects the Scottish Friendly planning cycle.

Tax strategy

Scottish Friendly has published its tax strategy on its website.

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.

Directors' Report
continued

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 and other written communications. In addition, a Staff Committee acts as a further mechanism through which matters, both formal and informal, can be communicated between staff and the Executive.

Policy on complaints by customers

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 Scottish Friendly is unable to resolve a complaint to the member's satisfaction, the member is made aware of the option to refer to the Financial Ombudsman Service.

Policyholders and members

As at 31 December 2016, Scottish Friendly had 1,201,000 (2015: 1,196,000) policyholders and estimated the number of members to be 513,000 (2015: 490,000).

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 or she ought to have taken as a Director to make himself or herself 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 Strategic Report, the Directors' Report, the Report on Corporate Governance 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 United Kingdom 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 of Scottish Friendly and enable them to ensure that the 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.

The Board confirms that, in its view, it has complied with the above requirements in preparing the Report and Accounts and that it considers the Report and Accounts, taken as a whole, are fair, balanced and understandable.

Auditors

In accordance with Scottish Friendly's Rules, Deloitte LLP offer themselves for annual re-appointment at the forthcoming Annual General Meeting.

The Strategic Report and Directors' Report are approved by order of the Directors.

M Pringle
Finance Director and Company Secretary

29 March 2017

Report on Corporate Governance

As a mutual organisation, Scottish Friendly is committed to maintaining accountability to its members. All members are represented by elected Delegates and the Board meets with the Delegates at least twice a year. In addition, members can raise points directly via the Member Relations function.

As a further part of that commitment to accountability, Scottish Friendly continues to embrace best practice in corporate governance and is committed to the principles of the Annotated United Kingdom Corporate Governance 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 guidance published by the Association of Financial Mutuals (AFM) in response to the Code, with explanations included where appropriate within this report.

Scottish Friendly is subject to the Senior Insurance Managers Regime (SIMR) introduced by the PRA and FCA to ensure greater individual accountability on specific individuals within an insurance business and to achieve greater clarity on governance structures. The Board is satisfied that the relevant reviews and revision of documentation, where appropriate, have been undertaken to ensure compliance with the SIMR.

The Board

The Board met formally on eight occasions in 2016. There is a schedule of regular reports which the Board considers and which is agreed at least annually. Reports are provided to Board members in advance of the meetings of the Board and Board Committee meetings. All Directors were present at the meetings except for apologies from the Chairman on two occasions for the Risk Committee and apologies from one Director on another occasion for a Board meeting. The Directors' attendance at Board and Committee meetings is set out in the table below (figures in brackets are the total number of meetings held during each Director's tenure). In addition to the Board meetings, the Non-Executive Directors met with Executive Management in November 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, business conduct, operational and risk matters, including:

- financial performance against budget, data and analysis relating to business volumes, and reports on investment strategy and performance;
- risk management, through the Risk Management Framework; (see Risk Management, below);
- actuarial matters including solvency and capital requirements;
- operational reports on customer service and staff matters; and
- business conduct information, including performance on the six outcomes of the Treating Customers Fairly initiative.

	Board meetings	Audit Committee	Risk Committee	Remuneration Committee	Investment Committee	Nomination Committee
Michael J Walker	9 (9)	–	4 (6)	2 (2)	4 (4)	2 (2)
Simon EC Miller	9 (9)	–	–	2 (2)	4 (4)	–
Dermot J Jenkinson	8 (9)	4 (4)	–	–	–	2 (2)
David C Huntley	9 (9)	4 (4)	6 (6)	2 (2)	–	–
Kerr Luscombe	9 (9)	4 (4)	6 (6)	2 (2)	–	–
Fiona C McBain	9 (9)	–	6 (6)	–	4 (4)	2 (2)
Jim Galbraith	9 (9)	–	–	–	4 (4)	–

Report on Corporate Governance
continued

Although many of the powers regarding business conduct, 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 the Chief Executive and to 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 framework is designed to manage the risk of failure to achieve business objectives, and to provide reasonable assurance against material misstatement or loss. Further information on Scottish Friendly's approach to Risk Management is set out below.

Risk management

The role of risk management

Scottish Friendly considers risk management to be fundamental to good management practice and a significant aspect of corporate governance. Effective management of risk provides an essential contribution towards the achievement of strategic and operational objectives. Risk management is an integral part of Scottish Friendly's routine decision making and management activity and is incorporated within the strategic and operational planning processes at all levels throughout the business.

Risk Management Framework

Scottish Friendly maintains a Risk Management Framework ("RMF"), which sets out how risk management operates throughout the business and how it is linked to Risk Appetite and Risk Policies, the strategy, the business and Solvency and Capital Management.

The key objective of the RMF is to ensure that Scottish Friendly has a sound and consistent basis for identifying, measuring, controlling, monitoring and reporting risk at all levels. The articulation of the Risk Appetite Statements and associated Key Risk Indicators is an important activity for creating an effective RMF across the business. This sets out the level of risk Scottish Friendly is willing to take in pursuit of the strategy and the measures that will be used to monitor the exposures on an ongoing basis across all risk categories. The RMF is integrated with the Solvency and Capital Management activity, in particular the Own Risk and Solvency Assessment (ORSA) which is a specific requirement of the Solvency II Directive which came into force on 1 January 2016 and which Scottish Friendly has been using for a number of years. The ORSA requires Scottish Friendly to consider the risks arising from the agreed strategic priorities, how much capital is needed to protect the business against those risks and how resilient the Scottish Friendly business model is under stressed conditions. The ORSA is a key risk management tool and is actively used by senior management and the Board to inform decision making.

The aim of the RMF is to ensure that Scottish Friendly stakeholders understand the key risks facing the business both in the near and long-term and how these risks are managed, reflecting the Risk Appetite and tolerances that have been approved by the Board.

Risk governance

Scottish Friendly adopts the 'Three Lines of Defence' model to define the roles and responsibilities for risk management throughout the organisation.

The First Line of Defence is represented by the operational areas across Scottish Friendly which are responsible for the identification and management of day-to-day risks and controls across the business. The management and monitoring of risks are the responsibility of each Executive owner.

The Second Line of Defence is represented by the Committees and control functions that provide ongoing oversight and challenge of the risk exposures and internal control environment. The Risk and Compliance functions provide independent challenge and oversight of each business function, led by a designated Executive Head of Risk. Primary activities include compliance monitoring reviews and reviews of risk and control self-assessments.

Internal Audit provides the Third Line of Defence by delivering a cyclical and prioritised programme of risk based audits covering all aspects of work undertaken in the First and Second Line business areas over a period of years. Internal Audit may take some assurance from the work of the Second Line functions to reduce or tailor its checking of the First Line operations.

The overall responsibility for risk within the business ultimately rests with the Board. Some responsibilities have been delegated to the Audit Committee, to assist the Board in reviewing the systems of internal controls and the external financial reports of the business, and the Risk Committee, to provide focused support and advice on risk governance and to assist the Board in reviewing the systems for managing all aspects of business risk, including operational, prudential, conduct and strategic risks. Further information is set out below on the activities of the Audit and Risk Committees during 2016.

In addition, the Executive Risk Committee (ERC) is the primary forum for Executive oversight and challenge of the risk and control environment across the business and is chaired by the Head of Risk. All Executives are responsible for the identification, assessment, management and control of risks in their respective areas, delegating such parts of this responsibility to appropriate managers or other individuals where practical and are required to report on their respective area at the ERC on at least a quarterly basis.

Risk management is embedded in the duties and responsibilities of all employees and it is the responsibility of managers to ensure that this approach is maintained, and the responsibility of the ERC to ensure that this is effectively monitored. The Corporate Risk Register is reviewed by the Risk Committee quarterly. This sets out the key strategic, conduct and operational risks facing Scottish Friendly, the likelihood of occurrence and the potential impact.

The Board has overall responsibility for the system of internal control and, through a combination of the above activities, 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.

Principal risks

The key risks facing Scottish Friendly are considered within the Own Risk and Solvency Assessment (ORSA) and presented to the Board on at least an annual basis. Quarterly ORSA Dashboard reports are presented to the ERC, Risk Committee and Board to highlight any significant movements in the risk profile of the business or the forward-looking risks.

The principal risks to which Scottish Friendly is exposed are strategic, market, financial soundness, credit, underwriting, operational and conduct risks. The Strategic Report on pages 1 to 5 discusses, in overview, Scottish Friendly's assessment of the current risks and uncertainties facing the Group and the strategies and other activities being exercised to mitigate these risks.

Strategic risk is the risk that the business is unable to implement its strategy, or elements of its strategy or that implementing the strategy may give rise to unexpected or unintended consequences which harm the business model. This is mitigated through the ongoing Strategic and Business Planning processes.

Market risk is the risk of adverse financial impact due to changes in fair values or future cash flows from fluctuations in interest rates, foreign currency exchange rates, equity prices and property values. This is mitigated through ongoing solvency monitoring and oversight provided by the Investment Committee.

Financial soundness is the risk of major capital loss impacting the solvency of the business or the inability to meet financial obligations as they fall due. This is mitigated by monthly solvency monitoring and finance management information on costs and expenses.

Credit risk is the risk of financial loss as a result of the default or failure of third parties to meet their obligations. This is mitigated via diversified counterparties and minimum counterparty credit ratings when establishing new relationships.

Underwriting risk is the risk of potential losses arising from inaccurate assessment of the risks entailed in writing an insurance policy. This is mitigated by the provision of reinsurance arrangements and limits on cover and explicit exclusions.

Operational risk is the risk of loss or adverse consequences for the business resulting from inadequate or failed internal processes, people or systems, in particular cyber risk, or from external events. This is mitigated through effective first line of defence controls within procedures and where appropriate automated processes.

Conduct risk is the risk that our products, distribution or post-sales practices result in poor customer outcomes. This is mitigated via the use of a robust product development process, including customer focus groups as well as post-launch monitoring such as complaints reviews and root cause analysis.

Report on Corporate Governance
continued

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 2016, three other Non-Executive Directors and two Executive Directors, being the Chief Executive and the Deputy Chief Executive. This composition is considered to provide an effective and balanced mix of skills and experience to meet the Board's remit. On 31 December 2016, Fiona McBain stepped down as Chief Executive. Jim Galbraith was appointed with approval from the regulator as her successor, with effect from 1 January 2017. Neil Lovatt was appointed to the Board as of 1 January 2017, with a new title of Commercial Director.

The Nomination Committee has reviewed the length of service of the Non-Executive Directors and considers that they all meet the criteria of independence.

Dermot Jenkinson continued as the Senior Independent Director; as such, he may, as necessary, lead meetings of the independent Non-Executive Directors (with/without the Chairman being present), be available to members through the Member Relations function to understand their concerns (in the event that other contacts within Scottish Friendly 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. He is also the whistleblowing champion.

Scottish Friendly's Rules provide for all Directors to stand for re-election at least once every three years. If any member of the Board who does not also hold or has not held an executive position with Scottish Friendly has been a member of the Board for nine years or more, that member of the Board is subject to annual re-election at the Annual General Meeting.

In line with the Code, the submission of any Non-Executive Director for re-election for a term which means he would serve more than six years is subject to particular review, taking into account the need for progressive refreshing of the Board.

In 2016 the Board again considered the recommendation in the Code that all Directors should be re-elected at the Annual General Meeting. Its view remains that such a provision could in certain circumstances have implications for the ongoing financial stability of Scottish Friendly which would not be in the interests of its members. It will however continue to consider the recommendation annually.

Particulars of Directors' remuneration are given in the Directors' Remuneration Report on pages 16 to 17.

Performance evaluation

On at least 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. 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 at least an annual basis and the results shared with the Board as a whole.

Board Committees

The terms of reference of the current Committees of the Board – Audit, Risk, Remuneration, Nomination and Investment – are available on the Scottish Friendly website at www.scottishfriendly.co.uk/customer-centre/board-committee-terms-of-reference. 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 during 2016 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 16 to 17.

Audit Committee

Kerr Luscombe (Chairman)
Dermot Jenkinson
David Huntley

The terms of reference of the Audit Committee included all matters indicated by the Code. The Committee consisted of three independent Non-Executive Directors, at least one of whom has recent and relevant financial experience, in line with the code. The Company Secretary acted as Secretary to the Committee.

During 2016 the Committee met on four occasions. The Committee:

- reviewed the internal control systems, including internal financial controls and ensured that these continued to be effective; advised the Risk Committee as appropriate of any concerns regarding the effectiveness of the current control framework;
- considered the audit plan which highlighted key judgement areas and summarised changes in reporting requirements;
- reviewed the annual financial statements and regulatory returns and approved them for submission to the Board. The Committee focused particularly on major judgmental areas and compliance with accounting standards and legal requirements, including the regulations and guidance of the PRA. The Committee reviewed thoroughly the external auditor's detailed report on the draft documents and obtained satisfactory explanations where necessary. The Committee also reviewed the external auditor's final report on internal controls and ensured that follow up action was completed where necessary;
- approved the internal audit programmes and received regular progress reports from internal audit and ensured that recommendations made were followed up. The Committee also monitored co-ordination between the internal and external auditors and ensured that the internal audit function was adequately resourced and had appropriate standing within the organisation; and
- assessed the effectiveness of the external and internal audit processes through the reporting that it receives from the respective auditors who were present at each Committee meeting. The Committee meets with each of internal and external audit in the absence of management at least once a year.

In planning its work and reviewing the audit plan of the external auditors, the Committee took account of the most significant issues and risks, both operational and financial, likely to impact on the Group's financial statements.

The two areas which have most impact on the financial statements and returns are:

- the calculation of life insurance technical provisions on a realistic and Solvency II basis. The Board reviews twice yearly reports from the Chief Actuary covering methodology, assumptions, significant judgements and other factors impacting the provisions; and
- the appropriate recording and valuation of the investment portfolio. Approximately 96% of the investment portfolio by value can be verified against daily market prices. Scottish Friendly uses appropriate independent safeguarding and custodian arrangements. The Committee has reviewed the control environment as relates to investments, including relevant internal or external audit activity.

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 maintain its independence. Deloitte was first appointed as auditor following a tendering exercise in 2012.

Report on Corporate Governance
continued

Risk Committee

David Huntley (Chairman)
Kerr Luscombe
Michael Walker
Fiona McBain (until 31 December 2016, with Jim Galbraith replacing from 1 January 2017)

The Risk Committee provides focused support and advice on risk governance, assisting the Board in reviewing the systems for managing all aspects of business risk. The Committee takes account of the most significant issues and risks, both operational and financial, likely to impact on the Group's financial statements.

During 2016 the Committee met on six occasions, with apologies from the Board Chairman on two occasions. The Company Secretary acts as Secretary to the Committee.

The Committee:

- reviewed, challenged and approved the revised Risk Appetite Methodology and Statements including monitoring measures with limits and triggers that are the basis for regular ORSA reporting;
- shaped the design and content of the Annual ORSA report to meet the requirements of the Board in terms of risk insights and forward-looking threats. Provided oversight and review of the Annual ORSA report in advance of the 1 January 2016 implementation of the Solvency II regulations, with specific focus on risks inherent in the strategy, the overall solvency needs assessment, and the adequacy of the stress and scenario testing; and
- received regular reports from the Risk and Compliance teams outlining the key prudential and conduct risks facing Scottish Friendly and the controls and actions in place to mitigate their impacts. This included updates on the Compliance Monitoring plan and any actions arising from Compliance Reviews during the period.

Nomination Committee

Michael Walker (Chairman)
Fiona McBain (until 31 December 2016, with Jim Galbraith replacing from 1 January 2017)
Dermot Jenkinson

During 2016 the Committee met formally on one occasion and informally on one other occasion in relation to succession planning for the Chief Executive. The Company Secretary acts as Secretary to the Committee. 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.

The Committee also ensures that Scottish Friendly's employee policies, described on page 7, are applied in Board nomination matters.

The Code recommends that a majority of members of the Nomination Committee should be independent Non-Executive Directors. The Chairman was independent on appointment and the Board was satisfied that the composition of the Committee and its operation was sufficient to ensure the Committee's independence and objectivity.

Investment Committee

Simon Miller (Chairman)
Michael Walker
Fiona McBain (until 31 December 2016, with Donald Macleod replacing from 1 January 2017)
Jim Galbraith
Bryan Johnston

During 2016 the Committee met on four occasions, with all members present. The Company Secretary acts as Secretary to the Committee. The Investment Committee oversees 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. External fund managers and investment advisors are routinely invited to present to the Committee.

Member Relations

Scottish Friendly's Delegate system has proven to be an effective model for communication 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. There are currently 30 Delegate positions (26 filled), elected to represent geographic constituencies and Delegate positions are advertised annually for the one third retiring by rotation.

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 always been very good.

Scottish Friendly's member relations strategy includes hosting a dedicated members' area at www.scottishfriendly.co.uk/customer-centre 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.

Directors' Remuneration Report

Remuneration Committee

David Huntley (Chairman)
Michael Walker
Simon Miller
Kerr Luscombe

The terms of reference of the Remuneration Committee include reviewing the remuneration of the Chairman, and determining appropriate levels of Executive Management remuneration.

The Committee consists of three independent Non-Executive Directors, as well as Michael Walker, who was considered independent on appointment, in line with the Code.

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. A range of data is taken into account to inform the review including comparable positions in other organisations, remuneration trends in the financial services sector, as well as wider economic influences. Any change to salary is effective from 1 January. 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 delivering growth and cost efficiencies while generating longer term value for members. Payments are capped at 60% of salary.

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

Non-Executive Directors' duties and responsibilities are set out in 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 the Chairman are set by the Committee in his absence. Fees for Non-Executive Directors are monitored and reviewed annually with changes effective from 1 May through approval by the Executive Directors and the Chairman. Fees 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 Scottish Friendly.

Fees are made up of an annual fee covering Board and Committee membership. Additional fees are payable to the Vice-Chairman and to the Chairs of the Audit, Risk, Remuneration and Investment Committees, 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.

Non-Executive Directors receive reimbursement of travel and accommodation costs where required for attending meetings.

Outside her commitment to Scottish Friendly, the former Chief Executive served as a Director of Scottish Mortgage Investment Trust PLC, and retained a fee of £30,000 per annum, and as a Vice Chair of Save The Children UK and Director of its subsidiary, which were not remunerated.

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	Performance pay £000	Benefits[1] £000	Total year ended 31 Dec 2016 £000	Total year ended 31 Dec 2015 £000
Chairman					
Michael J Walker	80	–	4	**84**	79
Executive Directors					
Fiona C McBain	384	250	164[2]	**798**	688
Jim Galbraith	313	210	74	**597**	563
Non-Executive Directors					
David C Huntley	53	–	–	**53**	41
Dermot J Jenkinson	45	–	–	**45**	42
Simon EC Miller	49	–	–	**49**	44
Kerr Luscombe	49	–	–	**49**	28

[1] For Executive Directors, benefits comprise the provision of a company car and healthcare insurance, payments covering bonus periods, as well as, since 6 April 2012, the provision of pay in lieu of pension contributions. For the Non-Executive Directors, figures in the benefits column comprise travel and accommodation cost reimbursements (these round to under £1,000 for the year 2016).

[2] Fiona McBain left employment on 31 December 2016, the benefits include 2 months salary paid in lieu of notice.

Independent Auditor's Report to the members of Scottish Friendly Assurance Society Limited

Opinion on the financial statements of Scottish Friendly Assurance Society Limited ("Scottish Friendly")

In our opinion the financial statements:

- give a true and fair view of the state of the Group's and Scottish Friendly's affairs as at 31 December 2016 and of the income and expenditure of the Group and Scottish Friendly for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, including FRS 102 "The Financial Reporting Standard applicable in the UK and Republic of Ireland"; and
- have been prepared in accordance with the Friendly Societies Act 1992.

The financial statements comprise the Group and Scottish Friendly Income and Expenditure Accounts, the Group and Scottish Friendly Balance Sheets and the related notes 1 to 22. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) including FRS 102 "The Financial Reporting Standard applicable in the UK and Republic of Ireland".

Going concern and the Directors' assessment of the principal risks that would threaten the solvency or liquidity of Scottish Friendly

We have reviewed the directors' statement regarding the appropriateness of the going concern basis of accounting contained within page 7 and note 2 of the financial statements, and the directors' statement on the longer-term viability of the Group and Scottish Friendly contained within the directors' report on page 7.

We are required to state whether we have anything material to add or draw attention to in relation to:

- the directors' confirmation on page 7 that they have carried out a robust assessment of the principal risks facing the Group and Scottish Friendly, including those that would threaten its business model, future performance, solvency or liquidity;
- the disclosures on page 7 that describe those risks and explain how they are being managed or mitigated;
- the directors' statement on page 7 and note 2 to the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, and their identification of any material uncertainties to Scottish Friendly's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements; and
- the directors' explanation on page 7 as to how they have assessed the prospects of the Group and Scottish Friendly, over what period they have done so, and why they consider that

Summary of our audit approach

Key risks	The key risks that we identified in the current year were: • Actuarial valuation of the technical provision; • Actuarial valuation of the reinsurance asset; and • Valuation and custody of investments. Within this report, any new risks are identified with ▲ and any risks which are the same as the prior year identified with ▶.
Materiality	The materiality that we used in the current year was £4,750,000 which was determined on the basis of 3% of the Funds for Future Appropriation ("FFA").
Scoping	Our Group audit scope included the audit of the subsidiary components. The audits of the components were performed at a materiality level determined with reference to the scale of the businesses concerned and were significantly lower than Group materiality, being set between approximately £1,500 and £80,000.
Key changes in our approach	In 2015, we included as a significant risk the accounting in relation to the transfer of engagements from The Marine and General Mutual Life Assurance Society "M&GM". This included an assessment of the fair value exercise and the alignment of accounting policies and assumptions in relation to the assets and liabilities being transferred in. This transfer changed the makeup of the balance sheet such that the relative proportion of business reinsured has increased and the relative proportion of business outsourced to third parties has decreased. We have updated our significant risks to align with this change removing the significant risk on third parties and outsourcers, and introducing the valuation of the reinsurance asset as a new risk. The valuation of the reinsurance asset is viewed as a risk due to the significant judgement applied particularly in respect of mortality and morbidity assumptions.

period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group and Scottish Friendly will be able to continue in operation and meet their liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

We confirm that we have nothing material to add or draw attention to in respect of these matters.

We agreed with the directors' adoption of the going concern basis of accounting and we did not identify any such material uncertainties. However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's and Scottish Friendly's ability to continue as a going concern.

Independence

We are required to comply with the Financial Reporting Council's Ethical Standards for Auditors and confirm that we are independent of the group and we have fulfilled our other ethical responsibilities in accordance with those standards.

We confirm that we are independent of the Group and Scottish Friendly, and that we have fulfilled our other ethical responsibilities in accordance with those standards. We also confirm we have not provided any of the prohibited non-audit services referred to in those standards.

Our assessment of risks of material misstatement

The assessed risks of material misstatement described below are those that had the greatest effect on our audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team.

Actuarial Valuation of the Technical Provisions ▶

Risk description

The assessment of the calculation of technical provisions of with-profit insurance contracts of £945.8 million and non-profit insurance contracts of £698.4 million on a realistic basis requires management to make significant judgements about assumptions and methodology. For with-profit insurance contracts these judgements impact the expected future costs of guarantees offered to policyholders as well as the reserves required for other guaranteed or discretionary benefits. These reserves are more sensitive to economic assumptions. For non-profit contracts, the reserves are more sensitive to changes in demographic and expense assumptions. The technical provisions are set out in Note 11 and the related accounting policy is on page 27.

How the scope of our audit responded to the risk

We have engaged actuarial specialists to challenge management's key judgements and the methodology used for consistency with recent experience and market data. These judgements are used in the calculation of the technical provisions for with-profit and non-profit insurance contracts as applicable in the realistic balance sheet and are described in Note 16.

We also completed testing on the underlying policyholder data used in the reserving process in order to evaluate its completeness and accuracy and tested the output of calculations and analysis of results.

Findings

The actuarial assumptions applied and the resulting technical provisions presented in the financial statements are considered to be within an acceptable range.

Actuarial Valuation of the Reinsurance Asset ▲

Risk description

The reinsurance asset relates to the reinsurance contracts in place over annuity and protection business. The valuation of the reinsurance asset of £1,135.3 million as shown in note 11 requires the application of significant judgement. In particular, the assumptions around future mortality and morbidity experience are set using expert judgement, to which the reinsurance asset is highly sensitive.

How the scope of our audit responded to the risk

We have utilised our actuarial specialists as an integral part of the audit team to challenge and test the assumptions set and the application of these in the calculation of the reinsurance asset. We have compared the assumptions used both with the claims experience of the books of business and with the benchmarks used in the market.

We have also reviewed the reinsurance contracts in place backing these assets to verify whether the assets booked represent assets for the Group and Scottish Friendly.

Findings

The assumptions applied and the resulting reinsurance asset presented in the financial statements are considered to be within an acceptable range.

Independent Auditor's Report to the members of Scottish Friendly Assurance Society Limited
continued

Valuation and Existence of Investments ▶

Risk description
The investments balances of £761 million non-linked and £611 million linked, set out in Note 9, represent the majority of the assets held. There is a risk of misstatement if investments are inappropriately recorded or are not valued appropriately in line with the accounting policy on page 26.

How the scope of our audit responded to the risk
We have tested the existence of investments by obtaining samples of independent confirmations from custodians and third parties.

We have also independently tested the market prices used to value these investments to third party sources, or we have involved our own financial instrument specialists where investments were not actively traded.

Findings
The investments have been valued on an appropriate basis, and the resultant valuations as presented in the financial statements have been assessed as being reasonable.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Our application of materiality

We define materiality as the magnitude of misstatement in the financial statements that makes it probable that the economic decisions of a reasonably knowledgeable person would be changed or influenced. We use materiality both in planning the scope of our audit work and in evaluating the results of our work.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

Materiality	£4,750,000 (2015: £4,450,000).
Basis for determining materiality	The materiality that we used in the current year was £4,750,000 (2015: £4,450,000) which was determined on the basis of 3% of the Funds for Future Appropriation ("FFA").
Rationale for the benchmark applied	FFA represents funds not yet allocated to policyholders and could be considered an equivalent for a net asset figure in accounting for Friendly Societies.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £95,000 (2015: £89,000), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

An overview of the scope of our audit

Our Group audit scope included the audit of the subsidiary components. The audits of the components were performed at a materiality level calculated with reference to the scale of the businesses concerned and were significantly lower than Group materiality being set between approximately £1,500 and £80,000 (2015: £1,500 and £60,000).

Opinion on other matters prescribed by the Friendly Societies Act 1992

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 Financial Statements for the financial year.

Matters on which we are required to report by exception

Adequacy of explanations received and accounting records

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

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by Scottish Friendly, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns.

We have nothing to report in respect of these matters.

Our duty to read other information in the Annual Report

Under International Standards on Auditing (UK and Ireland), we are required to report to you if, in our opinion, information in the annual report is:

- materially inconsistent with the information in the audited financial statements; or
- apparently materially incorrect based on, or materially inconsistent with, our knowledge of Scottish Friendly acquired in the course of performing our audit; or
- otherwise misleading.

In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the directors' statement that they consider the annual report is fair, balanced and understandable and whether the annual report appropriately discloses those matters that we communicated to the audit committee which we consider should have been disclosed.

We confirm that we have not identified any such inconsistencies or misleading statements.

Other matters

In accordance with our instructions from Scottish Friendly, we review whether the Corporate Governance Statement reflects Scottish Friendly's compliance with those provisions of the Annotated UK Corporate Governance Code specified for our review by the Association of Financial Mutuals.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they 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). Our audit methodology and tools aim to ensure that our quality control procedures are effective, understood and applied. Our quality controls and systems include our dedicated professional standards review team and independent partner reviews.

This report is made solely to Scottish Friendly'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 Scottish Friendly's members those matters we are required to state to them in an auditor's 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.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group and Scottish Friendly's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Stephen Williams
(Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
Glasgow, United Kingdom
29 March 2017

Income and Expenditure

Technical Account – Long Term Business
For year ended 31 December

	Note	Group 2016 £000	Group 2015 £000	Scottish Friendly 2016 £000	Scottish Friendly 2015 £000
Earned Premiums		**75,709**	66,345	**75,709**	66,345
Reinsurance Premiums		**(17,063)**	(10,935)	**(17,063)**	(10,935)
Earned Premiums, Net of Reinsurance	3	**58,646**	55,410	**58,646**	55,410
Investment Income	4	**90,986**	63,652	**90,926**	65,393
Unrealised Gains/(Losses) on Investments		**88,361**	(47,755)	**89,058**	(47,707)
Other Technical Income		**11,938**	5,697	**9,722**	3,064
Gain on Transfer of Engagements		**–**	5,118	**–**	5,118
		249,931	82,122	**248,352**	81,278
Claims Incurred		**157,004**	111,463	**157,004**	111,463
Reinsurance Claims		**(71,505)**	(43,250)	**(71,505)**	(43,250)
Net Claims Incurred	5	**85,499**	68,213	**85,499**	68,213
Change in Other Technical Provisions	11	**106,953**	(24,083)	**106,953**	(24,083)
Operating Expenses	6	**35,934**	31,455	**35,934**	31,455
Exceptional Costs	6	**–**	2,277	**–**	2,277
Investment Expenses & Charges		**995**	794	**995**	794
Other Technical Charges		**1,405**	598	**–**	21
Tax attributable to Long Term Business	8	**174**	267	**–**	–
Actuarial (Gain)/Loss re pension scheme		**8,426**	(56)	**8,426**	(56)
Transfer to/(from) the Fund for Future Appropriations		**10,545**	2,657	**10,545**	2,657
		249,931	82,122	**248,352**	81,278

Except as disclosed above, there are no recognised gains or losses for the year. All results are derived from continuing operations. The inclusion of unrealised gains and losses reflects the marking to fair value of investments in the balance sheet.

The notes on pages 24 to 48 form an integral part of these accounts.

Balance Sheet

Assets
As at 31 December

	Note	Group 2016 £000	Group 2015 £000	Scottish Friendly 2016 £000	Scottish Friendly 2015 £000
Investments					
Land & Buildings		**3,325**	3,325	**3,325**	3,325
Other Financial Investments		**757,316**	766,449	**757,243**	766,350
Investments in Group Undertakings		**–**	–	**4,528**	3,831
Non linked Financial Investments		**760,641**	769,774	**765,096**	773,506
Assets Held to Cover Linked Insurance & Investment Liabilities		**610,700**	604,203	**610,700**	604,203
Total Financial Investments	9	**1,371,341**	1,373,977	**1,375,796**	1,377,709
Reinsurers' Share of Technical Provisions		**1,135,282**	1,020,276	**1,135,282**	1,020,276
Debtors					
Debtors arising out of Direct Insurance Operations		**10,470**	8,610	**10,470**	8,610
Taxation Recoverable		**–**	640	**–**	640
Other Debtors		**7,886**	11,380	**6,937**	11,440
Other Assets					
Tangible Assets	10	**348**	384	**348**	384
Cash at Bank & In Hand		**180,755**	88,134	**176,511**	84,237
Prepayments & Accrued Income					
Prepayments & Accrued Interest, Dividends & Rents		**2,668**	7,674	**2,668**	7,674
		2,708,750	2,511,075	**2,708,012**	2,510,970

Liabilities
As at 31 December

Funds for Future Appropriations		**158,183**	147,639	**158,183**	147,639
Technical Provisions	11				
With-profit Insurance Contract Liabilities		**945,792**	748,820	**945,792**	748,820
Non-profit Insurance Contract Liabilities		**698,356**	731,770	**698,356**	731,770
Unit-linked Insurance Contract Liabilities		**120,046**	119,297	**120,046**	119,297
Claims Outstanding		**22,116**	20,032	**22,116**	20,032
Investment Contract Liabilities		**683,012**	669,655	**683,012**	669,655
Creditors					
Deposit Received from Reinsurers	18	**51,930**	52,882	**51,930**	52,882
Creditors arising out of Direct Insurance Operations	19	**6,851**	3,884	**6,851**	3,884
Other Creditors including Taxation & Social Security	20	**11,842**	10,502	**11,104**	10,397
Accruals and Deferred Income		**3,285**	5,190	**3,285**	5,190
Pension Scheme Deficit	13	**7,337**	1,404	**7,337**	1,404
		2,708,750	2,511,075	**2,708,012**	2,510,970

Approved by the Directors and signed on 29 March 2017 on their behalf by:

MJ Walker
Chairman

J Galbraith
Director and Chief Executive

The notes on pages 24 to 54 form an integral part of these accounts.

Notes to the Accounts

1. GENERAL INFORMATION

Scottish Friendly Assurance Society Limited ("Scottish Friendly") is an incorporated friendly society authorised by the Prudential Regulation Authority and regulated by the Financial Services Authority and the Prudential Regulation Authority. It is incorporated in the United Kingdom, and its principal place of business is its registered office: Scottish Friendly House, 16 Blythswood Square, Glasgow, G2 4HJ.

It has six wholly owned subsidiaries, together "the Group". The principal activities of each company in the Group are detailed in the Directors' report.

2. ACCOUNTING POLICIES

Basis of preparation

The Accounts have been prepared in accordance with FRS102 and FRS103 being applicable UK GAAP accounting standards. They have also been prepared in accordance with The Friendly Societies Act 1992 and The Friendly Societies (Accounts and Related Provisions) Regulations 1994.

The accounts have been prepared on a Going Concern basis, as confirmed in the Directors' Report.

As a mutual life assurance society, under Financial Reporting Standard 102, Scottish Friendly is exempt from the requirement to prepare a Statement of Cash Flow. The other companies in the Group are not entitled to this exemption on the basis that they are not mutual societies and therefore a Statement of Cash Flow has been disclosed in the individual accounts of each company.

These financial statements cover the Group and Scottish Friendly for the year ending 31 December 2016.

The financial statements are prepared in sterling which is the functional currency of the Group and rounded to the nearest £000.

Basis of consolidation

The Group accounts consolidate the assets, liabilities and income and expenditure account transactions of Scottish Friendly 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 the Group are accounted for in the Income and Expenditure Technical Account – Long Term Business.

Significant judgements and estimates

The preparation of the financial statements requires management to make judgements apart from those involving estimates that can significantly affect the amounts recognised in the financial statements; for example:

- fair value of financial instruments that are not quoted in active markets are recorded as Level 2 or 3 and valued accordingly (see Note 9); this includes private equity investments that are based on fund manager valuation;
- insurance contract liabilities are based on appropriate valuation assumptions; and
- pension plan liabilities are based on appropriate valuation assumptions.

Contract classification

Scottish Friendly has carried out an analysis of its business to categorise its business as either insurance contracts (where the contracts meet the definition below) or as investment contracts.

A contract that exposes Scottish Friendly to financial risk without significant insurance risk is not an insurance contract – financial risk comprises market risks (e.g. investment returns, index prices, interest rates, etc.).

Neither lapse, persistency nor expense risk is insurance risk as these do not impact the policyholder (so there is no risk transfer). Scottish Friendly has assessed 10% as the threshold for significant risk as an appropriate figure for its categorisation. Scottish Friendly has carried out its assessment by considering homogenous product classes, rather than contract by contract, as each class has common product features including levels of insurance risk.

The product range includes conventional and unitised with-profits business, unit- and index-linked business, and other non-profit business. Life product types include endowments, whole of life, and term assurance, as well as personal pensions accumulation and decumulation products, including annuities. Premiums may be regular or single.

This analysis has been carried out by assessing contracts at inception, including the investment funder where there is a unit-linked or unitised with-profits option.

2. ACCOUNTING POLICIES continued

Valuation of financial assets and derivative financial investments

Wherever possible the fair value of financial assets and derivative financial investments are derived from active markets. In the absence of an active market, fair value is estimated using valuation techniques that include the use of discounted cash flow models and/or mathematical models, the inputs to which are taken from observable data.

For discounted cash flow valuation, estimated future cash flows and discount rates are based on current market information and rates applicable to financial instruments with similar yields, credit quality and maturity characteristics. Note 9 contains more details on the valuation techniques applied.

Valuation of insurance and investment contract liabilities

The liability calculations are based on assumptions reflecting best estimates, at the time of calculation, and a margin for adverse deviation. All contracts are subject to a liability adequacy assessment at the end of each reporting period. The assessment considers current estimates of all contractual cash flows stochastically, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees. Any deficiency would be recognised through the Technical Account.

The main assumptions used relate to mortality, morbidity, longevity, investment returns, expenses, lapse and surrender rates and discount rates. Scottish Friendly bases mortality, morbidity and longevity rates on standard industry or reinsurers' tables, adjusted where necessary to reflect Scottish Friendly's own experience. Investment returns, expense, lapse and surrender rates assumptions are based on current market yields, product characteristics and relevant claims experience. Discount rates are based on current market risk rates, adjusted for Scottish Friendly's own risk exposure.

Under deposit accounting, investment contract premiums and claims are not treated as income or expense and instead are treated as deposits which are received and paid directly to investment contract liabilities in the Balance Sheet. As there is no significant transfer of risk, these deposits are treated as fully under the trust of Scottish Friendly and are not required to be recognised in the Technical Account. Related investment contract charges and expenses are treated as profit or loss items within the Technical Account.

Valuation of pension benefit obligations

The valuation of the defined benefit pension schemes are determined using actuarial valuations. The valuation will include assumptions about discount rates, expected returns on assets and mortality rates. The long-term nature of these obligations means the valuation is subject to significant uncertainty. Note 13 includes more details on the assumptions used.

Premiums

Insurance contracts

Gross regular premiums on insurance contracts are recognised when the policy liability is set up and the premium becomes due for payment; reinsurance premiums are accounted for when they come payable.

Investment contracts

Premiums and claims relating to investment contracts are not recognised in the Technical Account but are recorded as contributions to and deductions from the investment contract liabilities recorded in the Balance Sheet.

Reinsurance

Reinsurance premiums payable are recognised when the underlying contract premiums become receivable or the underlying contract becomes effective. Reinsurance recoveries are recognised as a deduction to claims and are recognised when the underlying contract claims become payable. Reinsurance assets represent the balances recoverable from reinsurance companies.

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.

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. 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. All unrealised gains and losses are included in the Technical Account.

2. ACCOUNTING POLICIES continued

Other technical income

Other technical income comprises fee income and, at Group level, the income of the subsidiaries. Fee income is charged to policyholders for administration services, investment management services and surrenders. These fees are recognised in the period over which the services are performed.

Claims

Insurance contracts

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.

Investment contracts

Gross claims on non-participating investment contracts are deducted from investment contract liabilities and are accounted for as deductions from investments in the Balance Sheet.

Acquisition costs

Acquisition costs comprise all direct and indirect costs arising from the conclusion of sales. The costs are not split between insurance and investment contracts because the business model manages the sales and marketing function on an integrated basis.

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.

Financial investments

Upon initial recognition, financial investments are classified as either financial assets at fair value through profit or loss or loans and receivables.

Financial investments at fair value through profit or loss

The Group has elected to apply the recognition and measurement provisions of sections 11 and 12 of FRS 102. Financial investments, including derivatives, are recognised at fair value through profit or loss. Scottish Friendly manages these investments and makes purchase and sale decisions based on their fair value in accordance with Scottish Friendly's investment strategy. Upon initial recognition, attributable transaction costs are recognised in profit or loss as incurred. Financial investments at fair value through profit or loss are measured at fair value and changes therein are recognised in profit or loss.

Financial investments at fair value through profit or loss include derivatives, listed and unlisted investments, units in authorised unit trusts, Open Ended Investment Companies (OEICs) and other investments. Scottish Friendly's derivative financial instruments are not designated formally as hedges and therefore hedge accounting does not apply. Instead they are considered to be economic hedges and as such fair value gains and losses on the derivatives are included in unrealised gains and losses on investments as are any gains or losses on the investments in which they hedge.

Land and buildings occupied by Scottish Friendly are valued at fair value as determined 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.

Investments in Group undertakings are valued at fair which is taken to be net asset value.

Derecognition of financial investments

A financial asset is derecognised when Scottish Friendly's right to receive cash flows from the asset has expired, and where Scottish Friendly has transferred to a third party its right to receive cash flow from an asset, or substantially all of the risks and rewardship of ownership or control of the asset.

2. ACCOUNTING POLICIES continued

Impairment of assets

Assets, other than those measured at fair value, are assessed for indicators of impairment; any impairment loss is recognised in profit and loss.

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

Cash and cash equivalents

Cash and cash equivalents comprise cash at bank and cash in hand as well as short-term deposits with a maturity of three months or less and known redemption values which are held to manage short-term operational cash requirements on origination.

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.

Technical provisions

In accordance with FRS103, liabilities relating to participating contracts are calculated on a realistic basis. Provision is made for all bonus payments. In accordance with FRS103, investment contracts have been excluded. 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.

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.

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; and
- 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.

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.

Notes to the Accounts
continued

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	
	2016 £000	2015 £000	**2016 £000**	2015 £000	**2016 £000**	2015 £000
Annual	**73,485**	63,645	**1,329**	1,469	**74,814**	65,114
Single	**895**	1,231	**–**	–	**895**	1,231
	74,380	64,876	**1,329**	1,469	**75,709**	66,345
Comprising						
Premiums for participating contracts					**40,126**	43,127
Premiums for non-participating contracts					**25,741**	9,360
Premiums from linked contracts					**9,842**	13,858
Gross Earned Premiums					**75,709**	66,345
Reinsurance Premiums on Insurance Contracts					**(17,063)**	(10,935)
Earned Premiums, net of reinsurance					**58,646**	55,410

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 2016		Scottish Friendly 2015	
	Annual £000	**Single £000**	Annual £000	Single £000
New Business Premiums	**33,194**	**7,130**	24,799	6,673

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

	Group		Scottish Friendly	
	2016 £000	2015 £000	**2016 £000**	2015 £000
Annual Contributions	**3,329**	2,937	**–**	–
Single Contributions	**1,268**	1,643	**–**	–

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

4. INVESTMENT INCOME

	Group		Scottish Friendly	
	2016 £000	2015 £000	**2016 £000**	2015 £000
Income from land & buildings	**139**	125	**139**	125
Income from other investments	**34,222**	33,447	**34,162**	35,188
Net gains on the realisation of investments	**56,625**	30,136	**56,625**	30,136
Net (loss) on pension scheme	**–**	(56)	**–**	(56)
	90,986	63,652	**90,926**	65,393

5. CLAIMS INCURRED

Group and Scottish Friendly

	Ordinary Assurance		Industrial Assurance		Total	
	2016 £000	2015 £000	**2016 £000**	2015 £000	**2016 £000**	2015 £000
Deaths	**21,153**	12,885	**3,004**	3,274	**24,157**	16,159
Maturities	**51,807**	45,998	**1,039**	1,723	**52,846**	47,721
Surrenders	**18,054**	9,974	**606**	523	**18,660**	10,497
Annuities	**60,866**	36,611	**–**	–	**60,866**	36,611
	151,880	105,468	**4,649**	5,520	**156,529**	110,988
Claims handling expenses					**475**	475
					157,004	111,463
Aggregate recoveries received from reinsurers					**(71,505)**	(43,250)
Net Claims Paid on Insurance Contracts					**85,499**	68,213

The above figures are stated after taking into account the movement in the provision for outstanding claims.

6. OPERATING EXPENSES AND EXCEPTIONAL COSTS

Group and Scottish Friendly

Operating Costs

	2016 £000	2015 £000
Acquisition costs	**11,455**	13,901
Administration expenses	**7,845**	6,818
Information Technology Infrastructure	**2,578**	1,658
Renewal commission	**14,056**	9,078
	35,934	31,455

Exceptional costs of £nil (2015: £2,277,000) related to funding the deficit in the MGM Assurance Staff Pension Plan (see Note 13).

Notes to the Accounts
continued

6. OPERATING EXPENSES AND EXCEPTIONAL COSTS continued

Remuneration of Auditors (included within administration expenses on page 29)

	2016 £000	2015 £000
Fees payable to the auditor for audit of annual accounts	**110**	135
Fees payable to the auditor for other services:		
The audit of subsidiary companies pursuant to legislation	**8**	8
Other services pursuant to legislation	**67**	29
Other services	**50**	–
Fees in respect of the Scottish Friendly Pension & Life Assurance Scheme audit	**–**	3

7. STAFF COSTS

Group and Scottish Friendly

Staff numbers and costs

The average number of persons, excluding Directors, employed by Scottish Friendly during the year was 97 (2015: 96).
The aggregate payroll costs of these persons were as follows:

	2016 £000	2015 £000
Wages and salaries	**3,221**	3,078
Social security costs	**342**	325
Other pension costs	**263**	220
	3,826	3,623

Remuneration of Directors

Details of Directors' remuneration are included in the Directors' Remuneration Report on pages 16 and 17.

8. TAXATION

	Group		Scottish Friendly	
	2016 £000	2015 £000	**2016 £000**	2015 £000
Corporation Tax and irrecoverable income tax	**174**	267	**–**	–

Scottish Friendly also has an unrecognised deferred tax asset of £24,000 (2015: £1,417,078) with regards to carried forward excess management expenses, unrealised capital losses and other items, that is not considered sufficiently likely to be included here.

Corporation tax is charged at the standard rate of 20% (2015: 20% for 9 months, 21% for 3 months) on the profit on ordinary activities of the subsidiaries SFAM £930,000 (2015: £851,000) and SFIS £nil (2015: £503,000) with adjustments in respect of prior years being £nil (2015: £nil).

9. FINANCIAL INVESTMENTS

	Group				Scottish Friendly			
	Carrying Value		Cost		Carrying Value		Cost	
	2016 £000	2015 £000	**2016 £000**	2015 £000	**2016 £000**	2015 £000	**2016 £000**	2015 £000
Non-linked and linked financial investments								
Non-linked financial investments	**760,641**	769,774	**555,579**	617,467	**765,096**	773,506	**560,108**	619,573
Linked financial investments	**610,700**	604,203	**459,281**	453,558	**610,700**	604,203	**459,281**	453,558
Total financial investments	**1,371,341**	1,373,977	**1,014,860**	1,071,025	**1,375,796**	1,377,709	**1,019,389**	1,073,131
of which financial investments designated as:								
(a) Financial investments designated at fair value	**1,329,632**	1,293,672	**974,844**	1,029,606	**1,334,087**	1,297,404	**979,373**	1,031,712
(b) Derivatives	**4**	38,209	**–**	–	**4**	38,209	**–**	–
(c) Loans and receivables	**41,705**	42,096	**40,016**	41,419	**41,705**	42,096	**40,016**	41,419
Total financial investments	**1,371,341**	1,373,977	**1,014,860**	1,071,025	**1,375,796**	1,377,709	**1,019,389**	1,073,131
Non-linked financial investments								
(a) Financial investments designated at fair value;								
Shares, other variable yield securities and units in OEICs and unit trusts	**645,112**	527,937	**437,227**	360,851	**645,039**	527,838	**437,227**	360,757
Debt securities and other fixed income securities	**91,485**	182,356	**92,988**	233,977	**91,485**	182,356	**92,988**	233,977
Private equity investments	**448**	1,458	**1,026**	1,409	**4,976**	5,289	**5,555**	3,609
Land and buildings	**3,325**	3,325	**5,003**	5,003	**3,325**	3,325	**5,003**	5,003
	740,370	715,076	**536,244**	601,240	**744,825**	718,808	**540,773**	603,346
(b) Derivatives								
Derivative assets	**4**	38,209	**–**	–	**4**	38,209	**–**	–
(c) Loans and receivables								
Policyholder loans	**36**	35	**36**	35	**36**	35	**36**	35
Deposits with credit institutions	**20,145**	16,368	**19,213**	16,106	**20,145**	16,368	**19,213**	16,106
Loans secured by mortgages	**86**	86	**86**	86	**86**	86	**86**	86
	20,267	16,489	**19,335**	16,227	**20,267**	16,489	**19,335**	16,227
Total non-linked financial investments	**760,641**	769,774	**555,579**	617,467	**765,096**	773,506	**560,108**	619,573
Linked financial investments								
(a) Financial investments designated at fair value;								
Shares, other variable yield securities and units in OEICs and unit trusts	**540,670**	510,918	**387,942**	361,792	**540,670**	510,918	**387,942**	361,792
Debt securities and other fixed income securities	**48,592**	67,678	**50,658**	66,574	**48,592**	67,678	**50,658**	66,574
	589,262	578,596	**438,600**	428,366	**589,262**	578,596	**438,600**	428,366
(b) Loans and receivables								
Deposits with credit institutions	**21,438**	25,607	**20,681**	25,192	**21,438**	25,607	**20,681**	25,192
Total linked financial investments	**610,700**	604,203	**459,281**	453,558	**610,700**	604,203	**459,281**	453,558

9. FINANCIAL INVESTMENTS continued

Scottish Friendly applies the following hierarchy for determining and disclosing the fair value of financial instruments by valuation technique:

Level 1: unadjusted prices quoted in active markets for identical assets or liabilities.
Prices are obtained from pricing service providers where there is clear evidence that the valuations are based on traded prices in an active market. The prices for assets in this category are received daily from Thomson Reuters, or are provided by third parties based on active market prices.

Level 2: inputs other than quoted prices that are observable either directly (as prices) or indirectly (as derived from prices).
Where it is not possible to determine prices based on actual transactions in an active market, the fair value is based on broker quotes and information from fund managers. Assets in this category include the investment property held by Scottish Friendly and derivatives.

Level 3: the inputs are not based on observable market data (unobservable inputs).
In a minority of cases there are no market observable inputs and therefore the fair value is determined using a valuation technique based on assumptions that are not supported by observable market transactions nor based on market data. Such assets include Scottish Friendly's investment in private equity funds and the subsidiary companies.

Each financial instrument is categorised according to the lowest level of input that is significant to the fair value measurement of the financial instrument. Both price volatility and market information on assets are reviewed periodically to see if there is any indicator that an asset may require reclassification due to illiquidity or impairment.

Fair value hierarchy

	Group				Scottish Friendly			
	Level 1 £000	Level 2 £000	Level 3 £000	**Total £000**	Level 1 £000	Level 2 £000	Level 3 £000	**Total £000**
Financial instrument assets 2016								
Financial investments designated at fair value;								
Shares, other variable yield securities and units in OEICs and unit trusts	1,184,800	982	–	**1,185,782**	1,184,727	982	–	**1,185,709**
Debt securities and other fixed income securities	137,154	–	2,923	**140,077**	137,154	–	2,923	**140,077**
Private equity investments	–	–	448	**448**	–	–	4,976	**4,976**
Land and buildings	–	3,325	–	**3,325**	–	3,325	–	**3,325**
	1,321,954	4,307	3,371	**1,329,632**	1,321,881	4,307	7,899	**1,334,087**
Derivative assets	–	4	–	**4**	–	4	–	**4**
Financial assets measured at fair value through profit and loss	1,321,954	4,311	3,371	**1,329,636**	1,321,881	4,311	7,899	**1,334,091**
Loans and receivables;								
Deposits with credit institutions				**41,583**				**41,583**
Loans secured by mortgages				**86**				**86**
Policyholder loans				**36**				**36**
				41,705				**41,705**
Total financial assets				**1,371,341**				**1,375,796**
Financial instrument liabilities 2016								
Derivatives liabilities (see Note 20)				**(47)**				**(47)**
Investment contract and liabilities (see Note 11)				**(683,012)**				**(683,012)**
				(683,059)				**(683,059)**

9. FINANCIAL INVESTMENTS continued

	Group				Scottish Friendly			
	Level 1 £000	Level 2 £000	Level 3 £000	**Total £000**	Level 1 £000	Level 2 £000	Level 3 £000	**Total £000**
Financial instrument assets 2015								
Financial investments designated at fair value;								
Shares, other variable yield securities and units in OEICs and unit trusts	1,038,855	–	–	**1,038,855**	1,038,756	–	–	**1,038,756**
Debt securities and other fixed income securities	245,561	–	4,473	**250,034**	245,561	–	4,473	**250,034**
Private equity investments	–	–	1,458	**1,458**	–	–	5,289	**5,289**
Land and buildings	–	3,325	–	**3,325**	–	3,325	–	**3,325**
	1,284,416	3,325	5,931	**1,293,672**	1,284,317	3,325	9,762	**1,297,404**
Derivative assets	–	38,209	–	**38,209**	–	38,209	–	**38,209**
Financial assets measured at fair value through profit and loss	1,284,416	41,534	5,931	**1,331,881**	1,284,317	41,534	9,762	**1,335,613**
Loans and receivables;								
Deposits with credit institutions				**41,975**				**41,975**
Loans secured by mortgages				**86**				**86**
Policyholder loans				**35**				**35**
				42,096				**42,096**
Total financial assets				**1,373,977**				**1,377,709**
Financial instrument liabilities 2015								
Derivatives liabilities (see Note 20)	–	(2,930)	–	**(2,930)**	–	(2,930)	–	**(2,930)**
Investment contract liabilities	(669,655)	–	–	**(669,655)**	(669,655)	–	–	**(669,655)**
	(669,655)	(2,930)	–	**(672,585)**	(669,655)	(2,930)	–	**(672,585)**

Financial instruments have been categorised between Levels 1, 2 or 3 for the fair value hierarchy on a consistent basis between 2015 and 2016. There have been no changes to the valuation methods of Levels 1, 2 or 3 in 2016 and no change in the nature of the financial instruments. All changes in fair value of financial instruments have resulted directly from trading in 2016 and market movement. On this basis, no reconciliation for movements between Level 1, 2 and 3 is required.

The derivatives to hedge against economic exposure of assets held by the Group and Scottish Friendly are shown in the table below.

	Non-linked Derivative Assets £000	Non-linked Derivative liabilities £000	Total £000
2016			
Currency forwards	4	(47)	(43)
Total	**4**	**(47)**	**(43)**
2015			
Interest rate swaps, interest rate swaptions and inflation swaps	38,209	(2,884)	35,325
Currency forwards	–	(46)	(46)
Total	38,209	(2,930)	35,279

Notes to the Accounts
continued

10. TANGIBLE ASSETS

Group and Scottish Friendly

	Computer equipment £000	Motor vehicles £000	Fixtures & fittings £000	Total £000
Cost				
At 1 January 2016	1,143	101	452	1,696
Additions	–	–	26	26
Disposals	–	–	–	–
At 31 December 2016	**1,143**	**101**	**478**	**1,722**
Depreciation				
At 1 January 2016	889	80	343	1,312
Charge for the year	8	17	37	62
Disposals	–	–	–	–
At 31 December 2016	**897**	**97**	**380**	**1,374**
Net Book Value at 31 December 2016	**246**	**4**	**98**	**348**
Net Book Value at 31 December 2015	254	21	109	384

11. TECHNICAL PROVISIONS

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

	Non-profit Insurance Contracts		With-Profits Insurance Contracts	
2016	Gross £000	Reinsured £000	Gross £000	Reinsured £000
1 January	731,770	(586,304)	748,820	(433,972)
Reattribution of liabilities	(115,498)	–	132,014	–
Premiums received	25,741	(17,063)	40,126	–
Liabilities paid by claims	(39,132)	65,070	(92,352)	6,435
Business transfer in	–	–	–	–
New Business	22,169	(27,685)	2,439	–
Experience variations and assumption changes	73,306	(111,756)	114,745	(30,006)
31 December	**698,356**	**(677,738)**	**945,792**	**(457,543)**

	Non-profit Insurance Contracts		With-Profits Insurance Contracts	
2015	Gross £000	Reinsured £000	Gross £000	Reinsured £000
1 January	234,438	(146,713)	312,485	–
Premiums received	9,361	(10,935)	43,126	–
Liabilities paid by claims	(47,337)	43,250	(52,389)	–
Business transfer in	485,905	(399,446)	460,263	(433,972)
New Business	68,454	(67,660)	3,905	–
Experience variations and assumption changes	(19,051)	(4,800)	(18,570)	–
31 December	731,770	(586,304)	748,820	(433,972)

11. TECHNICAL PROVISIONS continued

	Unit-Linked Insurance Contracts	
	2016 £000	2015 £000
1 January	**119,297**	24,152
Reattribution of liabilities	**(1,095)**	–
Premiums received	**9,842**	13,858
Liabilities paid by claims	**(25,045)**	(11,737)
Business transfer in	**–**	94,180
New Business	**–**	2,618
Fees deducted	**(2,558)**	(568)
Change in investment value of contracts	**19,605**	(3,206)
31 December	**120,046**	119,297

	Investment Contracts	
	2016 £000	2015 £000
1 January	**669,655**	285,205
Reattribution of liabilities	**(15,422)**	–
Premiums received	**20,550**	14,949
Liabilities paid by claims	**(58,442)**	(46,577)
Business transfer in	**–**	389,722
New Business	**2,109**	1,142
Fees deducted	**(6,404)**	(3,064)
Change in investment value of contracts	**70,966**	28,278
31 December	**683,012**	669,655

The principal assumption underlying the calculation of the technical provisions is that future interest earnings will be 2% for all assurance business. The mortality table used for ordinary assurance was the AM00, for industrial assurance English Life No.16 (Males), for term assurance TM00 and for other business PNMA00.

During 2016 work was undertaken to improve the attribution of elements of the liability between the UK GAAP classifications. The impact of these is shown separately in the reattribution of liabilities line.

12. COSTS OF BONUSES

Group and Scottish Friendly

Total bonuses attributable to the year are as follows:

	2016 £000	2015 £000
Year end reversionary bonus declared (included in change in other technical provisions)	**2,452**	2,722
Reversionary and terminal bonuses paid (included in claims)	**12,374**	11,492
	14,826	14,214

13. 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 2016, the charge included in the Technical Account relating to the employer's contributions to this scheme was £480,000 (2015: £220,000). There were no outstanding or prepaid contributions at the date of the Balance Sheet.

MGM Assurance Staff Pension Plan

The society sponsors MGM Assurance Staff Pension Plan, a funded defined benefit pension scheme in the UK. The scheme is set up on a tax relieved basis as a separate trust independent of the society and is supervised by independent trustees. The trustees are responsible for ensuring that the correct benefits are paid, that the scheme is appropriately funded and that scheme assets are appropriately invested.

The society pays the balance of the cost as determined by regular actuarial valuations. The Trustees are required to use prudent assumptions to value the liabilities and costs of the scheme whereas the accounting assumptions must be best estimates.

Under the current Recovery Plan, dated October 2016, the society is paying contributions of £226,667 per month for a period of 2 years and 6 months from 1 November 2016 to 30 April 2019.

A formal actuarial valuation was carried out as at 31 December 2015. The results of that valuation have been projected to 31 December 2016 with allowance for benefit cashflows and using the assumptions set out below. The figures in the following disclosure were measured using the Projected Unit Method.

The amounts recognised in the statement of financial position are as follows:

	2016 £000	2015 £000
Defined benefit obligation	**(119,433)**	(93,738)
Fair value of plan assets	**112,096**	90,134
Net defined benefit (liability)/asset	**(7,337)**	(3,604)
Restriction on asset recognised	**–**	2,200
Net amount recognised at year end (before any adjustment for deferred tax)	**(7,337)**	(1,404)

The amounts recognised in comprehensive income are:

The current and past service costs, settlements and curtailments, together with the net interest expense for the year as included in profit or loss. Remeasurements of the net defined benefit liability are included in other comprehensive income.

	2016 £000	2015 £000
Service cost:		
Current service cost (net of employee contributions)	**–**	–
Administration expenses	**–**	–
Loss/(gain) on plan introductions, changes, curtailments and settlements	**–**	–
Net interest expense/(credit)	**46**	56
Charge/(credit) recognised in profit of loss	**46**	56
Remeasurements of the net liability:		
Return on scheme assets (excluding amount included in net interest expense)	**(17,156)**	2,307
Actuarial gains/(losses)	**25,536**	(86)
Charge/(credit) recorded in other comprehensive income	**8,380**	2,221
Total defined benefit cost (credit)	**8,426**	2,277

13. PENSIONS continued

The principal actuarial assumptions used were:

	2016 %	2015 %
Liability discount rate	**2.60%**	3.70%
Inflation assumption – RPI	**3.70%**	3.50%
Inflation assumption – CPI	**3.00%**	2.80%
Rate of increase in salaries	–	–
Revaluation of deferred pensions:		
GMP	**Fixed rate**	Fixed rate
Excess over GMP	**3.00%**	2.80%
Increase for pensions in payment:		
Pre 88 GMP	**–**	–
Post 88 GMP	**3.00%**	3.00%
Excess over GMP (RPI capped at 5%)	**3.50%**	3.40%
Proportion of employees opting for early retirement	–	–
Proportion of employees commuting pension for cash	–	–
Expected age at death of current pensioner at age 65:		
Male aged 65 at year end:	**88.6**	87.4
Female aged 65 at year end:	**90.6**	89.7
Expected age at death of future pensioner at age 65:		
Male aged 45 at year end:	**90.8**	89.2
Female aged 45 at year end:	**92.2**	91.6

Reconciliation of Plan assets and liabilities	Assets £000	Reinsured £000	Gross £000
At start of period	90,134	(93,738)	(3,604)
Benefits paid	(3,249)	3,249	–
Administration expenses	–	–	–
Current service cost	–	–	–
Contributions from the employer	4,693	–	4,693
Contributions from employees	–	–	–
Interest income/(expense)	3,362	(3,408)	(46)
Return on assets (excluding amount included in net interest expense)	17,156	–	17,156
Actuarial gains/(losses)	–	(25,536)	(25,536)
Gain/(loss) on plan introductions and changes	–	–	–
Gain/(loss) on curtailments	–	–	–
Assets distributed/liabilities extinguished on settlements	–	–	–
Assets acquired/liabilities assumed in a business combination	–	–	–
At end of period	**112,096**	**(119,433)**	**(7,337)**

Notes to the Accounts
continued

13. PENSIONS continued

The return on Plan assets was:

	2016 £000	2015 £000
Interest income	**3,362**	3,249
Return on plan assets (excluding amount included in net interest expense)	**17,156**	(2,307)
Total return on plan assets	**20,518**	942

The major categories of Plan assets are as follows:

	2016 £000	2015 £000
Uk Equities	**1,746**	1,026
Overseas Equities	**3,760**	3,078
Corporates	**–**	–
Gilts	**11,234**	9,223
Index Linked	**76,772**	59,395
Property	**3,422**	3,506
Commodities	**1,075**	1,140
Hedge Fund	**12,105**	11,388
Cash	**1,982**	1,378
Total market value of assets	**112,096**	90,134

14. WITH PROFITS ACTUARY

Mr DJ Lechmere of OAC plc served as the With-profits Actuary for the financial year ending 31 December 2016.

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 Lechmere has confirmed that neither he nor his family 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 £99,989 (2015: £84,224).

15. TRANSACTIONS WITH RELATED PARTIES

The aggregate premiums payable for the year by five Directors in respect of Scottish Friendly's products amounted to £23,422 (2015: £17,994).

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

In 2015 the Executive Directors' pension rights with an aggregate value of £3,268,498 were transferred into policies with Scottish Friendly from a defined benefit pension arrangement called the Scottish Friendly Assurance Society Pension and Life Assurance Scheme ("the Scheme") operated by Scottish Friendly. The Scheme provided benefits based on final salary and length of service on retirement, leaving service or death. The Scheme wound up during May 2015 after having secured insurance policies in individual members' names, therefore leaving the Scheme with no further liability for pension benefits.

16. CAPITAL MANAGEMENT

(a) Capital management policies and objectives

Scottish Friendly's capital management objectives are:

- to protect Scottish Friendly's financial strength, providing security to policyholders;
- to comply with the PRA's capital requirements; Scottish Friendly has not breached these requirements at any point in the current or prior year;
- to enable smoothing of investment returns and payouts; and
- to ensure that Scottish Friendly's capital position is sufficient to enable it to invest in the development of the business in order to fulfil its stated core strategic objectives as determined by the Board.

The capital position of Scottish Friendly is monitored on a regular basis and reviewed formally by the Board. The capital position is reported here on the new Solvency II basis, unlike previous years where the realistic balance sheet basis was used.

(b) Solvency II balance sheet

A Solvency II available capital balance sheet is shown below, split between the Main Fund, which is open to new business, and its sub-funds that are closed. The closed funds are the Rational Shelley sub-fund, LANMAS (London Aberdeen and Northern Mutual Assurance Society) sub-fund, the Scottish Legal sub-fund, and the M&GM sub-fund.

Solvency II available capital for both the open and closed funds of Scottish Friendly is determined in accordance with the Solvency II balance sheet methodology. This can be broadly described as placing a fair value on both the assets and participating liabilities, including both benefits already guaranteed and future discretionary benefits.

Participating liabilities comprise asset shares, plus the costs of smoothing, and the value of guarantees and options which have been granted to policyholders plus a best estimate of the liabilities on the non-profit business. The asset share represents the premiums received to date, together with investment return earned, less expenses and charges.

There are two principal types of financial option and guarantee:

- guaranteed lump sum payments due on specified dates. These mainly comprise the sum assured together with annual bonuses added onto participating contracts. Although Scottish Friendly invests in a reasonably broad range of asset types, there is still a risk that assets held to back any individual policy (the asset share) may be depressed at the time that the guaranteed payment due at maturity falls to be paid. The potential cost of honouring these guarantees is quantified as part of the liability for participating contracts; and
- guaranteed annuities. These primarily arise in connection with pension business and occur in one of two forms:
  - a guaranteed income specified in the contract; and
  - guaranteed terms for converting lump sum maturity benefits into an income at maturity.

When calculating the participating liabilities, allowance has been made for actions that management would be expected to undertake on key assumptions, for example future bonus or investment policy in varying market conditions, in line with the PPFMs (Principles and Practices of Financial Management). The cost of financial options and guarantees are measured using a market-consistent stochastic model.

Notes to the Accounts
continued

16. CAPITAL MANAGEMENT continued

(c) Capital Statement

Available capital resources

	2016			2015		
	Main fund £000	**Closed sub-funds £000**	**Total £000**	Main fund £000	Closed sub-funds £000	Total £000
Total available capital resources	**94,332**	**70,135**	**164,467**	167,951	150,030	317,981

The capital resources in 2016 are calculated on the new Solvency II regulatory requirements and the total available capital resources presented represents Solvency II own funds. The Solvency II capital positions are presently unaudited. The 2015 capital resources represent the total capital resources arising within the long term insurance fund valued in line with the PRA regulations in force at that time.

Analysis of contract liabilities gross and net of reinsurance

	2016			2015		
	Gross £000	**Reinsurance £000**	**Net £000**	Gross £000	Reinsurance £000	Net £000
With-Profits insurance	**945,792**	**457,543**	**488,248**	748,820	433,972	314,848
Non-Profits insurance	**698,356**	**677,738**	**20,618**	731,770	586,304	145,466
Investment	**683,012**	**–**	**683,012**	669,655	–	669,655
Unit Linked Insurance	**120,046**	**–**	**120,046**	119,297	–	119,297
Total	**2,447,206**	**1,135,282**	**1,311,924**	2,269,542	1,020,276	1,249,266

(d) Movement in available capital resources

	2016 £000	2015 £000
Opening capital resources	**317,981**	183,413
Other changes to opening capital resulting from adoption of Solvency II	**(174,958)**	–
Transfer of engagements	**–**	147,067
Change in assumptions	**(89,828)**	3,764
Change in management policies	**–**	(19,935)
New business and other factors	**111,272**	3,672
Closing capital resources	**164,467**	317,981

(e) Solvency position (unaudited)

	2016 £000
Own Funds	**164,467**
SCR	**80,933**
Solvency Ratio	**203%**

16. CAPITAL MANAGEMENT continued

(f) 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. The liability valuation will include assumptions about interest rates and investment returns. An adverse change in either variable will increase liabilities and, to the extent that assets are impacted, this may increase or decrease the available capital. For example, a reduction in long-term interest rates would increase the amount of Scottish Friendly's liabilities and could therefore reduce its available capital, depending upon the extent to which the liabilities are matched by assets with similar anticipated cash flows. Currently, the available capital of Scottish Friendly will decrease if interest rates fall.

Similarly, an adverse change in the markets for Scottish Friendly's investment assets could increase or decrease the available capital of Scottish Friendly to the extent that equity falls cannot be reflected in reductions in payments to policyholders because of the present of guarantees and options in the underlying contracts, and any change in assets within the working capital. Currently, a fall in equity/property values would reduce available capital for the Scottish Friendly main fund.

Non-economic assumptions are set at best estimate levels based on historic experience. Scottish Friendly monitors actual experience in mortality, morbidity and persistency rates against the assumptions used, and applies that outcome to refine its long-term assumptions. Amounts paid will inevitably differ from estimates, particularly when the expected payments do not occur until well into the future. Liabilities are evaluated at least quarterly, allowing for changes in the assumptions used, as well as for the actual claims experience. If actual claims experience is less favourable than the underlying assumptions, or it is necessary to increase provisions in anticipation of a higher rate of future claims, then available capital will be reduced.

Scottish Friendly holds guarantees in respect of sums assured and reversionary bonus guarantees on with-profits contracts. Under the Solvency II balance sheet basis, these are explicitly calculated using a stochastic valuation model.

17. TRANSFER OF ENGAGEMENT

Transfer of Engagement for M&GM

On 1 June 2015 the entire long-term business and related assets and liabilities of M&GM transferred to Scottish Friendly. The transfer was carried out in accordance with Part VII of the Financial Services and Markets Act 2000. No consideration was paid.

Approximately 66,000 policies transferred across, with approximately 29,000 new members of Scottish Friendly.

The with-profits and annuity business transferred into a closed ring-fenced sub fund of the long term business fund of Scottish Friendly – "the M&GM sub fund". The unit linked and non-profit business of M&GM transferred into the Scottish Friendly main fund and £10,000,000 was transferred to the M&GM sub fund. The fair value of net assets transferred has been assessed and is shown gross of reinsurance, reflecting the bases in place immediately before and after the transfer.

17. TRANSFER OF ENGAGEMENT continued

The figures are shown gross of reinsurance, and reflect the bases in place immediately before and after the transfer.

	Valuation as at 31 May 2015 £000	Adjustments £000	**Valuation as at 1 June 2015 £000**
Deferred Acquisition Costs	1,162	(1,162)	**–**
Deferred Taxation	(2,015)	2,015	**–**
Investment in Subs	1	–	**1**
Financial Investments Non-Linked	357,624	–	**357,624**
Financial Investments Unit-Linked	374,528	–	**374,528**
Reinsurance assets	837,937	(4,519)	**833,418**
Receivables, Prepayments & Other Assets	16,404	(5,555)	**10,849**
Cash & Cash Equivalents	2,501	–	**2,501**
Total Assets	1,588,142	(9,221)	**1,578,921**
Fund for Future Appropriations	48,421	–	**48,421**
Policy liabilities	1,452,305	(22,235)	**1,430,070**
Deposits Received from Reinsurers	56,557	–	**56,557**
Defined Benefit Pension Liability	1,827	–	**1,827**
Deferred Income Liability	438	(438)	**–**
Insurance Payables & Other Liabilities	28,594	8,079	**36,673**
Total liabilities	1,588,142	(14,594)	**1,573,548**
Cost of Business Combination	–	–	**255**
Fair Value of Net Assets Acquired	–	–	**5,118**

The fair value of net assets transferred has been recognised in the Technical Account in 2015 as a gain on transfer of engagement.

Scottish Friendly sponsors the M&GM Staff Pension Plan ("the Plan") with effect from the date of transfer, as detailed in Note 13. £8,406,000 has been expensed in the Technical Account in relation to funding of the Plan deficit during 2016 (2015: £2,277,000).

18. DEPOSITS RECEIVED FROM REINSURERS

Group and Scottish Friendly

The "Standard" and "Select" annuity products written in the past by M&GM are reinsured under treaties with Pacific Life Re and Hannover respectively, with an overlay treaty with RGA providing 100% reinsurance in total.

The reinsurance treaties include appropriate collateral arrangements, including the following deposits with Scottish Friendly as collateral security for their liabilities and obligations under the contracts.

	2016 £000	2015 £000
Collateral deposits for:		
"Select" annuity (Hannover Re)	**45,182**	46,134
"Standard" annuity (RGA)	**6,748**	6,748
	51,930	52,882

At the year-end Scottish Friendly had pledged £5,743,000 (2015: £5,891,000) to Pacific Life Re as collateral for a longevity swap reinsurance arrangement.

19. CREDITORS ARISING OUT OF DIRECT INSURANCE OPERATIONS

Group and Scottish Friendly

	2016 £000	2015 £000
Due to reinsurers	**2,046**	2,097
Due to intermediaries	**3,508**	1,248
Other insurance payables	**1,297**	539
	6,851	3,884

20. OTHER CREDITORS INCLUDING TAXATION AND SOCIAL SECURITY

	Group		Scottish Friendly	
	2016 £000	2015 £000	2016 £000	2015 £000
Trade Creditors	**628**	323	**628**	323
Investments Creditors	**5,217**	3,987	**5,217**	3,987
Derivative Liabilities (see Note 9)	**47**	2,930	**47**	2,930
Other payables	**3,896**	1,625	**3,259**	1,451
HMRC payments PAYE and VAT	**2,054**	1,637	**1,953**	1,706
	11,842	10,502	**11,104**	10,397

21. RISK MANAGEMENT

Scottish Friendly's approach to risk management is detailed in the Report on Corporate Governance on pages 9 to 14, with a description of the key aspects, controls and risk mitigation details in relation to the principal risks to which Scottish Friendly is exposed, namely financial markets risk, life insurance risk, operational risk and strategic risk.

Further details are also included here below of insurance risk, credit risk and liquidity risk, and a sensitivity analysis of each type of market risk.

Insurance risk refers to the fluctuations in the timing, frequency and severity of insured events, and the expense of administering the in-force business relative to the expectations of Scottish Friendly at the inception of the contract. The exposure of Scottish Friendly depends on the value of claims to be paid in the future, relative to the assets accumulated to the date of claim. The amount of such future obligations is assessed by reference to assumptions with regard to future mortality and/or morbidity rates, persistency rates, expenses, investment returns, interest rates and tax rates.

The Board, having taken advice from the Chief Actuary, may set limits on business volumes, including the maximum volumes of specific products with particular risks based on its risk appetite. The risks are monitored by the Risk function.

The level of insurance risk assumed by Scottish Friendly varies with the type of business written. Additional risks also arise from the financial options and guarantees within contracts.

With profits contracts

With profits contracts (including both conventional and unitised with profits policies) contain a guaranteed benefit on maturity, death or surrender at certain specified dates.

This guaranteed benefit may be increased by the addition of annual bonuses and a final bonus may also be applied when the policy becomes a claim. Scottish Friendly can vary the amount of future bonuses paid, including reducing future bonus additions to zero. Scottish Friendly also has contractual discretion to vary the amount payable on early surrender of the contract. The setting of bonus rates and surrender terms are subject to the relevant PPFM. All discretionary actions must be consistent with the overriding principle that customers be treated fairly.

21. RISK MANAGEMENT continued

The key insurance risk factors of with-profits contracts are:

- *mortality:*
  The guaranteed payments on death generally exceed the value of the assets held to back the policy, giving rise to mortality risk. Assumptions regarding the rate of mortality are taken into account when determining the bonus payments to be added to with profits contracts. The level of these bonus additions can be varied to mitigate differences between expected and actual mortality experience.
- *guarantees:*
  With profits contracts are subject to the risk that the market value of assets held to back the liabilities is depressed at the time that the guaranteed payments specified in the contract fall due to be paid. Scottish Friendly's contractual right to vary future bonus additions can mitigate this risk.
- *persistency and expenses:*
  The most significant costs associated with writing insurance contracts are the costs incurred to acquire the policy. These expenses, together with the ongoing costs of administration, are recovered over the policy's lifetime. If the policy is terminated early, the expense deductions made to the point of termination may be less than the costs incurred. For some product types, this risk is mitigated by Scottish Friendly's contractual ability to vary the amount payable on surrender. Scottish Friendly also controls its administration expenses on an ongoing basis, and Scottish Friendly's right to vary future bonus additions can be used to mitigate this risk.

Protection contracts

Protection policies contain a guaranteed payment on death or disability or illness depending on the terms of the contract. These contracts may also be attached to with profits or unit-linked policies. For most policies the level of benefits payable is determined at the start of the contract and hence the ability of Scottish Friendly to reduce the level of insurance risk accepted by varying terms and conditions may be limited. However, many contracts include a premium review clause and for some contracts the policyholder has the option to reduce benefits in lieu of a premium increase.

The key insurance risk factors of protection contracts are:

- *mortality and morbidity:*
  Scottish Friendly has largely mitigated these risks through the use of reinsurance to transfer most of the mortality and morbidity risk to third-party reinsurers.
- *Persistency and expenses:*
  Scottish Friendly has largely mitigated these risks by charging premium rates it believes are sufficient to meet expenses while remaining competitive for the protection provided, and by the use of third-party reinsurers.

Non-participating insurance contracts – non-profit annuities

For non-profit annuities, the level of annuity payments is determined at the start of the contract and these payments continue until the death of the annuitant and in certain cases the later death of their dependants. Hence the ability of Scottish Friendly to reduce the level of insurance risk accepted by varying terms and conditions is limited.

The key insurance risk factors of annuity contracts are:

- *longevity:*
  The contractual stream of payments made until the death of the annuitant gives rise to longevity risk. An increase in life expectancy will increase the payments that have to be made. Scottish Friendly has mitigated this risk by the extensive use of third-party reinsurers.

Non-participating investment contracts – unit-linked policies

For unit-linked investment business most of the risks (particularly market and credit risk) are borne by the policyholders. The principal benefit payable is the value of the underlying assets and therefore Scottish Friendly generally has limited ability to apply penalties on early surrender or early cessation of regular premiums. The ability to increase charges or apply penalties may be constrained by regulatory or market pressures and by the obligation to treat customers fairly.

The key insurance risk factors of unit linked contracts are:

- *persistency and expenses:*
  Acquisition and administration costs are recovered by management charged deducted over the policy's lifetime. If the policy is terminated early, the expense deductions made to the point of termination may be less than the costs incurred. Expenses may also exceed expense deductions for continuing policies. These risks are mitigated by Scottish Friendly's ability to increase charges or in some instances to apply penalties on early surrender. Scottish Friendly also controls its administration expenses on an ongoing basis.

21. RISK MANAGEMENT continued

Insurance risk sensitivity analysis:

The following table illustrates the impacts on the Fund for Future Appropriations (FFA) of applying stress scenarios in line with the Standard Formula under Solvency II, which are believed to be good approximations of the sensitivities.

	2016 Impact on the FFA £m	2015 Impact on the FFA £m
Increase in expenses	**(4.9)**	(2.2)
Increase in assurance mortality rates	**0.6**	(0.7)
Reduction in persistency	**(3.7)**	(2.9)

Credit risk is the risk of loss arising in the event of the failure of third parties to meet their financial obligations in a timely manner. Scottish Friendly's key exposures relate to holdings in corporate bonds and cash deposits, and defaults in reinsurers and key counterparties. Scottish Friendly manages this risk by setting clear limits and tolerances on exposures to a single counterparty, or groups of counterparties, holding treaties with several different reinsurers and using only reinsurers with appropriate credit ratings.

The potential financial exposure is in the table below, showing the assets of the Group and Scottish Friendly that are subject to credit risk and the Balance Sheet carrying value for that asset. For derivatives the credit rating reflects the credit rating of the counterparty. Linked assets are not subject to credit risk as this risk is borne by the holders of the contracts concerned. The Board does not consider that there is any credit risk associated with Government gilts. Non-linked assets not subject to credit risk include shares and other variable yield securities that are subject to market risk.

Group 2016

	AAA £000	AA £000	A £000	BBB and below £000	Not rated £000	Not subject to credit risk £000	Value in the balance sheet £000
Non-linked assets subject to credit risk:							
Financial investments – debt and fixed income securities	2,047	4,345	59,061	70,299	638	–	136,390
Cash and cash equivalents	–	–	179,662	1,093	–	–	180,755
Reinsurers' share of technical provisions	–	655,282	–	–	480,000	–	1,135,282
Other assets	59	9,241	432	1,184	9,234	1,222	21,372
Linked assets not subject to credit risk	–	–	–	–	–	610,700	610,700
Non-linked assets not subject to credit risk	–	–	–	–	–	624,251	624,251
Total	**2,106**	**668,868**	**239,155**	**72,576**	**489,872**	**1,236,173**	**2,708,750**

21. RISK MANAGEMENT continued

Group 2015

	AAA £000	AA £000	A £000	BBB and below £000	Not rated £000	Not subject to credit risk £000	Value in the balance sheet £000
Non-linked assets subject to credit risk:							
Financial investments – debt and fixed income securities	18,170	11,202	62,001	102,390	–	–	193,763
Cash and cash equivalents	–	2,773	49,832	24,840	6,792	–	84,237
Reinsurers' share of technical provisions	–	586,304	–	–	433,972	–	1,020,276
Other assets	–	–	–	–	3,035	–	3,035
Linked assets not subject to credit risk	–	–	–	–	–	604,203	604,203
Non-linked assets not subject to credit risk	–	–	–	–	–	605,561	605,561
Total	18,170	600,279	111,833	127,230	443,799	1,209,764	2,511,075

The derivative investments require the Group and Scottish Friendly to pledge collateral derivative liabilities and for third parties to pledge collateral for the derivative assets. To help protect against the credit risk, all collateral is held by an intermediary company and at the end of the year Scottish Friendly had pledged £nil (2015: £nil) in cash margin collateral in respect of derivative investments.

No financial assets are past due or impaired at the reporting date and management expects no significant losses from non-performance by counterparties.

Other assets include premium debtors all of which are less than three months old. Scottish Friendly has never experience a significant loss arising from premium debtors because it maintains the right to cancel a policy if premiums are not paid when due. No provision is made for impairment of these assets (2015: £nil).

Liquidity risk is the risk that a firm, whether solvent or not, either does not have available sufficient financial resources to meet its obligations as they fall due, or can secure them only at excessive cost. The key aspect is the risk of mismanagement of short term cash flow that typically arises from the timing of premium receipts, maturities, claims and investment activity. Scottish Friendly managed this risk by monitoring cash flow across key transactions in the business, and investment strategies including level of liquid and readily marketable assets to allow for timely adjustments to match expected liabilities if required.

The analysis below summarises the exposures the Group and Scottish Friendly carry in respect of liquidity risks. The earliest contractual repayment date of investment contracts with discretionary participation features and unit linked investment contracts is repayment on demand and therefore the undiscounted cash flows subject to liquidity risk are £477,068,000 (2015: £459,712,000) and £193,331,000 (2015: £209,943,000) respectively.

Other financial liabilities are repayable between 0-5 years as follows:

	Group		Scottish Friendly	
	2016 £000	2015 £000	**2016 £000**	2015 £000
Other financial liabilities	**103,361**	93,896	**102,623**	93,786

21. RISK MANAGEMENT continued

The tables below show the undiscounted expected maturity analysis of the Group's and Scottish Friendly's insurance contracts and investment contracts with discretionary participation features. These are the amounts that are guaranteed on maturity (or any earlier date where the surrender value is guaranteed).

Group and Scottish Friendly

	0-5 years £000	5-10 years £000	10-15 years £000	15-20 years £000	Over 20 years £000	Total £000
2016						
Liabilities subject to liquidity risk:						
Insurance contracts – guaranteed component	144,688	84,356	19,950	6,635	1,116	256,745
Total	**144,688**	**84,356**	**19,950**	**6,635**	**1,116**	**256,745**
2015						
Liabilities subject to liquidity risk:						
Insurance contracts – guaranteed component	181,557	89,568	23,512	12,919	32,909	340,465
Total	181,557	89,568	23,512	12,919	32,909	340,465

Amounts under unit linked contracts are generally repayable on demand and the Group is responsible for ensuring there is sufficient liquidity within the asset portfolio to enable liabilities to unit linked policy holders to be met as they fall due.

Fair value estimation

Disclosure of the fair value measurements for financial instruments held at fair value in the balance sheet by level of the fair value measurement hierarchy is detailed at Note 9.

The Group does not have any financial liabilities that are held for trading.

The fair value of financial instruments traded in active markets is based on quoted bid prices at the Balance Sheet date, as described in Note 2 to the Financial Statements. These instruments are included in Level 1 and comprise primarily listed equities, OEICs and debt instruments.

The Group closely monitors the valuation of assets in markets that have become less liquid. Determining whether a market is active requires the exercise of judgement and is determined based upon the facts and circumstances of the market for the instrument being measured. Where it is determined that there is no active market, fair value is established using a valuation technique. The techniques applied incorporate relevant information available and reflect appropriate adjustments for credit and liquidity risks. These valuation techniques maximise the use of observable market data where it is available and rely as little as possible on entity specific estimates. The relative weightings given to different sources of information and the determination of non-observable inputs to valuation models can require the exercise of significant judgement.

If all significant inputs required to fair value an instrument are observable, the instrument is included in Level 2. If one or more significant inputs is not based on observable market data, the instrument is included in Level 3.

Specific valuation techniques used to value financial instruments include:

- the use of observable prices for recent arm's length transactions;
- quoted market prices or dealer quotes for similar instruments; in particular, for corporate bonds for which there is no active market the fair value is based on broker/dealer price quotations. Where possible the Group seeks at least two quotations for each bond and considers whether these are representative of fair value in light of current traded levels. Where this information is not available or where it is considered to be not representative of fair value, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics; and
- other techniques, such as discounted cash flow analysis, are used to determine fair value for the remaining financial instruments.

Note that all of the resulting fair value estimates are included in Level 2, except for certain asset back securities which are included in Level 3.

21. RISK MANAGEMENT continued

Market risk sensitivity analysis:

The following table illustrates the impacts on the Fund for Future Appropriations (FFA) of applying stress scenarios in line with the Standard Formula under Solvency II, which are believed to be good approximations of the sensitivities under UK GAAP.

	2016 Impact on the FFA £m	2015 Impact on the FFA £m
Equity Fall	**(2.8)**	(7.0)
Property Fall	**(0.3)**	(0.6)
Interest Rate Fall	**0.7**	(5.1)
Interest Rate Rise	**1.4**	2.3

Designed and produced by Thunderbolt Projects

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