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For more information on Scottish Friendly
and its products visit scottishfriendly.co.uk



We are proud to have been awarded
the best UK Mutual Insurer at this year's
Capital Finance International Awards.

2018 Financial Highlights

Scottish Friendly delivered another year of strong performance, with continuing high levels of sales as well as record assets under management.

Scottish Friendly's commitment to improving products and services for members was the key factor in recording the second highest level of sales in our history.

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

Scottish Friendly continues to monitor current economic and political uncertainty. We believe our long-term strategy based on organic growth, leveraging efficiencies and acquisitions allied with our flexibility, will enable us to overcome any short-term head-winds and continue to build for the future.

Number of members

594,000

The Society continues to grow and the number of members has increased from 559,000 to 594,000.

Pillar 1 Capital

188%

The solvency ratio, defined as the ratio of our capital resources to the capital requirements under the applicable Solvency II regulatory regime, remains strong and well above regulatory requirements.

Sales (APE) ¹

£38.6m

Sales of life protection through partnerships once again accounted for the bulk of the £38.6 million sales figure. There was continued growth across the Scottish Friendly branded product range.

Assets under Management (AuM) ²

£2.8bn

Assets under Management rose in 2018 to £2.8 billion primarily due to the acquisition of a book of business from Mobius Life.

Investment performance

(3.7%)

Our mutual status means we do not pay shareholders dividends and ensures that we are focused on delivering value for our members. The return on asset shares within the Scottish Friendly with-profits fund was -3.7%. This compares to the FTSE All Share Index performance of -9.5% and the FTSE Actuaries UK Conventional Gilts All Stocks Total Return Index of 0.6% over the year.

Notes

¹ Annual Premium Equivalent, gross of reinsurance (APE = Annual Premium Equivalent, calculated as the annual amount of regular premiums plus one tenth of the single premiums on business written during the year).

² Assets under management include assets in the Scottish Friendly Investment Funds ICVC.

Chairman's Statement

Our strategy for growth continues to deliver long term value to our customers in an uncertain economic environment.

Michael Walker
Chairman



Strategy

This has been another successful year for Scottish Friendly in which the continued commitment to mutuality and our strategy for growth has resulted in strong sales and growth in both customer numbers and funds under management.

Funds under management now stand at a record £2.8 billion, including the recently acquired section of business from Mobius Life, while sales of £38.6 million is the second highest figure recorded in the 157-year history of the Group. Member numbers increased to 594,000.

This year continued the significant growth we have delivered over the last five years, against the backdrop of a strong capital position. It was a particularly noteworthy performance given the backdrop of difficult market conditions and economic and political uncertainty.

Our continued progress can be attributed to the commitment to the Diversify and Grow strategy across the business and the tight focus on three key areas, namely:

1. Organic growth through the development of our product range and distribution channels;
2. Business process outsourcing for partners whilst leveraging our efficiencies; and

3. Seeking mergers and consolidation in the life sector

Scottish Friendly's e-business and direct marketing continued to deliver successful sales growth in 2018. Notable initiatives include developing the capabilities of the mobile app as well as the "Investophobia" campaign which drew significant social media attention.

Our continued commitment to our relationships with our partners allowed for the sustained delivery of innovative products. 2018 saw us offering protection products in the adviser market through a new partnership with Guardian Financial Services.

Two transactions during the year demonstrate the success and future potential of the consolidation of this strategy. The transfer of 12,000 members from Mobius Life took place in November 2018 along with total assets of circa £320 million. Meanwhile, Scottish Friendly signed an agreement to take over a substantial book of life and pensions business from Canada Life. This transfer is expected to complete later this year, subject to regulatory and Court approval.

Brexit will continue to influence both economic and political debates for the foreseeable future. We will monitor

developments but do not anticipate any significant changes to the Group's business as a result. While the UK economy held up better than many economic commentators predicted during the year, considerable uncertainty exists however Scottish Friendly has a history of reacting quickly to events and are confident we are able to do so going forward.

Scottish Friendly aims to help customers in their savings journey and today we are well placed to make further progress. While another difficult year may lie ahead for the UK economy, Scottish Friendly has always been able to respond rapidly to political and economic change. I am confident that we are well placed to consolidate our position in the marketplace.

The regulatory environment

This year has seen several areas of regulatory change and Scottish Friendly has implemented the relevant changes to ensure that we continue to meet the various requirements of our regulators.

In January, new regulations relating to the sale of Packaged Retail and Insurance-Based Investment Products (PRIIPs) were introduced and providers were required to produce Key Information Documents (KIDs) for the investments

they offer. Scottish Friendly is a PRIIP provider and KIDs have been prepared for all relevant investments.

In May, the EU's widely publicised General Data Protection Regulation (GDPR) came into effect in the UK. This introduced new requirements and obligations for firms who hold and process personal data. Scottish Friendly's privacy policy is available on our website along with details on how we use and manage customer data.

The delayed Insurance Distribution Directive came into effect in October with the aim of creating a level playing field for those involved in the sale and distribution of insurance products.

In December, the Senior Managers & Certification Regime (SM&CR) was implemented for insurers. The SM&CR aims to strengthen governance structures and the individual accountability of senior managers and directors within insurers. Appropriate changes were made throughout 2018 to ensure Scottish Friendly meets the requirements of the new regime.

Finally, throughout 2018 we have been trying to anticipate the effects of the UK's withdrawal from the EU and the possible regulatory changes this may bring about. Amid the uncertainty, Scottish Friendly's primary focus has been ensuring that we continue to fulfil our obligations to customers and meet their expectations in relation to the services and products we provide.

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. The strength and flexibility of our governance processes help us to respond to regulatory changes and developments in best practice. 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 14 to 22 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. These are further examples of our commitment to best practice and to the continued improvement and evolution of our key processes.

Scottish Friendly is a member of the Association of Financial Mutuals and support its governance standards. This promotes the interests of our members and helps to sustain the value of mutual societies in the UK.

Corporate social responsibility

The Scottish Friendly Children's Book Tour supports the Scottish Book Trust in its efforts to improve child literacy by organising visits by authors to primary and secondary schools in deprived communities and remote areas to foster a love of reading, writing and illustration.

To mark the 20th anniversary in 2018, well-known authors visited schools in every local authority area in Scotland, as well as making visits to England and Northern Ireland for the first time. The writers included Julia Donaldson, author of the bestselling Gruffalo series and a former Children's Laureate. In all, around 10,000 children took part in tour events throughout 2018.

The highlight of the tour was a special Jamboree event at the Glasgow Royal Concert Hall attended by more than 2,000 young people. Appearing at the event were Jacqueline Wilson, author of Tracy Beaker, Cressida Cowell, author of How to Train Your Dragon and The Etherington Brothers, creators of comic Monkey Nuts.

Corporate recognition

Increasing our media profile remains a key objective for Scottish Friendly, as a strong profile reinforces our credentials as a UK-wide organisation. It also supports our marketing and sales efforts in organic growth and raises awareness of our business process outsourcing model, as well as our strong track record in mergers and acquisitions.

Scottish Friendly continues to contribute regularly to debate in the media on personal finance and economic issues affecting consumers. In addition, we are constantly looking for new and original ways to differentiate our activity from others. Developing a relationship with the Centre for Economics and Business

Research, we undertook research looking at the most popular investment vehicle, ISAs, and how they have shaped our financial outlook. The research received widespread coverage on radio and television, as well as generating extensive articles in national, online and regional newspapers.

The Board

April 2018 saw the arrival of two new Non-Executive Directors to the Board, Anja Balfour and Gillian Watson. Anja assumed the Chairmanship of the Investment Committee and is a member of the Risk Committee whilst Gillian is a member of the Audit and Remuneration Committees. In April we also said farewell to Simon Miller who retired as a Non-Executive Director and Chair of the Investment Committee.

Scottish Friendly's people

Once again I would like to thank all of our people for their continued commitment to Scottish Friendly. They make a major contribution to ensuring the Board's strategic objectives are met.

While 2018 proved to be a challenging year of economic and political uncertainty, the ability of our teams to react quickly and effectively to changing circumstances delivered significant value for customers and helped to drive the business forward.

Michael Walker
Chairman

Chief Executive's Review

Our mutual status is a tremendous strength, delivering positive results this year and helping Scottish Friendly plan for the long term.

Jim Galbraith
Chief Executive



Strategy

As a Group we are always looking for new ways to enhance the overall experience for our customers, recognising that is one of the best ways to differentiate ourselves in the market. This year we completed an upgrade of our back office system, Sonata, which will deliver a number of improvements to service levels. In addition, we have worked hard to refresh our product statements. When this project is completed later this year customers will find it much easier to access important information and see how we are able to help them save and invest throughout the various stages of their lives.

Scottish Friendly's strategy

Organic growth

Scottish Friendly's e-business and direct marketing initiatives continued to help record significant gains in 2018 with a 27% increase in sales attributable to these initiatives. Some of the initiatives deployed in 2018 were developments in our mobile app, with new functionality allowing customers to do more on the go. We also launched a successful brand campaign called 'Investophobia', aiming to help take the fear out of investing. In addition, we undertook our most

successful Black Friday campaign, which was promoted via traditional mail packs and email. We continue to fulfil an important role in offering Investment ISAs at a price point that makes them affordable to mid-to-low income families.

Partnerships business process outsourcing

We successfully delivered innovative products and services for all our partners, both new and existing. These initiatives not only generated positive results for the Group but met the growth ambitions of our partners and needs of customers. Beagle Street continued to be a major driving force behind Scottish Friendly's robust results. Guardian Financial Services is our first major partner in the adviser protection market and results have built steadily since its full launch in September 2018. We are confident our investment in innovative products, technology and customer service will continue to add value to existing relationships and attract new business partners.

Mergers and consolidation

We have a proven record of acquiring and consolidating businesses and it was another busy year on the transaction front. In November 2018 the agreement to purchase a bundled group pension

business from Mobius Life received High Court approval and the transfer of 12,000 members and total assets of circa £320 million took place. Scottish Friendly also signed an agreement to take over a substantial book of life and pensions business from Canada Life. We expect the transfer to be completed in the fourth quarter of 2019, subject to regulatory and Court approval. Since 2008 Scottish Friendly has acquired eight blocks of business and continues to look for new opportunities.

Results

Scottish Friendly delivered the second-best sales results in its history in 2018. Total sales were £38.6 million APE (the industry standard measure of annual premium equivalent – regular premiums plus one tenth of single premiums). The corresponding figure in 2017 was £44.8 million, a record year in relatively benign market conditions. Of the 2018 total, protection sales were £24.3 million (2017: £32.3 million) and savings and investments amounted to £14.3 million (2017: £12.5 million). Included within these, direct marketing and e-business sales increased in 2018 to £12.1 million. Statutory earned premiums increased to £110.5 million (2017: £93.9 million).

Net premium income from insurance contracts increased to £65.7 million from £60.9 million in 2017 and premiums earned on investment contracts increased to £32.5 million from £25.1 million. There was a fall in the ratio of administration expenses to total premium income APE to a 6.9% renewal ratio (2017: 7.8%). The Net Transfer to the Fund for Future Appropriations for the year was £14.4 million (2017: £1.5 million).

Scottish Friendly membership increased from 559,000 in 2017 to 594,000 in 2018, taking into account new customer numbers offset by matured policies. Scottish Friendly administers more than one million policies across more than 150 product lines.

Financial position

The return on the asset shares within the Scottish Friendly with-profits fund for 2018 was -3.7%, against 9.2% in 2017. This performance reflects a year of significant volatility across all markets and asset classes, which saw the FTSE All Share Index fall by -9.5% and the FTSE Actuaries UK Conventional Gilts All Stocks Total Return Index increase by 0.6%. As a result, we saw a small reduction in final bonus rates for most with-profits customers over the year. Scottish Friendly assets under management grew slightly to £2,800 million, compared to £2,706 million in 2017, primarily due to the acquisition of the Mobius Life pension book.

Our capital position as measured by the solvency coverage ratio remains strong and, at 188% (2017: 199%), is significantly in excess of the regulatory requirements under the Solvency II regulatory regime that applies to insurers. We continue to concentrate on a robust Risk Management Framework in order to support the capital position and diverse cash flows while also being flexible enough to allow us to take advantage of future opportunities.

Scottish Friendly's Fund for Future Appropriations is £184.7 million with a surplus of £14.4 million being generated in the year. The Fund for Future Appropriations represents funds that have not been allocated to specific policyholders and free assets.

Outlook

The economic outlook for the UK will be heavily influenced by its new arrangement with the European Union, which may not fully stabilise for some time. However we believe the direct impact of Brexit will be limited on the Society.

Against this background, Scottish Friendly takes strength from its mutual status. Throughout our history we have experienced many economic cycles and have always taken the long view. With our current strategy we are able to protect value during short term turbulence while simultaneously planning measures to enhance our asset base in the future.

Scottish Friendly's financial results in 2018 demonstrate our continuing ability to be successful in times of great uncertainty while building the business with strategic partnerships and acquisitions. We therefore look forward to 2019 with confidence.

Jim Galbraith
Chief Executive

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 and M&GM Assurance (Trustees) Limited. Recently retired as Chairman of Walkers Shortbread Limited and former Chairman of legal firm Maclay Murray & Spens.

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. Executive Chairman of Ascensos Limited and other private companies.

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

Executive

J Galbraith BSc, MBA, FFA
Chief Executive

NE Lovatt ACII, BA, MSc (Dip)
Commercial Director

M Pringle BSc, FCA
Finance Director and Company Secretary

A Abernethy BSc, MSc
Head of Risk Assurance and Compliance

of Swiss Re Life and Health Australia. Currently Chair of FIL Life Insurance Limited and FIL Life Insurance (Ireland) DAC and Non-Executive Director 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. 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 and M&GM Assurance (Trustees) Limited. Fellow of the Institute and 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 and Santander's life insurance businesses. Currently a Non-Executive Director of Clyde Valley Housing Association and Independent Member of the With Profits Committees at Aegon UK and Phoenix Group.

Anja M Balfour BSc (Hons), ASIP

Appointed as a Director in April 2018. Chairman of the Investment Committee and member of the Risk Committee. Currently Chair and Non-Executive of Schroeder Japan Growth Fund, and Non-Executive Director and Chair of Audit Committee of Martin Currie Asia Unconstrained Trust Plc. Also holds Non-Executive Director positions at British Trust Empire plc and BMO Global Smaller Companies Plc.

Gillian Watson

Appointed as a Director in April 2018. Member of the Audit Committee and Remuneration Committee. Currently

J Mackay BA (Hons)
Head of Marketing

S Macpherson BSc (Hons)
Head of IT (joined on 23 April 2018)

I Neilson
Operations Director

A Rankine BSc, FFA
Head of Actuarial (joined on 30 July 2018)

Chair of both Speyside Whisky Distributors (t/a Gordon & Macphail) and DC Alpha Investments SPC Ltd. Also holds Non-Executive Director positions in Meallmore Ltd, Martin Currie Global Portfolio Trust and Royal Edinburgh Military Tattoo and is a Trustee of the Boswell Trust.

Jim Galbraith BSc, MBA, FFA

Chief Executive from 1 January 2017

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 and M&GM 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.

Martin Pringle BSc, FCA

Finance Director and Company Secretary

Joined Scottish Friendly in June 2016. Appointed as a Director in February 2018. A qualified chartered accountant with over 20 years' experience in the financial services industry. Member of the Investment Committee and Board. Secretary for the Board, Board Committees and the subsidiary companies.

Directors' Report

The Directors have pleasure in submitting their Annual Report and Accounts for the year ended 31 December 2018. 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 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 five 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 and M&GM 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. 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 MGM Assurance (Trustees) Limited which is registered in England and Wales.

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 and the Board, Scottish Friendly had the required margin of solvency as prescribed in the Solvency II regulatory requirements as at 31 December 2018 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 Chief Actuary, 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.

Longer term viability statement

Scottish Friendly invests for long term capital growth and as such members rely on the stability of the group over the longer term. This is reflected in the analysis of the principal risks within the Corporate Governance section of this report. Key risks have been analysed and disclosed as well as the framework in place to manage and mitigate these risks. The sensitivity of the capital position to these principal risks has also been illustrated.

The Risk Management Framework is integrated within 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 scenarios covering a period of five years. This enables management to take any necessary actions to de-risk the balance sheet to ensure the adequate level of capital is held, in line with Scottish Friendly's risk appetite. Overall, this empowers the Board to make an assessment of Scottish Friendly's viability to continue operations and meet its obligations over five year time period. This period reflects the Scottish Friendly planning cycle. Based on this robust assessment of the principal risks, 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 Board has also considered the impact that Brexit is likely to have on the continuing operations of Scottish Friendly and deems that Scottish Friendly have a reasonable expectation that the company will be able to continue its operations post Brexit.

Tax strategy

Oversight of the operation of tax risk has been delegated to the Finance Director. Scottish Friendly has published its tax strategy on its website and this can be found at: www.scottishfriendly.co.uk/tax-strategy

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 (cont)

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.

Modern Slavery Act

The Modern Slavery Act 2015 (Slavery Act) requires a commercial organisation over a certain size to publish a slavery and human trafficking statement for each financial year. This statement can be found on Scottish Friendly's website. Scottish Friendly welcomes the act and is committed to the eradication of human trafficking and slavery. Slavery and human trafficking are abuses of a person's freedom and rights. We are totally opposed to such abuses in our direct operations, our indirect operations and our supply chain as a whole. We consider that the greatest risk of slavery and human trafficking would be in our supply chain where operational and managerial oversight is out of our direct control and we expect our partners to operate in line with our corporate values.

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 2018, Scottish Friendly had 1,256,000 (2017: 1,230,000) policies and estimated the number of members to be 594,000 (2017: 559,000).

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
27 March 2019

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 Managers & Certification Regime (SM&CR) 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 SM&CR.

The Board

The Board met formally on ten occasions in 2018 and informally on two occasions (May and November strategy sessions). 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 Board and Board Committee meetings. All Directors were present at the meetings except for apologies from the Chairman on one occasion and the following apologies from Non-Executive Directors and Directors:

- Apologies on four separate occasions for Board meetings from three Non-Executive Directors and one Executive Director;
- Apologies on one occasion from one Non-Executive Director for the Audit Committee;
- Apologies on one occasion from one Non-Executive Director for the Risk Committee.

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 May to set out the strategic framework and 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	10 (10)	–	4 (4)	2 (2)	3 (4)	3 (3)
Simon EC Miller (left April 2018)	4 (5)	–	–	1 (1)	1 (1)	–
Dermot J Jenkinson	10 (10)	4 (4)	–	–	–	3 (3)
David C Huntley	9 (10)	4 (4)	4 (4)	2 (2)	–	–
Kerr Luscombe	10 (10)	4 (4)	4 (4)	2 (2)	–	–
Anja Balfour (joined April 2018)	5 (6)	–	2 (3)	–	4 (4)	–
Gillian Watson (joined April 2018)	6 (6)	2 (3)	–	1 (1)	–	–
Jim Galbraith	10 (10)	–	4 (4)	–	4 (4)	3 (3)
Neil Lovatt	9 (10)	–	–	–	–	–
Martin Pringle	10 (10)	–	–	–	3 (3)	–

Report on Corporate Governance (cont)

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

Scottish Friendly maintains a robust Risk Management Framework (RMF) that creates an effective risk management capability across the business. The RMF describes both the strategic aspects of risk management, such as stress testing, as well as the more operational aspects such as risk assessment and assurance. The components of the RMF are shown below.

Risk Management Framework

The RMF sets out the basis of how risks are managed across the business and the linkage between the various activities. Each risk category is allocated an Executive Risk Owner (ERO).

Board approved Risk Appetite Statements (RAS) are in place for each risk category; these consider the implications of the current strategy and the risks that are created in pursuit of the objectives.

The assessment considers not only the strategic priorities at the point in time assessment, but also what is proposed over the planning horizon and potential deviations from the agreed strategy.

The Own Risk and Solvency Assessment (ORSA) is an integral part of the strategic decision making process within Scottish Friendly and its results inform capital management, investment and product development decisions taken by the Executive and the Board. As well as this, the ORSA creates a link between the risks that are being taken to deliver the strategy and the capital implications that arise as a consequence of the chosen strategy.

Risk policies are in place; these define the principles and standards for managing key risks across the business. Each policy has been allocated an ERO who is responsible for ensuring compliance with the standards across the company on an ongoing basis.

For each risk category, Key Risk Indicators (KRIs) and associated metrics have been developed and agreed. These enable risk to be measured on an ongoing basis against agreed tolerance levels. Metrics include not only the solvency specific metrics, but also a range of additional elements covering the risks to which Scottish Friendly is exposed. The KRIs also highlight whether risks are increasing or otherwise.

Scottish Friendly maintains a Risk Register that categorises risks at 3 levels appropriate to the characteristic of the risk:

- An ongoing process of Risk and Control Self-Assessment (RCSA) is in place for monitoring and managing inherent and

Risk Management Framework



residual risk exposures. A key element of the RCSA process is the identification of risks and the management of risk through the assessment of the performance of key controls. This process is performed at both a functional and at a consolidated corporate wide level and is the mechanism for identifying, assessing and reporting the key risks from a strategic perspective.

- The RCSA process also requires the identification and assessment of emerging risks. These are risks that may arise from changing external factors and that are not of immediate concern but which may however, pose a threat to the business model over the longer term.
- The output of the RCSA process enables EROs at functional area level, as well as at risk category level, to attest to their assessment of residual risk. The Risk function performs regular sampling of the RCSA returns to determine the quality of the assessments and provide reporting to the ERC and Risk Committee on the results of the RCSA.

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 of risks, monitoring of risks and the reporting of breaches of risk appetite are the responsibility of each Executive owner.

In addition, the governance structure includes first line oversight committees such as the Information Security and Business Continuity Committee (ISBCC) and Product and Distribution Committee (PADCOMM). These meetings are chaired by the relevant Executive and membership includes the Risk and Compliance function.

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 Chief Risk Officer. Primary activities include risk assurance reviews, 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 accountability for risk within the business ultimately rests with the Board. Some responsibilities have been delegated to the Audit Committee of the Board, to assist the Board in reviewing the systems of internal controls and the external financial reports of the business, and to the Risk Committee of the Board (BRC), 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. On behalf of the Board, the BRC also conducts an annual assessment of the effectiveness of the Risk function. Further information is set out below on the activities of the Audit and Risk Committees during 2018.

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 Chief Risk Officer. 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 ERC on a quarterly basis and overseen and challenged by the BRC. 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 BRC and the Board on at least an annual basis. EROs review key risk appetite metrics on a monthly basis to assess whether Scottish Friendly is within its risk appetite and also to confirm whether the key risk appetite metrics remain up to date. This analysis is formally presented on a quarterly basis to the ERC, BRC 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, solvency, liquidity, operational, reputation and conduct risks as well as cyber-crime and Brexit. 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.

Solvency risk is defined as the risk that Scottish Friendly does not retain appropriate levels of solvency. This is mitigated by Scottish Friendly maintaining a target capital coverage.

A number of risks will impact the overall Solvency risk including market, underwriting and credit risk.

Report on Corporate Governance (cont)

Liquidity risk is the risk that loss or adverse circumstances will result in the inability of Scottish Friendly, although solvent, to meet its liabilities as they fall due. This is mitigated by monthly budget vs. actual reporting, regular key account reconciliations and Board review of the business plan.

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.

Cyber-crime is continuing to increase and as such Scottish Friendly continue to focus on developing robust controls to monitor and mitigate the threat of cyber risk, which is identified as a key risk within Scottish Friendly given our use of innovative technology for policy administration, sales and customer interaction. Consideration of cyber risk is embedded within the RMF and forms part of the annual stress and scenario testing considered within the ORSA.

Reputation and 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.

Brexit has been a key consideration of the RMF and the ORSA process. These included consideration of the potential risks arising from the UK's withdrawal from the EU. Potential risks to Scottish Friendly as a result of Brexit include economic downturn and changes in customer behaviour, both of which could pose threats to the strategic objectives of Scottish Friendly. Stress and scenario testing is carried out under various Brexit scenarios as part of the ORSA (such as a "no-deal" scenario) to measure Scottish Friendly's exposure and resilience to the uncertainties posed by Brexit. In addition, Brexit has the potential to cause operational risks. Scottish Friendly is actively engaging with the UK and overseas regulators to ensure that this risk is minimised and overall Brexit is expected to have a limited impact on the Society.

Directors

Brief biographies of the current Directors are set out on page 9.

In addition to the Chairman and Vice-Chairman, the Board comprised, as at 31 December 2018, four other Non-Executive Directors and three Executive Directors, being the Chief Executive, the Commercial Director and the Finance Director. This composition is considered to provide an effective and balanced mix of skills and experience to meet the Board's remit. Anja Balfour and Gillian Watson were appointed as Non-Executive Directors as of 1 April 2018. Martin Pringle was appointed to the Board as of 5 February 2018.

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.

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 www.scottishfriendly.co.uk/about-us/board-committee-terms-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 2018 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 and 17.

Audit Committee

Kerr Luscombe

(Chairman)

Dermot Jenkinson

David Huntley

Gillian Watson

(Appointed 1 April 2018)

The terms of reference of the Audit Committee include all matters indicated by the Code. The Committee consisted of four 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. In addition the Chairman, CEO, Finance Director and CRO all attend the audit committee meetings.

During 2018 the Committee met formally on four occasions, with apologies from Ms Watson and the Board Chairman on one occasion. 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 judgment areas and summarised changes in reporting requirements, an example being Scottish Friendly's change in tax status to now paying tax where previously brought forward losses were used to offset any tax charge;
- reviewed the annual financial statements and annual regulatory returns including Solvency II reporting and the Solvency and Financial Condition Report (SFCR) 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 appropriate and completed where necessary;

- approved the internal audit programmes and received regular progress reports from internal audit and ensured that recommendations made were followed up by management. Individual internal audit reviews are scheduled both according to regular assessments of key risk areas on a cyclical approach supplemented with matters of a topical nature. 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;
- reviewed the internal audit charter which had been revised based on new guidance from the Chartered Institute of Internal Auditors. This was compared to the existing charter and areas of change were identified and the charter updated to reflect this;
- reviewed the external auditor's benchmarking exercise and considered recommendations for enhancements to the report and accounts; 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 and reinsurance valuation on a Solvency II basis. The Audit Committee reviews these on behalf of the Board including reports from the Chief Actuary covering methodology, assumptions, significant judgments and other factors impacting the provisions and recommends their approval to the board, this included the impact of the Mobius transfer of business and prior year re-statements; and

- the appropriate recording and valuation of the investment portfolio, especially in the light of Brexit. Approximately 97% 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. No issues with the independence of Deloitte were identified.

Report on Corporate Governance (cont)

Risk Committee

David Huntley
(Chairman)

Kerr Luscombe

Michael Walker

Jim Galbraith

Anja Balfour

(Appointed 1 April 2018)

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 2018 the Committee met on four 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. In particular reviewing 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;
- received regular reports from the Risk Assurance 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 and Risk Assurance reviews during the period;
- Shaped and overseen development of an enhanced risk appetite framework that will be implemented by the group in 2018; and
- Reviewed the relevant risks associated with the Mobius Life and upcoming Canada Life transactions including the risk oversight of the proposed acquisition.

Nomination Committee

Michael Walker
(Chairman)

Jim Galbraith

Dermot Jenkinson

During 2018 the Committee met formally on three occasions. 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 judgment to the Board.

The Committee also ensures that Scottish Friendly's employee policies, described on pages 7 and 8, 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, until 25 April 2018)

Anja Balfour

(Chairman, with effect from 21 June 2018)

Michael Walker

Jim Galbraith

Donald Macleod

(until 14 March 2018)

Martin Pringle

(with effect from 21 June 2018)

Alan Rankine

(with effect from 18 September 2018)

Bryan Johnston

During 2018 the Committee met on four occasions. 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 liability profile, 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 were invited to present to the Committee at an investment away day and investment advisors are routinely invited on an ongoing basis.

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 (30 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

(until 25 April 2018)

Kerr Luscombe

Gillian Watson

(with effect from 28 November 2018)

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. In line with relevant Solvency II requirements, 40% of bonus payments may be deferred for 3 years, if applicable.

The Executive Directors' benefits include a company car and healthcare insurance where applicable.

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.

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	Entitled performance pay deferred £000	Benefits ¹ £000	Year ended 31 Dec 2018 £000	Year ended 31 Dec 2017 £000
Chairman						
Michael J Walker	85	–	–	3	88	86
Executive Directors						
Jim Galbraith	401	106	71	80	658	611
Neil Lovatt	175	44	–	10	229	280
Martin Pringle²	166	70	–	7	243	–
Non-Executive Directors						
Anja Balfour³	38	–	–	–	38	–
David C Huntley	55	–	–	1	56	57
Dermot J Jenkinson	47	–	–	–	47	45
Kerr Luscombe	51	–	–	1	52	50
Simon EC Miller⁴	17	–	–	–	17	50
Gillian Watson⁵	29	–	–	–	29	–

¹ For Executive Directors, benefits comprise the provision of a company car and healthcare insurance payments covering notice periods, as well as, 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.

² Appointed 1 February 2018.

³ Appointed 1 April 2018.

⁴ Resigned 25 April 2018.

⁵ Appointed 1 April 2018.

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

Report on the audit of the financial statements

Opinion

In our opinion the financial statements of Scottish Friendly Assurance Society and its subsidiaries (the 'group'):

- give a true and fair view of the state of the group's and of Scottish Friendly Assurance Society's affairs as at 31 December 2018 and of the group's and Scottish Friendly Assurance Society's income and expenditure for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, including Financial Reporting Standard 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.

We have audited the financial statements which comprise:

- the group and Scottish Friendly Income and Expenditure Accounts;
- the group and Scottish Friendly Balance Sheets; and
- the related Notes 1 to 23 excluding the capital disclosures in Note 16 calculated in accordance with the Solvency II regime which are marked as unaudited.

The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards, including Financial Reporting Standard 102 "The Financial Reporting Standard applicable in the UK and Republic of Ireland" (United Kingdom Generally Accepted Accounting Practice).

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law.

Our responsibilities under those standards are further described in the auditor's responsibilities for the audit of the financial statements section of our report.

We are independent of the group and Scottish Friendly in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the Financial Reporting Council's (the 'FRC's') Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We confirm that the non-audit services prohibited by the FRC's Ethical Standard were not provided to the group or Scottish Friendly.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Summary of our audit approach

Key audit matters

The key audit matters 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 key audit matters are identified with ▲ and any key audit matters which are the same as the prior year identified with ►.

Materiality

The materiality that we used for the group financial statements was £5,500,000 which was determined on the basis of 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 £1,400 and £5,445,000.

Significant changes in our approach

There is no significant change in our approach in the current year.

Conclusions relating to going concern, principal risks and viability statement

Going concern

We have reviewed the directors' statement in page 7 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 the group's and 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.

We considered as part of our risk assessment the nature of Scottish Friendly, its business model and related risks including where relevant the impact of Brexit, the requirements of the applicable financial reporting framework and the

system of internal control. We evaluated the directors' assessment of Scottish Friendly's ability to continue as a going concern, including challenging the underlying data and key assumptions used to make the assessment, and evaluated the directors' plans for future actions in relation to their going concern assessment.

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

Principal risks and viability statement

Based solely on reading the directors' statements and considering whether they were consistent with the knowledge we obtained in the course of the audit, including the knowledge obtained in the evaluation of the directors' assessment of the group's and Scottish Friendly's ability to continue as a going concern, we are required to state whether we have anything material to add or draw attention to in relation to:

- the disclosures on page 11 that describe the principal risks and explain how they are being managed or mitigated;
- the directors' confirmation on page 11 that they have carried out a robust assessment of the principal risks facing the group, including those that would

threaten its business model, future performance, solvency or liquidity; or

- the directors' explanation on page 11 as to how they have assessed the prospects of the group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the group will be able to continue in operation and meet its 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 report, add or draw attention to in respect of these matters.

Key audit matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified. These matters included those which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit; and directing the efforts of the engagement team.

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.

Actuarial Valuation of the Technical Provision ►

Key audit matter description

The assessment of the calculation of technical provisions of with-profit insurance contracts of £729m (2017: £836m) and non-profit insurance contracts of £567m (2017: £563m) on a realistic basis requires management to make significant judgements about assumptions and methodology.

Due to the high level of assumptions and judgements involved, we determined that there was a potential for fraud through possible manipulation of these balances.

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. The related accounting policy and management's consideration of significant judgements and estimates is on page 36.

It is also noted that following an actuarial review performed by management, errors were identified in the measurement of technical provisions and claims outstanding in relation to the reserving methodologies applied. Details of the changes and the resulting restatements for the year ended 31 December 2017 are set out in Note 22.

How the scope of our audit responded to the key audit matter

We have assessed the design and implementation of the internal controls put in place by management to manage the setting of technical provision assumptions.

We have engaged actuarial experts to challenge management's key judgements and the methodology used for consistency with recent experience and market data.

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

We have engaged actuarial experts to assess the detailed actuarial review that had been undertaken by management, and to evaluate the errors that were identified in the measurement of technical provisions and claims outstanding.

Key observations

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

The restatements for the year ended 31 December 2017 set out in Note 22 are considered to be appropriate.

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

Actuarial Valuation of the Reinsurance Asset ►

Key audit matter description

The reinsurance asset relates to the reinsurance contracts in place over annuity and protection business underwritten by Scottish Friendly. The valuation of the reinsurance asset of £1,199m (2017: £945m), as shown in Note 11, requires the application of significant judgement.

Due to the high level of assumptions and judgements involved, we have determined that there was a potential for fraud through possible manipulation of this balance.

In particular, the assumptions around future mortality and morbidity experience are set using expert judgement, to which the reinsurance asset is highly sensitive.

The reinsurance asset split between with-profit and non-profit contracts are set out in Note 11. The related accounting policy and management's consideration of significant judgements and estimates is on page 27.

How the scope of our audit responded to the key audit matter

We have assessed the design and implementation of the internal controls put in place by management to manage the setting of reinsurance asset assumptions.

We have utilised our actuarial experts 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 Scottish Friendly and group have rights to recognise those assets under the specified terms of the contracts.

Key observations

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

Valuation and Custody of Investments ►

Key audit matter description

Investments recorded on the balance sheet represent the largest asset of Scottish Friendly and the group. The balance comprises of £726m (2017: £698m) non-linked financial investments and £550m (2017: £643m) assets held to cover linked insurance and investment liabilities, as set out in Note 9.

Due to the significant and diverse financial asset holding of Scottish Friendly and group, there is a risk of misstatement if investments are inappropriately recognised or incorrectly valued outwith the accounting policy set out on page 27.

Uncertainty and price volatility in the market due to the unknown consequences of Brexit could result in heightened potential risk of pricing errors and uncertainty of future economic inputs into pricing models.

How the scope of our audit responded to the key audit matter

We have assessed the design and implementation of the internal controls put into place by management to verify the existence of investments held and validate the valuation of those investments.

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, and we have involved our own financial instrument specialists where investments were not actively traded. In addition, we have also considered the potential impact of Brexit and reviewed Scottish Friendly's memo on plan.

Key observations

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.

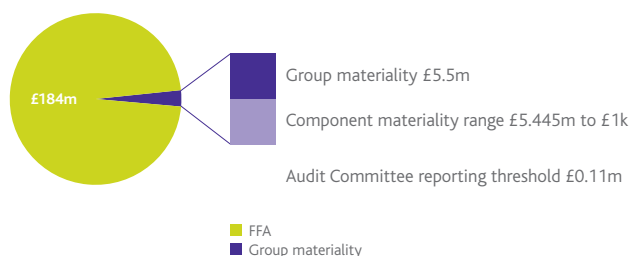
Our application of materiality

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:

	Group financial statements	Society financial statements
Materiality	£5,500,000 (2017: £5,400,000)	£5,445,000 (2017: £5,346,000)
Basis for determining materiality	3% (2017: 2.8%) of Funds for Future Appropriation ("FFA"). In the prior year, a scaled rate of 2.8% was applied to account for the uplift in FFA as a result of the transition to Solvency II reporting methodology.	3% (2017: 2.8%) of Funds for Future Appropriation ("FFA").
Rationale for the benchmark applied	FFA represents funds not yet allocated to policyholders and is considered an equivalent to a net asset figure in accounting for Friendly Societies.	FFA represents funds not yet allocated to policyholders and is considered an equivalent to a net asset figure in accounting for Friendly Societies. Scottish Friendly represents the largest component of the group with 99.97% (2017: 99.98%) of the total asset position being composed of Scottish Friendly held assets. As such, a component materiality threshold cap of 99% of group materiality (2017: 99%) has been applied to reflect the significance of Scottish Friendly to the group structure.



We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £110,000 (2017: £108,000), 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 and Scottish Friendly. 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 £1,400 and £72,000 (2017: £1,500 and £78,000). Scottish Friendly materiality was set at £5,445,000 (2017: £5,346,000) after consideration of the significance of Scottish Friendly to the group structure. All of the audit work to respond to the risks of material misstatement was performed directly by the audit engagement team.

Other information

The directors are responsible for the other information. The other information comprises the information included in the annual report, other than the financial statements and our auditor's report thereon.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our

knowledge obtained in the audit or otherwise appears to be materially misstated.

If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.

In this context, matters that we are specifically required to report to you as uncorrected material misstatements of the other information include where we conclude that:

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

- **Fair, balanced and understandable** – the statement given by the directors that they consider the annual report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the group's position and performance, business model and strategy, is materially inconsistent with our knowledge obtained in the audit; or
- **Audit committee reporting** – the section describing the work of the audit committee does not appropriately address matters communicated by us to the audit committee.

We have nothing to report in respect of these matters.

Responsibilities of directors

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, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the group's and Scottish Friendly's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the group or Scottish Friendly or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists.

Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Details of the extent to which the audit was considered capable of detecting irregularities, including fraud are set out below.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

Extent to which the audit was considered capable of detecting irregularities, including fraud

We identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and then design and perform audit procedures responsive to those risks, including obtaining audit evidence that is sufficient and appropriate to provide a basis for our opinion.

Identifying and assessing potential risks related to irregularities

In identifying and assessing risks of material misstatement in respect of irregularities, including fraud and non-compliance with laws and regulations, our procedures included the following:

- enquiring of management, internal audit and the audit committee, including obtaining and reviewing supporting documentation, concerning Scottish Friendly's policies and procedures relating to:
 - identifying, evaluating and complying with laws and regulations and whether they were aware of any instances of non-compliance;
 - detecting and responding to the risks of fraud and whether they have knowledge of any actual, suspected or alleged fraud;
 - the internal controls established to mitigate risks related to fraud or non-compliance with laws and regulations;

- discussing among the engagement team and involving relevant internal specialists, including tax, valuations, pensions, IT and actuarial specialists regarding how and where fraud might occur in the financial statements and any potential indicators of fraud. As part of this discussion, we identified potential for fraud in the following areas: management judgement in the setting of assumptions for valuation of technical provisions and reinsurance assets; and
- obtaining an understanding of the legal and regulatory framework that Scottish Friendly operates in, focusing on those laws and regulations that had a direct effect on the financial statements or that had a fundamental effect on the operations of Scottish Friendly. The key laws and regulations we considered in this context included the Friendly Societies Act 1992, tax legislation and pensions legislation. In addition, compliance with regulatory solvency requirements were fundamental to Scottish Friendly's ability to continue as a going concern.

Audit response to risks identified

As a result of performing the above, we identified Actuarial Valuation of the Technical Provisions and Actuarial Valuation of Reinsurance Asset as key audit matters. The key audit matters section of our report explains the matters in more detail and also describes the specific procedures we performed in response to those key audit matters.

In addition to the above, our procedures to respond to risks identified included the following:

- reviewing the financial statement disclosures and testing to supporting documentation to assess compliance with relevant laws and regulations discussed above;
- enquiring of management, the audit committee and external legal counsel concerning actual and potential litigation and claims;
- performing analytical procedures to identify any unusual or unexpected relationships that may indicate risks of material misstatement due to fraud;

- reading minutes of meetings of those charged with governance, reviewing internal audit reports and reviewing correspondence with HMRC and the PRA; and
- in addressing the risk of fraud through management override of controls, testing the appropriateness of journal entries and other adjustments; assessing whether the judgements made in making accounting estimates are indicative of a potential bias; and evaluating the business rationale of any significant transactions that are unusual or outside the normal course of business.

We also communicated relevant identified laws and regulations and potential fraud risks to all engagement team members including internal specialists, and remained alert to any indications of fraud or non-compliance with laws and regulations throughout the audit.

Report on other legal and regulatory requirements

Opinions on other matters prescribed by the Friendly Societies Act 1992

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the strategic report and the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the strategic report and the directors' report has been prepared in accordance with applicable legal requirements.

In the light of the knowledge and understanding of the group and of Scottish Friendly and their environment obtained in the course of the audit, we have not identified any material misstatements in the strategic report or the directors' report.

Matters on which we are required to report by exception

Adequacy of explanations received and accounting records

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

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

We have nothing to report in respect of these matters.

Other matters

Auditor tenure

Following the recommendation of the audit committee, we were appointed by Scottish Friendly's Board on 7 August 2012 to audit the financial statements for the year ending 31 December 2012 and subsequent financial periods. The period of total uninterrupted engagement including previous renewals and reappointments of the firm is 7 years, covering the years ending 31 December 2012 to 31 December 2018.

Consistency of the audit report with the additional report to the audit committee

Our audit opinion is consistent with the additional report to the audit committee we are required to provide in accordance with ISAs (UK).

Use of our report

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.

Stephen Williams (Senior statutory auditor)

For and on behalf of Deloitte LLP
Statutory Auditor
Glasgow, United Kingdom
27 March 2019

Income and Expenditure

Technical Account – Long Term Business

For year ended 31 December

	Note	Group 2018 £000	Restated* Group 2017 £000	Scottish Friendly 2018 £000	Restated* Scottish Friendly 2017 £000
Earned Premiums		110,468	93,940	110,468	93,940
Reinsurance Premiums		(44,772)	(33,089)	(44,772)	(33,089)
Earned Premiums, Net of Reinsurance	3	65,696	60,851	65,696	60,851
Investment Income	4	87,403	75,269	87,403	75,269
Unrealised (Losses)/Gains on Investments		(136,479)	36,583	(135,642)	37,427
Other Technical Income		16,807	19,368	14,199	16,866
		33,427	192,071	31,656	190,413
Claims Incurred		154,161	174,956	154,161	174,956
Reinsurance Claims		(76,786)	(76,439)	(76,786)	(76,439)
Net Claims Incurred	5	77,375	98,517	77,375	98,517
Change in Other Technical Provisions		(93,489)	44,842	(93,489)	44,842
Operating Expenses	6	45,085	38,913	45,085	38,913
Investment Expenses & Charges		422	644	422	644
Other Technical Charges		2,364	1,458	777	–
Tax attributable to Long Term Business	8	(4,283)	9,781	(4,467)	9,581
Actuarial Gain re pension scheme		(8,481)	(3,621)	(8,481)	(3,621)
Transfer to/(from) the Fund for Future Appropriations		14,434	1,537	14,434	1,537
		33,427	192,071	31,656	190,413

* Details of the restatement are included in Note 22 to the financial statements.

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 26 to 50 form an integral part of these accounts.

Balance Sheet

Assets

As at 31 December

	Note	Group 2018 £000	Restated Group 2017 £000	Scottish Friendly 2018 £000	Restated Scottish Friendly 2017 £000
<i>Investments</i>					
Land & Buildings		3,500	3,325	3,500	3,325
Other Financial Investments		719,227	691,809	719,151	691,667
Investments in Group Undertakings		–	–	3,114	3,413
<i>Non linked Financial Investments</i>					
Assets Held to Cover Linked Insurance & Investment Liabilities		722,727	695,134	725,765	698,405
		549,511	642,999	549,511	642,999
<i>Total Financial Investments</i>	9	1,272,238	1,338,133	1,275,276	1,341,404
Reinsurers' Share of Technical Provisions		1,199,149	944,681	1,199,149	944,681
<i>Debtors</i>					
Deposits held for Reinsurers	18	6,961	5,081	6,961	5,081
Debtors arising out of Direct Insurance Operations		6,769	1,944	6,769	1,944
Taxation recoverable		277	–	277	–
Other Debtors		3,509	2,792	3,474	2,696
<i>Other Assets</i>					
Tangible Assets	10	404	490	404	490
Negative Goodwill	23	(1,459)	–	(1,459)	–
Pension Scheme Surplus/(Deficit)	13	10,205	(997)	10,205	(997)
Cash at Bank & In Hand		144,504	227,129	140,806	223,485
<i>Prepayments & Accrued Income</i>					
Prepayments & Accrued Interest, Dividends & Rents		62	2,025	62	2,025
		2,642,619	2,521,278	2,641,924	2,520,809

Liabilities

As at 31 December

<i>Funds for Future Appropriations</i>					
		184,653	170,219	184,653	170,219
<i>Technical Provisions</i>					
With-profit Insurance Contract Liabilities	11	728,859	835,723	728,859	835,723
Non-profit Insurance Contract Liabilities	11	566,628	563,056	566,628	563,056
Unit-linked Insurance Contract Liabilities	11	102,028	121,030	102,028	121,030
Investment Contract Liabilities	11	942,215	722,547	942,215	722,547
Claims Outstanding		39,568	33,803	39,568	33,803
<i>Creditors</i>					
Deposit Received from Reinsurers	17	44,607	48,685	44,607	48,685
Creditors arising out of Direct Insurance Operations	19	9,314	6,082	9,314	6,082
Other Creditors including Taxation & Social Security	20	22,112	14,222	21,761	13,927
Accruals and Deferred Income		2,635	5,911	2,291	5,737
		2,642,619	2,521,278	2,641,924	2,520,809

Approved by the Directors and signed on 27 March 2019 on their behalf by:

MJ Walker
Chairman

J Galbraith
Director and Chief Executive

The notes on pages 26 to 50 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 Conduct 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 five 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 the 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.

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

The prior year financial statements were restated for errors in the modelling of the Society's liabilities in the current year. For more information, see Note 22.

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.

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 fund where there is a unit-linked or unitised with-profits option.

Significant judgements and estimates

The group makes estimates and assumptions that affect the reported amounts of assets and liabilities and also makes critical accounting judgements in applying the group's accounting policies. Such estimates and judgements are regularly evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable.

The directors are of the view that there are no critical judgements, but there are more critical areas, where accounting estimates are made, set out below.

- The vast majority of investments held by Scottish Friendly are now in collective investment schemes and are quoted in active markets. The 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. The evaluation of the Technical Provisions is the area of the accounts most reliant on judgement, assumptions about future experience and estimates. For with-profit insurance contracts these judgements impact the expected costs of meeting future guaranteed or discretionary benefits payable to policyholders. For non-profit contracts, these reserves are more sensitive to changes in demographic and expense assumptions; and

2. ACCOUNTING POLICIES continued

- The value placed on the associated reinsurance contracts are based on appropriate valuation assumptions, which are consistent with those used in the evaluation of the relevant insurance contract liabilities.

The reinsurance asset is highly sensitive to assumptions around future mortality and morbidity experience, which are set based on observed experience and rely on judgements about how to interpret that experience and how that experience may change in the future.

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.

Scottish Friendly did not hold any derivative financial investments at either the current or prior year-end.

Valuation of insurance and investment contract liabilities

The liability calculations are undertaken on a Solvency II basis and are based on the demographic and expense assumptions that reflect Scottish Friendly's best estimates of future experiences at the time of calculation. The economic assumptions used are market consistent, in line with the requirements of Solvency II and are set using current market data.

For with-profits the underlying liabilities are based on "asset shares" and reflect the accumulated premiums, investment return, expenses and charges applied to each contract. Where appropriate, the cost of meeting future expected cash flows relating to the with-profits policies, including cash flows resulting from embedded options and guarantees, is evaluated using a stochastic approach. For non-profit contracts, the best estimate liability is calculated using a cash flow projection of all future benefit payments, future expenses and future premiums. These are adjusted for tax where applicable and discounted to give a present value. Credit is only taken for future premiums to the extent that they fall within the boundary of the contract, as defined under Solvency II.

The main assumptions used relate to mortality, morbidity, longevity, 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 re-enact Scottish Friendly's own experience. Expense, lapse and surrender rates assumptions are based on product characteristics and relevant claims experience. Investment returns and discount rates are based on current risk-free market rates as prescribed under Solvency II.

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.

Prior year restatement

During the prior year the Society made corrections to the modelling of the Society's liabilities. The prior year financial statements have been adjusted to reflect the material changes from this work. The prior year restatement is shown in Note 22 and further information on the new Technical Provisions is shown in Note 11.

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 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.

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.

Notes to the Accounts (cont)

2. ACCOUNTING POLICIES continued

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.

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 interests" 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.

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.

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.

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.

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.

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 FRS102. 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.

Land and buildings

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 de-recognised 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.

Claims outstanding

Claims outstanding represents the best estimate of the expected cashflows resulting from all outstanding obligations which have not as yet been paid to policyholders as at year end.

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.

Technical provisions

The technical provisions are determined in accordance with the requirements of the PRA rulebook: Solvency II Firm Technical Provisions Instrument 2015. They are calculated as the expected future cash flows (claims and expenses less premiums) plus a risk margin. The risk margin allows for the cost to a third party of holding the Solvency II capital until all contracts are settled. The prior year finance statements have been restated for material adjustments due to the corrections identified within the actuarial models. Further detail is provided in Note 22.

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.

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.

Notes to the Accounts (cont)

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	
	2018 £000	2017 £000	2018 £000	2017 £000	2018 £000	2017 £000
Annual	104,479	89,656	875	1,056	105,354	90,713
Single	5,114	3,227	–	–	5,114	3,227
	109,593	92,883	875	1,056	110,468	93,940
<i>Comprising</i>						
Premiums for participating contracts					24,667	26,771
Premiums for non-participating contracts					78,790	60,028
Premiums from linked contracts					7,011	7,141
Gross Earned Premiums					110,468	93,940
Reinsurance Premiums on Insurance Contracts					(44,772)	(33,089)
Earned Premiums, net of reinsurance					65,696	60,851

Where policyholders 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 2018		Scottish Friendly 2017	
	Annual £000	Single £000	Annual £000	Single £000
New Business Premiums	37,737	9,120	44,083	7,050

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

	Group		Scottish Friendly	
	2018 £000	2017 £000	2018 £000	2017 £000
Annual Contributions	2,187	3,224	–	–
Single Contributions	532	1,250	–	–

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

4. INVESTMENT INCOME

	Group		Scottish Friendly	
	2018 £000	2017 £000	2018 £000	2017 £000
Income from land & buildings	86	157	86	157
Income from other investments	26,152	26,606	26,152	26,606
Net gains on the realisation of investments	61,165	48,506	61,165	48,506
	87,403	75,269	87,403	75,269

5. CLAIMS INCURRED

Group and Scottish Friendly

	Ordinary Assurance		Industrial Assurance		Total	
	2018 £000	Restated 2017 £000	2018 £000	Restated 2017 £000	2018 £000	Restated 2017 £000
Deaths	26,413	25,040	2,697	2,877	29,110	27,917
Maturities	57,709	76,296	665	1,314	58,374	77,610
Surrenders	11,843	14,337	526	380	12,369	14,717
Annuities	53,833	54,237	–	–	53,833	54,237
	149,798	169,910	3,888	4,571	153,686	174,481
Claims handling expenses					475	475
Aggregate recoveries received from reinsurers					(76,786)	(76,439)
Net Claims Paid on Insurance Contracts					77,375	98,517

The above figures are stated after taking into account the movement in the provision for outstanding claims. The 2017 comparatives have been restated to reflect the prior year adjustment as shown in Note 22.

6. OPERATING EXPENSES AND EXCEPTIONAL COSTS

Group and Scottish Friendly

Operating Costs

	2018 £000	2017 £000
Acquisition costs	10,546	9,251
Administration expenses	8,292	7,667
Information Technology Infrastructure	4,875	3,949
Renewal commission	21,372	18,046
	45,085	38,913
<i>Remuneration of Auditors (included within administration expenses above)</i>		
	2018 £000	2017 £000
Fees payable to the auditor for audit of annual accounts	151	114
Fees payable to the auditor for other services:		
The audit of subsidiary companies pursuant to legislation	10	9
Other services pursuant to legislation	89	78

Notes to the Accounts (cont)

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 109 (2017: 101).

The aggregate payroll costs of these persons were as follows:

	2018 £000	2017 £000
Wages and salaries	4,077	3,700
Social security costs	430	398
Other pension costs	264	221
	4,771	4,319

Remuneration of Directors

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

8. TAXATION

	Group		Scottish Friendly	
	2018 £000	2017 £000	2018 £000	2017 £000
Current tax charge	859	2,788	675	2,588
Deferred tax liabilities	(5,142)	6,993	(5,142)	6,993
Corporation Tax and irrecoverable income tax	(4,283)	9,781	(4,467)	9,581

UK corporation tax in the technical account has been calculated at a rate of 20% (2017: 20%) in accordance with rates applicable to the long term business of a friendly society.

	2018 £000	2017 £000
Transfer to fund for future appropriations	14,434	1,417
Income tax using the policyholder tax rate of 20%	2,887	283
Differences due to policyholder tax items	(6,824)	290
(Over)/Under provided in earlier years	(530)	9,008
Current tax year	(4,467)	9,581

The deferred tax liabilities expected to be settled after 12 months is £2m in the Group (2017: £7m) and £2m in the Society (2017: £7m).

Corporation tax is charged at the standard rate of 19% on the profit on ordinary activities of the subsidiary SFAM £968,876 (2017: £1,040,656) with adjustments in respect of prior year's being £nil (2017:nil).

9. FINANCIAL INVESTMENTS

	Group				Scottish Friendly			
	Carrying Value		Cost		Carrying Value		Cost	
	2018 £000	2017 £000	2018 £000	2017 £000	2018 £000	2017 £000	2018 £000	2017 £000
Non-linked and linked financial investments								
Non-linked financial investments	722,727	695,134	577,537	497,637	725,765	698,405	580,576	501,050
Linked financial investments	549,511	642,999	402,167	448,644	549,511	642,999	402,167	448,644
<i>Total financial investments</i>	1,272,238	1,338,133	979,704	946,281	1,275,276	1,341,404	982,743	949,694
of which financial investments designated as:								
(a) Financial investments designated at fair value	1,107,369	1,298,155	819,755	907,219	1,110,407	1,301,426	822,794	910,632
(b) Loans and receivables	164,869	39,978	159,949	39,062	164,869	39,978	159,949	39,062
<i>Total financial investments</i>	1,272,238	1,338,133	979,704	946,281	1,275,276	1,341,404	982,743	949,694
<i>Non-linked financial investments</i>								
(a) Financial investments designated at fair value;								
Shares, other variable yield securities and units in OEICs and unit trusts	560,575	660,416	419,977	464,824	560,498	660,274	419,901	464,824
Debt securities and other fixed income securities	10,313	10,269	8,337	8,336	10,313	10,269	8,337	8,336
Private equity investments	149	148	657	658	3,264	3,561	3,773	4,071
Land and buildings	3,500	3,325	3,325	3,325	3,500	3,325	3,324	3,325
	574,537	674,158	432,296	477,143	577,575	677,429	435,335	480,556
(b) Loans and receivables								
Policyholder loans	4	36	4	37	4	36	4	37
Deposits with credit institutions	148,186	20,854	145,237	20,371	148,186	20,854	145,237	20,371
Loans secured by mortgages	–	86	–	86	–	86	–	86
	148,190	20,976	145,241	20,494	148,190	20,976	145,241	20,494
<i>Total non-linked financial investments</i>	722,727	695,134	577,537	497,637	725,765	698,405	580,576	501,050
<i>Linked financial investments</i>								
(a) Financial investments designated at fair value;								
Shares, other variable yield securities and units in OEICs and unit trusts	532,832	623,585	387,460	429,640	532,832	623,585	387,460	429,640
Debt securities and other fixed income securities	–	412	–	436	–	412	–	436
	532,832	623,997	387,460	430,076	532,832	623,997	387,460	430,076
(b) Loans and receivables								
Deposits with credit institutions	16,679	19,002	14,707	18,568	16,679	19,002	14,707	18,568
<i>Total linked financial investments</i>	549,511	642,999	402,167	448,644	549,511	642,999	402,167	448,644

Notes to the Accounts (cont)

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 classification due to liquidity or impairment.

Fair value hierarchy

	Group			Total £000	Scottish Friendly			Total £000
	Level 1 £000	Level 2 £000	Level 3 £000		Level 1 £000	Level 2 £000	Level 3 £000	
Financial instrument assets 2018								
Financial investments designated at fair value;								
Shares, other variable yield securities and units in OEICs and unit trusts*	1,088,020	5,387	–	1,093,407	1,087,943	5,387	–	1,093,330
Debt securities and other fixed income securities	6,281	–	4,032	10,313	6,281	–	4,032	10,313
Private equity investments	–	–	149	149	–	–	3,264	3,264
Land and buildings	–	3,500	–	3,500	–	3,500	–	3,500
	1,094,301	8,887	4,181	1,107,369	1,094,224	8,887	7,296	1,110,407
Derivative assets								
Financial assets measured at fair value through profit and loss	1,094,301	8,887	4,181	1,107,369	1,094,224	8,887	7,296	1,110,407
Loans and receivables;								
Deposits with credit institutions	164,865	–	–	164,865	164,865	–	–	164,865
Loans secured by mortgages	–	–	–	–	–	–	–	–
Policyholder loans	–	–	4	4	–	–	4	4
	164,865	–	4	164,869	164,865	–	4	164,869
<i>Total financial assets</i>				1,272,238				1,275,276
Financial instrument liabilities 2018								
Investment contract and liabilities (see Note 11)				(942,215)				(942,215)
				(942,215)				(942,215)

* During the year there has been a transfer of £5.3m from level 1 to level 2 due to the frequency of pricing received from the fund managers.

9. FINANCIAL INVESTMENTS continued

	Group			Total £000	Scottish Friendly			Total £000
	Level 1 £000	Level 2 £000	Level 3 £000		Level 1 £000	Level 2 £000	Level 3 £000	
Financial instrument assets 2017								
Financial investments designated at fair value;								
Shares, other variable yield securities and units in OEICs and unit trusts	1,283,486	515	–	1,284,001	1,283,344	515	–	1,283,859
Debt securities and other fixed income securities	6,556	–	4,125	10,681	6,556	–	4,125	10,681
Private equity investments	–	–	148	148	–	–	3,561	3,561
Land and buildings	–	3,325	–	3,325	–	3,325	–	3,325
	1,290,042	3,840	4,273	1,298,155	1,289,900	3,840	7,686	1,301,426
Derivative assets	–	–	–	–	–	–	–	–
Financial assets measured at fair value through profit and loss								
	1,290,042	3,840	4,273	1,298,155	1,289,900	3,840	7,686	1,301,426
Loans and receivables;								
Deposits with credit institutions				39,856				39,856
Loans secured by mortgages				86				86
Policyholder loans				36				36
				39,978				39,978
<i>Total financial assets</i>				1,338,133				1,341,404
Financial instrument liabilities 2017								
Investment contract liabilities				(722,547)				(722,547)
				(722,547)				(722,547)

10. TANGIBLE ASSETS
Group and Scottish Friendly

	Computer equipment £000	Motor vehicles £000	Fixtures & fittings £000	Total £000
<i>Cost</i>				
At 1 January 2018	1,203	70	643	1,916
Additions	177	–	–	177
Disposals	(894)	(37)	(479)	(1,410)
At 31 December 2018	486	33	164	683
<i>Depreciation</i>				
At 1 January 2018	954	66	406	1,426
Charge for the year	62	4	16	82
Disposals	(786)	(37)	(406)	(1,229)
At 31 December 2018	230	33	16	279
Net Book Value at 31 December 2018	256	–	148	404
Net Book Value at 31 December 2017	249	4	237	490

Notes to the Accounts (cont)

11. TECHNICAL PROVISIONS

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

	Non-profit Insurance Contracts		With-Profits Insurance Contracts	
	Gross £000	Reinsured £000	Gross £000	Reinsured £000
2018				
1 January (Restated – see Note 22)	563,056	(489,633)	835,723	(455,048)
Premiums received	78,790	(42,195)	24,667	(2,577)
Liabilities paid by claims	(82,242)	46,977	(54,302)	29,809
New Business	10,451	(3,680)	2,744	–
Experience variance and assumption changes	(3,427)	(9,725)	(79,973)	29,300
31 December	566,628	(498,256)	728,859	(398,516)

	Non-profit Insurance Contracts		With-Profits Insurance Contracts	
	Restated Gross £000	Reinsured £000	Restated Gross £000	Reinsured £000
2017				
1 January (Restated – see Note 22)	585,306	(513,600)	853,194	(457,543)
Premiums received	60,028	(33,089)	26,771	–
Liabilities paid by claims	(79,118)	44,537	(73,732)	31,902
New Business	6,399	(944)	3,014	–
Experience variance and assumption changes	(9,559)	13,463	26,476	(29,407)
31 December (Restated – see Note 22)	563,056	(489,633)	835,723	(455,048)

	Unit -Linked Insurance Contracts	
	2018 £000	Restated 2017 £000
1 January	121,030	124,722
Premiums received	7,011	7,141
Liabilities paid by claims	(17,142)	(18,513)
New Business	–	–
Fees deducted	(2,217)	(2,630)
Change in investment value of contracts	(6,654)	10,310
31 December	102,028	121,030

11. TECHNICAL PROVISIONS continued

	Investment Contracts	
	2018 £000	Restated 2017 £000
1 January	722,547	707,532
Premiums received	32,458	25,143
Liabilities paid by claims	(74,221)	(59,975)
New Business	6,147	5,427
Fees deducted	(6,110)	(7,044)
Transfer of Engagement	315,479	–
Change in investment value of contracts	(54,085)	51,464
31 December	942,215	722,547

As at 31 December some investment contract liabilities were reinsured. This amount is disclosed in Note 16 and taken with other reinsured assets adds to £1,199m of reinsured assets at the year end.

The principal assumption underlying the calculation of the technical provisions is that future interest earnings will be in line with the European Insurance and Occupational Pensions Authority (EIOPA) risk free rate for all assurance business. The mortality table used for ordinary assurance was the AMOO, for industrial assurance English Life No.16 (Males), for term assurance TMOO and for other business PMA08.

The 2017 comparatives have been restated to reflect the prior year adjustment as shown in Note 22.

12. COSTS OF BONUSES

Group and Scottish Friendly

Total bonuses attributable to the year are as follows:

	2018 £000	2017 £000
Year end reversionary bonus declared (included in change in other technical provisions)	2,262	2,647
Reversionary and terminal bonuses paid (included in claims)	12,647	13,550
	14,909	16,197

Notes to the Accounts (cont)

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 2018, the charge included in the Technical Account relating to the employer's contributions to this scheme was £266,000 (2017: £217,000). There were no outstanding or prepaid contributions at the date of the Balance Sheet.

MGM Assurance Staff Pension Plan

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

The Company 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 Plan whereas the accounting assumptions must be best estimates.

Under the current Recovery Plan, dated October 2016, the Company 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 2018 with allowance for benefit cash flows 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:

	2018 £000	2017 £000
Defined benefit obligation	(97,093)	(112,727)
Fair value of plan assets	107,298	111,730
Net defined benefit asset/(liability)	10,205	(997)
Restriction on asset recognised	–	–
Net amount recognised at year end (before any adjustment for deferred tax)	10,205	(997)

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.

	2018 £000	2017 £000
Service cost:		
Current service cost (net of employee contributions)	–	–
Administration expenses	–	–
Loss/(gain) on plan introductions, changes, curtailments and settlements	1,623	–
Net interest (credit)/expense	(9)	155
Charge recognised in profit of loss	1,614	155
Remeasurements of the net liability:		
Return on scheme assets (excluding amount included in net interest expense)	5,129	18
Actuarial (gains)	(15,224)	(3,794)
(Credit) recorded in other comprehensive income	(10,095)	(3,776)
Total defined benefit cost	(8,481)	(3,621)

13. PENSIONS continued

The principal actuarial assumptions used were:

	2018	2017
Liability discount rate	2.80%	2.45%
Inflation assumption – RPI	3.15%	3.40%
Inflation assumption – CPI	2.15%	2.40%
Revaluation of deferred pensions:		
GMP	Fixed rate	Fixed rate
Excess over GMP	2.15%	2.40%
Increases for pensions in payment:		
Pre 88 GMP	–	–
Post 88 GMP	3.00%	3.00%
Excess over GMP (RPI capped at 5%)	3.05%	3.30%
Expected age at death of current pensioner at age 65:		
Male aged 65 at year end:	88.2	88.7
Female aged 65 at year end:	90.3	90.7
Expected age at death of future pensioner at age 65:		
Male aged 45 at year end:	89.9	90.9
Female aged 45 at year end:	91.5	92.2

Reconciliation of Plan assets and liabilities	Assets £000	Liabilities £000	Total £000
At start of period	111,730	(112,727)	(997)
Benefits paid	(4,736)	4,736	–
Contributions from the employer	2,720	–	2,720
Interest income/(expense)	2,713	(2,704)	9
Return on assets (excluding amount included in net interest expense)	(5,129)	–	(5,129)
Actuarial gains	–	15,224	15,224
(Loss) on plan introductions and changes	–	(1,623)	(1,623)
At end of period	107,298	(97,093)	10,205

The return on Plan assets was:

	2018 £000	2017 £000
Interest income	2,713	2,873
Return on plan assets (excluding amount included in net interest expense)	(5,129)	(18)
Total return on plan assets	(2,416)	2,855

Notes to the Accounts (cont)

13. PENSIONS continued

The major categories of Plan assets are as follows:

	2018 £000	2017 £000
UK Equities	1,518	2,184
Overseas Equities	3,707	5,148
Gilts	11,606	11,643
Index Linked	73,456	73,380
Property	3,899	3,724
Commodities	1,955	1,248
Hedge Fund	10,093	12,413
Cash	1,064	1,990
Total market value of assets	107,298	111,730

14. WITH PROFITS ACTUARY

Mr DJ Lechmere of OAC plc served as the With-profits Actuary for the financial year ending 31 December 2018.

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 £106,648 (2017: £68,456).

15. TRANSACTIONS WITH RELATED PARTIES

The aggregate premiums payable for the year by seven Directors in respect of Scottish Friendly's products amounted to £52,056 (2017: £30,543).

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

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 years;
- 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.

(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 sub-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 and an allowance for any withdrawals.

16. CAPITAL MANAGEMENT continued

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.

(c) Capital Statement (unaudited)

Available capital resources

	2018			2017		
	Main fund £000	Closed sub-funds £000	Total £000	Main fund £000	Closed sub-funds £000	Total £000
Total available capital resources	79,048	31,695	110,743	96,614	62,046	158,660

The capital resources in 2018 are calculated under the Solvency II regulatory requirements and the total capital resources presented represents Solvency II own funds. The Solvency II capital positions are presently unaudited.

Analysis of contract liabilities gross and net of reinsurance

	2018			2017		
	Gross	Reinsurance	Net	Restated Gross	Reinsurance	Net
With-Profits insurance	728,859	398,516	330,343	835,723	455,048	380,675
Non-Profits insurance	566,628	498,256	68,372	563,056	489,633	73,423
Investment	942,215	302,377	639,838	722,547	–	722,547
Unit Linked Insurance	102,028	–	102,028	121,030	–	121,030
Total Reinsurance	2,339,730	1,199,149	1,140,581	2,242,356	944,681	1,297,675

(d) Movement in available capital resources (unaudited)

	2018 £000	2017 £000
Opening capital resources	158,660	164,467
Prior year adjustments	(23,748)	(1,634)
Increase/(Decrease) in Current Assets	(156,352)	4,395
(Increase)/Decrease in Technical Provisions	157,401	3,733
(Increase)/Decrease in Current Liabilities	15,125	545
Total	151,086	171,506
Increase/(Decrease) in ring-fencing of available capital	(40,343)	(12,846)
Closing capital resources	110,743	158,660

Notes to the Accounts (cont)

16. CAPITAL MANAGEMENT continued

(e) Solvency position

	2018 £000	2017 £000
Own Funds	110,743	158,660
SCR	58,820	78,526
Solvency Ratio	188%	202%

The 2017 capital position subsequently changed to 199% as a result of the restatement detailed in Note 22.

(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 apply 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 has provided 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. DEPOSITS RECEIVED FROM REINSURERS

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.

	2018 £000	2017 £000
Collateral deposits for:		
"Select" annuity (Hannover Re)	38,327	42,129
"Standard" annuity (RGA)	6,280	6,556
	44,607	48,685

18. DEPOSITS HELD FOR REINSURERS

The "Standard" and "Select" annuity products written in the past by 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, in deposits with Scottish Friendly as collateral security for their liabilities and obligations under the contracts.

	2018 £000	2017 £000
Collateral deposits for:		
Longevity Swap (Pacific Life Re)	6,961	5,081
	6,961	5,081

19. CREDITORS ARISING OUT OF DIRECT INSURANCE OPERATIONS

Group and Scottish Friendly

	2018 £000	2017 £000
Due to reinsurers	1,907	1,911
Due to intermediaries	5,435	2,686
Other insurance payables	1,972	1,485
	9,314	6,082

20. OTHER CREDITORS INCLUDING TAXATION AND SOCIAL SECURITY

	Group		Scottish Friendly	
	2018 £000	2017 £000	2018 £000	2017 £000
Taxation	2,667	9,748	2,483	9,549
Trade Creditors	188	157	188	157
Investments Creditors	13,230	–	13,230	–
Other payables	3,895	3,499	3,728	3,403
HMRC payments PAYE and VAT	2,132	818	2,132	818
	22,112	14,222	21,761	13,927

Notes to the Accounts (cont)

21. RISK MANAGEMENT

The principal risks to which Scottish Friendly is exposed are strategic, solvency, liquidity, operational, reputation and conduct risks as well as cyber-crime and Brexit. 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.

This has included an assessment of the impact of Brexit on Scottish Friendly. Other than the fact that Brexit could impact the investment markets to which our results are sensitive, we consider that our operating model is relatively unaffected by Brexit.

In addition, 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) usually 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.

The key 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 manages these risks by monitoring persistency experience, including through discussions with our partners and actively controlling and monitoring expense levels.

21. RISK MANAGEMENT continued

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:

- *persistence and expenses:*

Acquisition and administration costs are recovered by management charges 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.

Insurance risk sensitivity analysis:

The following table illustrates the impacts on the Scottish Friendly Main Fund of applying stress scenarios prescribed under the Solvency II regulations, which are believed to be good approximations of the sensitivities under UK GAAP.

	2018 Impact £m	2017 Impact £m
Increase in expenses by 10%	(11.7)	(7.7)
Increase in assurance mortality rates by 15%	(1.6)	(1.1)
Reduction in persistency by 10%	(5.3)	(4.0)

Credit risk

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, 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.

Notes to the Accounts (cont)

21. RISK MANAGEMENT continued

Group 2018

	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	99,254	272,191	37,195	117,709	6	–	526,355
Cash and cash equivalents	–	101,667	28,737	14,100	–	–	144,504
Reinsurers' share of technical provisions	–	498,787	–	–	700,362	–	1,199,149
Other assets	–	6,961	–	–	8,819	10,948	26,728
Linked assets not subject to credit risk	–	–	–	–	–	455,866	455,866
Non-linked assets not subject to credit risk	–	–	–	–	–	290,017	290,017
Total	99,254	879,606	65,932	131,809	709,187	756,831	2,642,619

Group 2017

	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	4,377	282,679	37,946	116,392	597	–	441,991
Cash and cash equivalents	–	116,792	66,884	43,453	–	–	227,129
Reinsurers' share of technical provisions	–	489,633	–	–	455,048	–	944,681
Other assets	–	6,731	–	506	2,287	5,136	14,460
Linked assets not subject to credit risk	–	–	–	–	–	555,914	555,914
Non-linked assets not subject to credit risk	–	–	–	–	–	336,903	336,903
Total	4,377	895,835	104,830	160,351	457,932	897,953	2,521,278

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 experienced 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 (2017: £nil).

Liquidity risk

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 mis-management 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 £432,710,000 (2017: £479,264,000) and £180,793,000 (2017: £200,010,000) respectively.

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

	0-5 years £000	5-10 years £000	10-15 years £000	15-20 years £000	Over 20 years £000	Total £000
2018						
Liabilities subject to liquidity risk:						
Non-profit (insurance)	66,223	123,352	165,152	187,695	184,104	726,526
With-Profits (insurance)	381,970	348,920	139,085	93,843	166,885	1,130,703
Unit Linked	100,297	–	–	–	–	100,297
Investment	926,179	–	–	–	–	926,179
Other Liabilities	108,031	–	–	–	–	108,031
Total	1,582,700	472,272	304,237	281,538	350,989	2,991,736
2017						
Liabilities subject to liquidity risk:						
Non-profit (insurance)	82,917	121,930	150,740	167,749	181,028	704,364
With-Profits (insurance)	418,397	370,521	153,125	96,017	158,318	1,196,378
Unit Linked	118,258	–	–	–	–	118,258
Investment	699,783	–	–	–	–	699,783
Other Liabilities	102,478	–	–	–	–	102,478
Total	1,421,833	492,451	303,865	263,766	339,346	2,821,261

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 policyholders 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 are 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.

Notes to the Accounts (cont)

21. RISK MANAGEMENT continued

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.

Market risk sensitivity analysis:

The following table illustrates the impacts on the Scottish Friendly Main Fund 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.

The equity price sensitivity considers the changes in prices of UK and other type 1 equities as defined under Solvency II. This is a change in equity prices of +39% plus the symmetric adjustment of the equity capital charge as published by EIOPA.

The property value sensitivity considers a 25% reduction in property values.

The interest rate sensitivities are based on the Solvency II Standard Formula interest rates stresses which are expressed as a duration dependent multiplicative factor applied to the base curve.

	2018 Impact £m	2017 Impact £m
Equity Fall	(9.7)	(11.3)
Property Fall	(0.6)	(0.6)
Interest Rate Fall	(2.5)	(1.9)
Interest Rate Rise	5.1	4.0

22. PRIOR YEAR RESTATEMENT

Following a detailed actuarial review, errors have been identified in the measurement of technical provisions and claims outstanding in relation to the reserving methodologies applied to certain products.

The Board consider that reflecting these changes in the measurement of technical provisions and claims outstanding results in a more appropriate quantification of the required reserves and provisions for these products. The adjustments to technical provisions and claims outstanding resulting from the errors are reflected by an equal and opposite change to the Fund for Future Appropriations ("FFA").

The following table sets out the adjustments to the consolidated balance sheet for the year ended 31 December 2017:

Impact on the 2017 Balance Sheet

	2017 as previously reported £000	Adjustment One £000	Adjustment Two £000	Adjustment Three £000	2017 restated £000
Claims Outstanding	26,602	–	7,201	–	33,803
<i>Technical Provisions</i>					
With-profit Insurance Contract Liabilities	831,636	4,087	–	–	835,723
Non-profit Insurance Contract Liabilities	566,155	(3,099)	–	–	563,056
Unit Linked Insurance Contract Liabilities	119,159	1,871	–	–	121,030
Investment Contract Liabilities	711,377	11,170	–	–	722,547
Fund for Future Appropriations	191,450	–	–	(21,231)	170,219

22. PRIOR YEAR RESTATEMENT continued

Explanation of adjustments to Technical Income for the year ending 31 December 2017:

Impact on the 2017 Income and Expenditure

	2017 as previously reported £000	Adjustment One £000	Adjustment Two £000	Adjustment Three £000	2017 restated £000
Change in other Technical Provisions	34,973	9,869	–	–	44,842
Claims incurred	171,838	–	3,118	–	174,956
Transfer to/(from) the Fund for Future Appropriations	14,524	–	–	(12,987)	1,537

Explanation of adjustments to the consolidated balance sheet for the year ended 31 December 2016:

Impact on the Opening Funds for Future Appropriations Position for 2017

	2016 as previously reported £000	Adjustment One £000	Adjustment Two £000	Adjustment Three £000	2016 restated £000
Claims Outstanding	22,116	–	1,815	–	23,931
<i>Technical Provisions</i>					
With-profit Insurance Contract Liabilities	848,092	5,102	–	–	853,194
Non-profit Insurance Contract Liabilities	587,804	(2,498)	–	–	585,306
Unit Linked Insurance Contract Liabilities	124,156	566	–	–	124,722
Investment Contract Liabilities	704,320	3,212	–	–	707,532
Fund for Future Appropriation	176,879	–	–	(8,197)	168,682

The adjustments above are summarised below:

Adjustment 1: these adjustments relate to the measurement of technical provisions in relation to the reserving methodologies applied to certain products and comprise the methodology applied to subfund charges for expenses, the reserves required for the mutuality benefit bonus in relation to the FIA policies, the projection of expenses for certain unit linked policies subject to contract boundaries and the asset share calculation methodology adopted.

Adjustment 2: this adjustment related to omitted outstanding claims in relation to certain pension products which had passed their nominated retirement date and an adjustment to the methodology of calculating the outstanding claims reserve.

Adjustment 3: impact of above changes flowing through the Technical Income Account into Funds for Future Appropriation.

We note that none of the above adjustments have any tax impact for Scottish Friendly.

23. TRANSFER OF ENGAGEMENTS**Acquisition of Canada Life Portfolio**

Scottish Friendly has signed a transfer agreement with Canada Life to acquire a group of life and pension business. The business consists of 145,000 scheme members with assets totalling around £2.7bn. The agreement is subject to both regulatory and Court approval and these would be likely to be obtained in the final quarter of 2019.

Acquisition of Mobius Life Limited Group Pension Business Portfolio

On 9 November 2018 Scottish Friendly acquired a book of bundled group pension business from Mobius Life Limited. The transfer was carried out in accordance with Part VII of the Financial Services and Markets Act 2000. £3.0m of consideration was paid.

Approximately 12,000 scheme members were transferred across into the Scottish Friendly main fund. The fair value of net assets transferred across has been assessed and is shown gross of reinsurance, reflecting the bases in place immediately before and after the transfer.

Notes to the Accounts (cont)

23. TRANSFER OF ENGAGEMENTS continued

	Acquired Value £000	Consideration Paid £000	Fair Value Adjustment £000	Fair Value £000
Assets				
Reinsurance Asset	319,938	–	–	319,938
Negative Goodwill	–	–	(1,459)	(1,459)
Current Assets				
Debtors	49	–	–	49
Cash at Bank	153	–	–	153
Consideration Paid	–	(3,000)	–	(3,000)
Total Assets	320,140	(3,000)	(1,459)	315,681
Liabilities				
Long Term Liabilities				
Technical Provisions	316,938	–	(1,459)	315,479
Outstanding Claims	9	–	–	9
Current Liabilities				
Total Creditors	193	–	–	193
Total Liabilities	317,140	–	(1,459)	315,681

Find out more about
Scottish Friendly products
and services at
www.scottishfriendly.co.uk

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