Scottish Friendly

Annual Report and Accounts 2015

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Strategic Report

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Financial Highlights

2015 was a landmark year for Scottish Friendly with our takeover of Marine & General Mutual (M&GM) more than doubling assets under management plus a record set of sales results.

These results have been generated through our strategy for growth and diversification, designed to provide long term value for members. We offer products and services of value to all our customers, helping secure the future for them and their families through saving, investing and protecting.

Sales grew strongly in 2015, achieving the highest level of results in Scottish Friendly's history. Growth was realised across our range of savings and protection products as well as across our range of distribution channels; distribution lines include products branded by distribution partners as well as our own branded products.

The key highlight of the 2015 results is the more than doubling of Scottish Friendly's assets under management to over £2 billion following our takeover of M&GM in June, creating additional economies of scale for all our members.

Following a worldwide economic deterioration in the second half of the year which worsened at the start of 2016, the outlook for markets and economies in 2016 remains fragile, but our results in 2015 once again demonstrate that our long term strategy can successfully rise to the challenge.

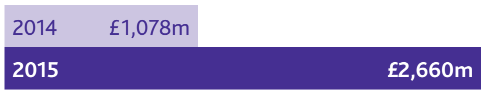
Sales (APE)[1]

£25.5m

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

Assets under management[2]

£2,660m



Number of members

490,000

Notes

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

Chairman's Statement

Michael Walker
Chairman

2015 was a record year for Scottish Friendly, with further growth in sales and a significant increase in assets following the transfer of Marine & General Mutual.

Our growth delivers economies of scale for all policyholders, including those that transferred to Scottish Friendly during the year.

Strategy

I am very pleased to report that 2015 has been another year of substantial accomplishment for Scottish Friendly over each of the three key parts of our Diversify and Grow strategy:

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

The two key highlights of 2015 are the record level of sales and the completion on 1 June 2015 of the takeover of Marine & General Mutual (M&GM) which more than doubled Scottish Friendly's assets under management. The take-over was a major coup for Scottish Friendly, bringing opportunities for significant economies of scale for all policyholders, including those that transferred from M&GM.

Scottish Friendly has continued to build sales and increase membership as a result of strong e-business transactions and major collaborations with companies like the BGL Group and Neilson Financial Services. In June 2015 Scottish Friendly announced a substantial new partnership with long-term savings and investment business, Standard Life, to create an innovative new Junior ISA, available exclusively through Standard Life as a direct online offering. The partnership brings together Scottish Friendly's specialisms in devising flexibly structured plans that enable customers to set up multiple named 'pots' within a Junior ISA, with Standard Life's highly regarded investment expertise.

Scottish Friendly constantly strives to enhance interactions with customers and to ease the ways with which they do business with us. We have invested further over 2015 in addressing customers' evolving requirements, for example interacting with Scottish Friendly via mobile phones and tablets, whilst ensuring that we maintain our competitive advantage in product design and development on a financially attractive basis.

With the date for the referendum on EU membership now set for June, we face another period of political uncertainty. However, as I have noted in the past, Scottish Friendly has an established record of responding rapidly to political and economic change and we remain well placed to take any appropriate action as events occur.

The regulatory environment

The main aspects of regulatory change during 2015 have been in relation to the run up to the commencement of Solvency II, mentioned in last year's report, and the introduction of the Senior Insurance Managers Regime (SIMR).

Solvency II is the risk-based regulatory regime for insurance companies in the EU, affecting the way insurers' capital requirements are maintained and reported. Long anticipated, the regime came into effect on 1 January 2016. Our internal Solvency II project over recent years ensured our full compliance within the regulatory timetable. Enhancements have been made to our risk management framework and internal reporting. Our view remains that Solvency II is not anticipated to impact substantially on our existing strong capital position.

The SIMR is a consequence of changes introduced by Solvency II and the regulators' stated intention to bring insurance into line with new banking supervision rules. The SIMR replaces the PRA's Approved Persons Regime and covers the assessment of fitness and propriety of senior insurance managers and directors, the allocation of certain responsibilities and the application of relevant conduct rules to senior individuals. Scottish Friendly undertook an SIMR project, including a complete review and revision of relevant documentation and role responsibilities, to ensure compliance with the new rules by 1 January.

The cost of regulation increases year-on-year and this places greater pressure to achieve efficiencies elsewhere in the Group to minimise the impact on our members.

The Chief Executive comments overleaf on the changes in reporting standards that have also come into force in the period.

Corporate governance

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

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

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

Corporate social responsibility

Scottish Friendly's long-standing sponsorship of the Scottish Friendly Children's Book Tour in conjunction with Scottish Book Trust flourished in 2015. The programme promotes literacy for young people throughout the UK, particularly in areas of social deprivation and geographically remote regions. The Scottish Friendly Children's Book Tour was enthusiastically received by young people in 2015 and attracted widespread, positive, regional and national press coverage. We plan to build on this further in 2016.

Corporate recognition

Scottish Friendly has placed considerable emphasis on expanding its national media profile over the last two years. Bolstering our media profile by highlighting our credentials as a UK-wide organisation supports our organic growth in addition to our business process outsourcing, and mergers and consolidation bids. Good progress has been made in this area with Scottish Friendly now achieving regular mentions in national newspaper titles, both in print and online, regional press and regional and local radio.

The Board

As advised last year, Jim Jack, the Vice Chairman and Senior Independent Director who had been a Board member since July 2006, retired as a Director at the 2015 AGM, just before the ninth anniversary of his appointment. I would like to reiterate the Board's sincere thanks to him for his contribution, and I am delighted that he continues as a Delegate.

I am very pleased to advise that Dermot Jenkinson accepted nomination as Vice Chairman and Senior Independent Director.

Kerr Luscombe joined the Board in June 2015; Kerr brings a wealth of life company experience and we are delighted to have the benefit of that along with his technical skills. Kerr has also assumed the chairmanship of the Audit Committee.

I would also like to put on record once more my sincere thanks to all Board members for their sustained support, guidance and valued contributions during the past year, particularly with the additional oversight required of the transfer of M&GM.

Scottish Friendly's people

We are focused on retaining and developing a pool of diversified talent with a shared commitment to the Group's core values and strategic goals.

On behalf of the Board, I would like to thank everyone at Scottish Friendly for their hard work in 2015 and for helping to deliver another year of outstanding results.

Chief Executive's Review

Fiona McBain
Chief Executive

There have been significant changes in the business in 2015, reflecting further success of our strategy for growth.

Changes in the year

Our results in the Report & Accounts look quite different this year, in part a matter of presentation and in part reflecting real changes of substance in the business.

The key changes of substance were the take-over of M&GM and the further development of our partnership distribution.

Scottish Friendly welcomed almost 30,000 new members from M&GM and took on assets of £1.6 billion, more than doubling our assets under administration. We have retained our headcount at below 100, and continue to run all the business out of our office in Glasgow.

Our partnership distribution continued to grow from strength to strength, with substantial increases in sales. On the back of our strong track record, we have revised contract terms that have further reduced the costs of acquisition. As that distribution channel matures, the level of renewal commission increases, up from £5 million in 2014 to £9 million, reflecting the growth and persistency in that business.

The presentation has changed in line with new financial reporting standards (FRS) 102 and 103 which were incorporated into UK accounting standards in 2015. In addition to more disclosure on capital and risk management and investments, premiums and claims are now split between 'insurance' and 'investment' contracts.

Whereas traditionally all life insurance business was categorised as insurance, the new standard 103 requires a distinction between contracts which carry 'insurance risk' and 'financial risk'; now, risks such as lapse, persistency and expense are deemed to be financial risks, rather than insurance. The basis of categorisation applied is explained in Note 2, and the impact on premiums and claims in Notes 3 and 5. So where, for example, premium income net of reinsurance in 2014 was £63 million, that is now reported as net premium income of £51 million and deposit element/premiums earned on investment contracts of £12 million. In 2015 total premium income from investment and insurance contracts net of reinsurance increased by 11%.

Scottish Friendly's strategy

We have continued to diversify and grow the business across three main strands.

Organic growth
Scottish Friendly's e-business sales, complemented by a refreshed approach to direct marketing, and partnership distribution generated record sales in 2015, via Scottish Friendly's My Plans platform for savings and investments, along with our innovative protection partnerships.

White labelling and business process outsourcing
Scottish Friendly's substantial set of corporate partnerships, including leading brands such as Beagle Street and Smart Insurance, helped drive Scottish Friendly's exceptionally strong results in 2015. Meanwhile our new partnership to create an innovative new Junior ISA, available exclusively as a direct online offering from Standard Life, represents another vote of recognition from a major financial organisation in Scottish Friendly's expertise as a product solution provider.

Mergers and consolidation

The addition of transfers of engagements from other firms is a key component of our strategy that produces long term economies of scale. The seven transfers of engagements completed to date since 2006 continue to make a positive contribution to each set of policyholders. As discussed above, 2015 was the year of M&GM – Scottish Friendly's biggest take-over to date. The transfer took effect on 1 June; as with any major take-over, it was followed by a period of adjustment however the business was fully integrated from day 1 and is now truly embedded in 'business as usual'.

The policy liabilities were revalued on transfer to Scottish Friendly, to reflect the different risk profile, for example as part of a larger fund open to new business, and the lower cost base going forward. That released a net £5.1 million, realised as a gain in 2015.

The increase in investment management expenses in the year reflects the different size and complexity of the expanded investment portfolio. The M&GM portfolio included derivatives, £38 million at the year end. As part of the process to realign the combined portfolio with the different risk profile (as noted above), the derivatives were sold in February 2016.

M&GM included a large book of annuity business, and so claims in 2015 included a significant increase in annuity payments from £6k in 2014 to £36 million in 2015. This business is reinsured, as part of Scottish Friendly's prudent approach to risk management.

Results

Scottish Friendly delivered record results in 2015. Total sales increased by 18% to £25.5 million APE (the industry standard measure of annual premium equivalent – regular premiums plus one tenth of single premiums); the corresponding amount in 2014 was £21.6 million. Of this, protection sales were £14.7 million (2014: £12.2 million) and savings and investments amounted to £10.8 million (2014: £9.4 million). Our overall acquisition cost-to-sales ratio decreased to 55% (2014: 68%) as a consequence of efficiencies in our marketing operation and revised terms with partners in line with our increased scale.

Net premium income from insurance contracts increased to £55.4 million from £51.5 million in 2014 and premiums earned on investment contracts increased to £14.9 million from £12 million; the results for 2014 have been restated to be on a comparable basis with 2015 under the new FRS, as discussed above. (On the old reporting basis, total premium income in 2015 increased to £81.3 million (2014: £70 million)). We are very proud to have maintained the ratio of administration expenses to total premium income APE at 8.6% (2014: 8.6%), notwithstanding the challenges of taking on a substantial business in the period.

Scottish Friendly's membership grew in 2015 to 490,000 (2014: 417,000), in part due to the addition of approximately 29,000 new members from M&GM. Scottish Friendly administers over one million policies across more than 150 product lines.

Investment performance

The return of the asset shares within the Scottish Friendly with-profits fund for 2015 was 2.3% (2014: 4.9%), reflecting a year where markets rose considerably at the start of the year and then fell substantially due to lower growth in China and falling oil prices. While this has had the impact of slightly reducing final bonus rates for with-profits customers with 10 year plans, we have been able to maintain regular bonus rates and increase final bonus rates on longer term policies as at 31 December. Please note that Scottish Friendly's investment return figures are net of fund management charges as compared to the majority of published returns which are reported gross of charges. Scottish Friendly assets under management rose to £2,660 million (2014: £1,078 million).

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

Scottish Friendly's Fund for Future Appropriations has increased from £97.4 million to £147.6 million, reflecting the transfer from M&GM. The Fund for Future Appropriations represents funds that have not been allocated to specific policyholders and free assets.

Outlook

While the UK economy improved in 2015 with increased employment, low or zero inflation, and wage rises above inflation, the economic outlook in 2016 does give some cause for concern. Although fears about Eurozone economies have receded, they have been replaced by worries of the state of the world economy, particularly the effects of lower growth in China and decreasing oil prices. Indeed the Chancellor as recently as January 2016 said he is concerned that the UK faces a "cocktail of threats."

In the UK, the referendum on the future of the country as part of the European Union is now less than three months away. The lead up to the referendum itself creates uncertainty which will increase considerably should the decision be for the UK to leave the EU.

Scottish Friendly has consistently proved its ability over recent years to respond positively in times of change, including difficult economic circumstances. We are confident that Scottish Friendly's successes in 2015 position us favourably to respond to future challenges. In line with our proven strategy, we shall carry on seeking out opportunities that will benefit our members and partners, offering quality products and service.

The record results in 2015 didn't come without record levels of achievement, and I would particularly like to thank everyone at Scottish Friendly who has risen to the challenges of a major take-over and record growth, delivering continued good results for our members; thank you.

Directors

Michael J Walker LLB

Chairman
Appointed as a Director and as Chairman in January 2009. Chairman of the Nomination Committee and a member of the Remuneration Committee, Investment Committee and Risk Committee. Director of the Scottish Friendly Assurance subsidiary companies Scottish Friendly Asset Managers Limited, Scottish Friendly Insurance Services Limited, S.L. Insurance Services Limited, SFIS (Nominees) Limited, M&GM and MGM Assurance (Trustees) Limited. Former Chairman of legal firm Maclay Murray & Spens. Non-Executive Chairman of Walkers Shortbread Limited.

Jim W Jack MA, CA (retired April 2015)

Vice-Chairman and Senior Independent Director until April 2015
Appointed as a Director in July 2006. Chairman of the Audit Committee and a member of the Nomination Committee, Remuneration Committee and Risk Committee, until retirement. A chartered accountant with many years' experience in the financial services industry. Director of Omnilife Insurance. Member of the Case Management Committee of the Financial Reporting Council. Previously held senior financial positions in the Prudential Group.

Simon EC Miller

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

Dermot J Jenkinson

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

David C Huntley BA, FIA

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

Kerr Luscombe BSc, FFA

Appointed as a Director in June 2015. Chairman of the Audit Committee from July and member of the Risk Committee and Remuneration Committee. A qualified actuary with extensive experience at Board level in the life insurance industry. Previously a director of Royal London Group and held finance directorships at Lloyds Banking Group and at Santander's life business. Currently also a Non-Executive Director of Clyde Valley Housing Association.

Fiona C McBain MA, ACA

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

Jim Galbraith BSc, MBA, FFA

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

Executive

FC McBain MA, ACA	Chief Executive
J Galbraith BSc, MBA, FFA	Deputy Chief Executive
A Brown BA, CA	Interim Finance Director
DA Elston LLB, Solicitor	Head of Corporate Services
NE Lovatt ACII, BA, MSc (Dip)	Sales and Marketing Director
D Macleod MSci, BAcc, FFA	Head of Actuarial
I Neilson	Head of Client Services
J Wilson BSc, BEng, MSc	Head of IT

Directors' Report

The Directors have pleasure in submitting their Annual Report and Accounts for the year ended 31 December 2015. This report should be read in conjunction with the Strategic Report on pages 1 to 5.

Business objectives and activities

The principal activity of Scottish Friendly Assurance Society Limited ("Scottish Friendly") is the transaction of long-term insurance business in the United Kingdom. In accordance with the Friendly Societies Act 1992, the Directors confirm that all activities carried on during the year by Scottish Friendly are believed to have been carried on within its powers.

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

Scottish Friendly Investment Funds ICVC, an OEIC (Open Ended Investment Company), provides the stocks and shares component of the Scottish Friendly ISA and Child Trust Fund.

All of the above are registered in Scotland, other than M&GM and MGM Assurance (Trustees) Limited which are registered in England.

Business review

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

Directors and Chief Executive

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

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

Statement of solvency

In the opinion of Scottish Friendly's Actuarial Function Holder, Scottish Friendly had the required margin of solvency as prescribed in the Prudential Sourcebook for Insurers (INSPRU) for each class of relevant business as at 31 December 2015.

Going concern basis

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

Viability statement

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

The Risk Management Framework is integrated with the Solvency and Capital Management activity, in particular the Own Risk and Solvency Assessment (ORSA) which is a specific requirement of the Solvency II Directive which came into force on 1 January 2016. The ORSA requires Scottish Friendly to consider the risks arising from the agreed strategic priorities, how much capital is needed to protect the business against those risks in the context of the agreed risk appetite, and how resilient the Scottish Friendly business model is under stressed conditions. This analysis involves a range of projections of the capital position under a range of severe but plausible adverse stress and scenario tests covering a period of five years, Scottish Friendly's planning horizon.

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

Employees

Scottish Friendly is committed to a policy which ensures that, in all aspects of recruitment, training and career development, equal opportunities are afforded to job applicants and employees irrespective of their age, race, religion, sex, marital status, sexual orientation or disability. If employees become disabled during the period of employment, Scottish Friendly will endeavour to retrain or redeploy individuals to enable their employment to continue.

Directors' Report
continued

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

Policy on complaints by members

Scottish Friendly's complaints procedures, detailing the action to be taken in the event of a complaint being received from a member, are documented in Scottish Friendly's Memorandum and Rules, Complaints Manual and Compliance Manual. There is provision for an arbiter to be appointed. In the event that 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 2015, Scottish Friendly had 1,196,000 (2014: 1,153,000) policyholders and estimated the number of members to be 490,000 (2014: 417,000).

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.

DA Elston
Secretary
31 March 2016

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.

With effect from 1 January 2016 Scottish Friendly is subject to the Senior Insurance Managers Regime (SIMR) introduced by the PRA and FCA to ensure greater individual accountability on specific individuals within an insurance business and to achieve greater clarity on governance structures. The Board is satisfied that the relevant reviews and revision of documentation, where appropriate, have been undertaken to ensure compliance with the SIMR.

The Board

The Board met formally on eight occasions in 2015. There is a schedule of regular reports which the Board considers and which is agreed at least annually. Reports are provided to Board members in advance of the meetings. All Directors were present at the meetings except for apologies from two Directors on one occasion each. The Directors' attendance at Board and Committee meetings is set out in the table below (figures in brackets are the total number of meetings held during each Director's tenure). In addition to the Board meetings, the Non-Executive Directors met with Executive Management in November to review strategic objectives and the business plan for the forthcoming year.

The matters considered by the Board, and on which it receives regular reports, cover financial, business conduct, operational and risk matters, including:

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

	Board meetings	Audit Committee	Risk Committee	Remuneration Committee	Investment Committee	Nomination Committee
Michael J Walker	8 (8)	–	3 (4)	2 (3)	4 (4)	1 (1)
Jim W Jack	3 (3)	1 (1)	1 (1)	2 (2)	–	1 (1)
Simon EC Miller	7 (8)	–	–	3 (3)	4 (4)	–
Dermot J Jenkinson	8 (8)	3 (3)	1 (1)	–	–	1 (1)
David C Huntley	7 (8)	3 (3)	4 (4)	3 (3)	–	–
Kerr Luscombe	4 (4)	2 (2)	2 (2)	1 (1)	–	–
Fiona C McBain	8 (8)	–	4 (4)	–	4 (4)	1 (1)
Jim Galbraith	8 (8)	–	–	–	4 (4)	–

Although many of the powers regarding business conduct, operational management and day-to-day activities of Scottish Friendly are delegated to Executive Management, through the Chief Executive, there is a formal schedule of matters reserved to the Board for approval which includes: the authorisation regime for bank accounts, changes to investment parameters and deals outwith those parameters, transfers of engagement, the budget and the distribution of surpluses and bonuses. The Board also retains responsibility for a number of statutory duties relating to the prudent management of Scottish Friendly's activities; these include responsibility for maintaining required solvency and liquidity levels as well as maintenance of requisite accounting records and systems of control. The powers retained by the Board, and those delegated to the Chief Executive and to Board Committees, are reviewed at least annually by the Board.

The roles of the Chairman and Chief Executive are separate and their respective responsibilities have been agreed and documented.

Scottish Friendly has established a framework of internal controls for the management of risk within its business and to safeguard the interests of members. The framework is designed to manage the risk of failure to achieve business objectives, and to provide reasonable assurance against material misstatement or loss. Further information on Scottish Friendly's approach to Risk Management is set out below.

Risk management

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

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

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

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

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

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

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

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

The overall responsibility for risk within the business ultimately rests with the Board. The responsibilities have been delegated to the Audit Committee, to assist the Board in reviewing the systems of internal controls and the external financial reports of the business, and the Risk Committee, to provide focused support and advice on risk governance and to assist the Board in reviewing the systems for managing all aspects of business risk, including operational, prudential, conduct and strategic risks. Further information is set out below on the activities of the Audit and Risk Committees during 2015.

In addition, the Executive Risk Committee (ERC) is the primary forum for Executive oversight and challenge of the risk and control environment across the business and is chaired by the Head of Risk. All Executives are responsible for the identification, assessment, management and control of risks in their respective areas, delegating such parts of this responsibility to appropriate managers or other individuals where practical and are required to report on their respective area at the ERC on at least a quarterly basis. The Conduct and Operational Risk Committee (CORC) met each quarter during 2015; to achieve a more consistent approach to executive risk management the CORC responsibilities have been incorporated into the ERC going forward.

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

The Board has overall responsibility for the system of internal control and, through a combination of the above activities, is able to review its effectiveness annually, including financial, operational and compliance controls and risk management systems. Its effectiveness has also been reviewed by the Board specifically for the purposes of this statement.

Principal risks

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

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

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

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

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

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

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

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

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

Directors

Brief biographies of the current Directors are set out on page 6.

In addition to the Chairman and Vice-Chairman, the Board comprised, as at 31 December 2015, three other Non-Executive Directors and two Executive Directors, being the Chief Executive and the Deputy Chief Executive. This composition is considered to provide an effective and balanced mix of skills and experience to meet the Board's remit.

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

Following Jim Jack's retiral, Dermot Jenkinson has been appointed 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.

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. There are no such Board members in 2015. Following Jim Jack's retiral as planned in April 2015, a new director Kerr Luscombe was appointed.

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

In 2015 the Board again considered the recommendation in the Code that all Directors should be re-elected at the Annual General Meeting. Its view remains that such a provision could in certain circumstances have implications for the ongoing financial stability of Scottish Friendly which would not be in the interests of its members. It will however continue to consider the recommendation annually.

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

Performance evaluation

On at least an annual basis, the Chairman conducts a performance evaluation of each Director in order to verify that each continues to contribute effectively and demonstrate commitment, including time commitment, to the role. Feedback from the evaluation is communicated individually to the Director by the Chairman. The performance of the Chairman is reviewed by the Non-Executive Directors, led by the Senior Independent Director, taking into account the views of the Executive Directors. Executive Directors are appraised in respect of their directorial duties.

The performance of the Board and its Committees is also considered on at least an annual basis and the results shared with the Board as a whole.

Board Committees

The terms of reference of the current Committees of the Board – Audit, Risk, Remuneration, Nomination and Investment – are available on the Scottish Friendly website at www.scottishfriendly.co.uk/customer-centre/board-committee-terms-of-reference. Membership of the Committees of the Board is intended to make best use of the skills and experience of the Directors. The work carried out during 2015 by the Audit, Risk, Nomination and Investment Committees in discharging their responsibilities is summarised below. The work carried out by the Remuneration Committee is described within the Directors' Remuneration Report on pages 16 to 17.

Audit Committee

Kerr Luscombe (Chairman from July 2015)
Jim Jack (Chairman) (retired April 2015)
Dermot Jenkinson (Interim Chair)
David Huntley

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

During 2015 the Committee met on three occasions and all members were present at the meetings. 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 in advance of the transfer the planning for the take-over of M&GM; commissioned internal audit reports both pre and post transfer, and tracked actions arising;
- considered, in advance of the external audit commencing, the Audit Plan which highlighted key judgment areas and summarised changes in reporting requirements;
- reviewed the annual financial statements and regulatory returns and approved them for submission to the Board. The Committee focused particularly on major judgmental areas and compliance with accounting standards and legal requirements, including the regulations and guidance of the PRA. The Committee reviewed thoroughly the external auditor's detailed report on the draft documents and obtained satisfactory explanations where necessary. The Committee also reviewed the external auditor's final report on internal controls and ensured that follow up action was completed where necessary;
- approved the internal audit programmes and received regular progress reports from internal audit and ensured that recommendations made were followed up. The Committee also monitored co-ordination between the internal and external auditors and ensured that the internal audit function was adequately resourced and had appropriate standing within the organisation; and
- assessed the effectiveness of the external and internal audit processes through the reporting that it receives from the respective auditors who were present at each Committee meeting. The Committee meets with each of internal and external audit in the absence of management at least once a year.

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

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

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

Both the Board and the external auditor have safeguards in place to prevent the auditor's independence and objectivity being compromised. The external auditor reports regularly to the Committee on the actions that it has taken to maintain its independence. Deloitte was first appointed as auditor following a tendering exercise in 2012.

Report on Corporate Governance
continued

Risk Committee

David Huntley (Chairman)
Jim Jack (retired April 2015)
Kerr Luscombe (from July 2015)
Michael Walker
Fiona McBain

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 2015 the Committee met on four occasions, with one apology on one occasion. The Head of Corporate Services 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;
- considered the impact of the acquisition of the M&GM business and how this was reflected in the Corporate Risk Register, Stress and Scenario Testing and Solvency requirements;
- shaped the design and content of the Annual ORSA report to meet the requirements of the Board in terms of risk insights and forward-looking threats. Provided oversight and review of the Annual ORSA report in advance of the 1 January 2016 implementation of the Solvency II regulations, with specific focus on risks inherent in the strategy, the overall solvency needs assessment, and the adequacy of the stress and scenario testing;
- received regular reports from the Risk and Compliance teams outlining the key prudential and conduct risks facing Scottish Friendly and the controls and actions in place to mitigate their impacts. This included updates on the Compliance Monitoring plan and any actions arising from Compliance Reviews during the period.

Nomination Committee

Michael Walker (Chairman)
Jim Jack (retired April 2015)
Fiona McBain
Dermot Jenkinson

During 2015 the Committee met formally on one occasion and informally on a number of occasions in relation to confirming a new position. The Committee ensures that plans are in place for orderly succession for appointments to the Board. The Committee leads the process for such appointments and makes recommendations to the Board, taking into consideration the time commitments required of Non-Executive Directors and their independence. It considers the overall balance of skills, experience and knowledge to ensure that Directors bring informed and independent judgement to the Board.

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

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

Investment Committee

Simon Miller (Chairman)
Michael Walker
Fiona McBain
Jim Galbraith
Bryan Johnston (appointed November 2015)

During 2015 the Committee met on four occasions, with all members present. The Investment Committee oversees Scottish Friendly's investment holdings and performance on behalf of the Board. The terms of reference of the Committee include making decisions on asset allocation and strategy of the Scottish Friendly funds in line with the liabilities, relevant risk appetite and parameters established by the Board or by the relevant fund objective, and also monitoring risk appetite, investment parameters and fund objectives, making recommendations to the Board as appropriate. External fund managers and investment advisors are routinely invited to present to the Committee.

During the year, the Committee considered the portfolio transferred from M&GM and reviewed the process of aligning the holdings with Scottish Friendly's own holdings whilst managing the risk profile and transaction costs of any changes.

Bryan Johnston was appointed to the Committee in November 2015 as an independent consultant. He is not a Director of Scottish Friendly.

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, 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
Jim Jack (retired April 2015)
Simon Miller
Kerr Luscombe (appointed June 2015)

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. The Chief Executive acts as Secretary to the Committee.

Scottish Friendly's policy is to provide a competitive remuneration package which will attract and retain the appropriate calibre of Executive and Non-Executive Directors.

Executive Director salaries are reviewed annually by reference to comparable positions in other organisations and any change to salary is effective from 1 January. In reviewing salaries, the Committee takes into account remuneration trends in the financial services sector, as well as considering wider economic influences. The Remuneration Committee ensures that it remains appraised of these factors and of best practice, taking external advice where appropriate.

The remuneration package for Executive Directors incorporates a performance element which is targeted at increasing growth and cost efficiencies, generating longer term value for members. Payments are capped at 60% of salary.

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

Non-Executive Directors' duties and responsibilities are set out in Scottish Friendly's Governance and Control Procedures Manual. Non-Executive Directors initially hold office until the conclusion of the Annual General Meeting following their appointment, at which they are eligible for election without nomination. The circumstances in which a Board member would be required to vacate office are set out in the Rules of Scottish Friendly.

Fees for 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 Chairman and 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 for the Chairman are set by the Committee in his absence. 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.

During the year, the Chief Executive served as a Director of the Association of Financial Mutuals; this role is not remunerated and the term of office ended on 31 December 2015. Outside her commitment to Scottish Friendly, the Chief Executive serves as a Director of Scottish Mortgage Investment Trust PLC, and retains a fee of £30,000 per annum, and as a Vice Chair of Save The Children UK and Director of its subsidiary, which are not remunerated.

Service contracts

The Executive Directors have service agreements with a notice period of less than 12 months. The service agreements do not have a fixed term and provide for retirement at age 65.

In the event of termination, any payments made would be based on individual circumstances including the reason for termination and contractual obligations.

Directors’ emoluments (audited)

	Salary and fees £000	Performance pay £000	Benefits[1] £000	Total year ended 31 Dec 2015 £000	Total year ended 31 Dec 2014 £000
Chairman					
Michael J Walker	75	–	4	**79**	72
Executive Directors					
Fiona C McBain	361	226	101	**688**	511
Jim Galbraith	294	184	85	**563**	418
Non-Executive Directors					
David C Huntley	58	–	5	**63**	41
Jim W Jack	13	–	3	**16**	41
Dermot J Jenkinson	41	–	1	**42**	35
Simon EC Miller	44	–	–	**44**	37
Kerr Luscombe	28	–	–	**28**	–

[1] For Executive Directors, benefits comprise the provision of a company car and healthcare insurance, as well as, since 6 April 2012, the provision of pay in lieu of pension contributions. For the Non-Executive Directors, figures in the benefits column comprise travel and accommodation cost reimbursements.

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

Opinion on financial statements of Scottish Friendly Assurance Society Limited (“Scottish Friendly”)

In our opinion:

- the financial statements give a true and fair view of the state of Scottish Friendly’s and the Group’s affairs as at 31 December 2015 and of the income and expenditure of Scottish Friendly and the Group for the year then ended;
- Scottish Friendly’s and the Group’s financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- the financial statements have been prepared in accordance with the Friendly Societies Act 1992.

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

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

We have nothing material to add or draw attention to in relation to:

- the Directors’ confirmation on page 7 that they have carried out a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity;
- the disclosures on page 7 that describe those risks and explain how they are being managed or mitigated;
- the Directors’ statement on page 7 in the Directors’ Report and Note 2 to the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them and their identification of any material uncertainties to the Group’s ability to continue to do so over a period of 12 months from the date of approval of the financial statements;
- the Directors’ explanations on page 7 as to how they have assessed the prospects of the Group, over what period they have done so and why they consider that period 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 agreed with the Directors’ adoption of the going concern basis of accounting and we did not identify any such material uncertainties. However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group’s ability to continue as a going concern.

Independence

We are required to comply with the Financial Reporting Council’s Ethical Standards for Auditors and we confirm that we are independent of the Group and we have fulfilled our other ethical responsibilities in accordance with those standards. We also confirm we have not provided any of the non-audit services referred to in those standards.

Our assessment of risks of material misstatement

The assessed risks of material misstatement described below are those that had the greatest effect on our audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team. The acquisition of the assets and liabilities of The Marine and General Mutual Life Assurance Society "M&GM" as described in the Directors' report and Note 17 to the financial statements has had the greatest effect on changing our audit scope and the materiality we have applied in the current year as described below.

Risk	How the scope of our audit responded to the risk
Actuarial valuations and assumptions	
The assessment of the calculation of technical provisions of with-profit insurance contracts of £749m and non-profit insurance contracts of £732m on a realistic basis requires management to make significant judgements about assumptions and in particular for with-profit insurance contracts that the asset share applied to the policies and the cost of guarantee granted to policyholders are appropriate. These numbers are set out in Note 11 and the accounting policy is on page 27.	We have engaged actuarial specialists to challenge management's key judgements and the methodology used for consistency with recent experience and market data. These judgements are used in the calculation of the technical provisions for with-profit and non-profit insurance contracts as applicable in the realistic balance sheet and are described in Note 16. We also completed testing on the underlying policyholder data, including the data transferred as part of M&GM transfer of engagements (referred to below) used in the reserving process in order to evaluate its completeness and accuracy and tested the output of calculations and analysis of results.
Valuation and existence of investments	
The investments balances of £770m non-linked and £604m linked, set out in Note 9, represent the majority of the assets held. There is a risk of misstatement if investments are inappropriately recorded or are not valued appropriately in line with the accounting policy on page 26.	We have tested the existence of investments by obtaining samples of independent confirmations from custodians and third parties, which included for the assets transferred as part of the M&GM transfer of engagements (referred to below) a sample of independent confirmations as at 1 June 2015. We have independently tested the market prices used to value these investments to third party sources or we have involved our own financial instrument specialists where investments were not actively traded.
M&GM transfer of engagements	
On 1 June 2015 Scottish Friendly transferred in the business of Marine & General Life Assurance Society (M&GM) by way of a transfer of engagements in accordance with Part VII of the Financial Services and Markets Act 2008. There is a risk that the related accounting entries have not been appropriately recorded.	We have tested the accounting adjustments and related disclosure related to this transaction (see Note 17). Our testing included independently assessing the change in control criteria applied to this transaction, ensuring that the accounting policies of M&GM were aligned appropriately to those of Scottish Friendly (including those applicable to actuarial valuations and assumptions) and testing the fair value adjustments recognised in respect of this transfer.
Third party service organisations	
The reliance on third parties for outsourced services can lead to complexities in oversight and governance. There is a risk that errors or failures of outsourcers adversely impact the Group's financial results.	We have obtained and assessed the available controls reports and tested the design and implementation of management controls in place regarding oversight and monitoring of third parties, including obtaining copies of service agreements in place with third parties and testing samples of underlying source data and key reconciliations.

The description of risks above should be read in conjunction with the significant issues considered by the Audit Committee discussed on page 13.

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 separate opinion on these matters.

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

continued

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.

We determined materiality for the Group to be £4,450,000 (2014: £2,900,000), which is approximately 3% (2014: 3%) of the Funds for Future Appropriation.

We agreed with the Audit Committee that we would report to them all audit differences in excess of £89,000 (2014: £140,000), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

An overview of the scope of our audit

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

Opinion on other matters prescribed by the Friendly Societies Act 1992

- In our opinion the report of the directors has been prepared in accordance with the Friendly Societies Act 1992 and the regulations made under it, and the information given therein is consistent with the Financial Statements for the financial year.

Other matters

In our opinion:

- the part of the Directors' Remuneration Report which we were engaged to audit has been properly prepared in accordance with Schedule 8 to the Companies Act 2006 The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, as if those requirements were to apply to Scottish Friendly.

Matters on which we are required to report by exception

Adequacy of explanations received and accounting records
Under the Friendly Societies Act 1992 we are required to report to you if, in our opinion:

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

We have nothing to report in respect of these matters.

Our duty to read other information in the Annual Report

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

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

In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the directors' statement that they consider the annual report is fair, balanced and understandable and whether the annual report appropriately discloses those matters that we communicated to the audit committee which we consider should have been disclosed. We confirm that we have not identified any such inconsistencies or misleading statements.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Our audit methodology and tools aim to ensure that our quality control procedures are effective, understood and applied. Our quality controls and systems include our dedicated professional standards review team and independent partner reviews.

This report is made solely to Scottish Friendly's members, as a body, in accordance with section 73 of the Friendly Societies Act 1992. Our audit work has been undertaken so that we might state to Scottish Friendly's members those matters we are required to state to them in an auditor's report or those further matters we have expressly agreed to report to them in our engagement letter 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 or Scottish Friendly's members as a body, for our audit work, for this report, or for the opinions we have formed.

Scope of the audit of the financial statements

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

David Claxton ACA (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
Glasgow, United Kingdom
31 March 2016

Income and Expenditure

Technical Account – Long Term Business
For year ended 31 December

	Note	Group 2015 £000	restated Group 2014 £000	Scottish Friendly 2015 £000	restated Scottish Friendly 2014 £000
Earned Premiums		66,345	58,093	66,345	58,093
Reinsurance Premiums		(10,935)	(6,620)	(10,935)	(6,620)
Earned Premiums, Net of Reinsurance	3	55,410	51,473	55,410	51,473
Investment Income	4	63,652	27,600	65,393	28,457
Unrealised Gains/(Losses) on Investments		(47,755)	25,129	(47,707)	25,714
Other Technical Income		5,697	3,004	3,064	857
Gain on Transfer of Engagements		5,118	–	5,118	–
		82,122	107,206	81,278	106,501
Claims Incurred		111,463	61,530	111,463	61,530
Reinsurance Claims		(43,250)	(3,642)	(43,250)	(3,642)
Net Claims Incurred	5	68,213	57,888	68,213	57,888
Change in Other Technical Provisions	11	(24,083)	16,863	(24,083)	16,863
Operating Expenses	6	31,455	28,923	31,455	28,923
Exceptional Costs	6	2,277	–	2,277	–
Investment Expenses & Charges		794	253	794	253
Other Technical Charges		598	1,672	21	1,122
Tax attributable to Long Term Business	8	267	147	–	(8)
Actuarial Gain re pension scheme		(56)	(185)	(56)	(185)
Transfer to the Fund for Future Appropriations		2,657	1,645	2,657	1,645
		82,122	107,206	81,278	106,501

Except as disclosed above, there are no recognised gains or losses for the year. All results are derived from continuing operations.

The inclusion of unrealised gains and losses reflects the marking to fair value of investments in the balance sheet.

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

Balance Sheet

Assets
As at 31 December

	Note	Group 2015 £000	restated Group 2014 £000	Scottish Friendly 2015 £000	restated Scottish Friendly 2014 £000
Investments					
Land & Buildings		**3,325**	3,300	**3,325**	3,300
Other Financial Investments		**766,449**	484,209	**766,350**	484,126
Investments in Group Undertakings		**–**	–	**3,831**	3,779
Non linked Financial Investments		**769,774**	487,509	**773,506**	491,205
Assets Held to Cover Linked Insurance & Investment Liabilities		**604,203**	251,542	**604,203**	251,542
Total Financial Investments	9	**1,373,977**	739,051	**1,377,709**	742,747
Reinsurers' Share of Technical Provisions		**1,020,276**	146,713	**1,020,276**	146,713
Debtors					
Debtors arising out of Direct Insurance Operations		**8,610**	539	**8,610**	539
Taxation Recoverable		**640**	2,467	**640**	2,467
Other Debtors		**11,380**	1,112	**11,440**	985
Other Assets					
Tangible Assets	10	**384**	285	**384**	285
Cash at Bank & In Hand		**88,134**	79,818	**84,237**	75,503
Prepayments & Accrued Income					
Prepayments & Accrued Interest, Dividends & Rents		**7,674**	2,380	**7,674**	2,380
		2,511,075	972,365	**2,510,970**	971,619

Liabilities
As at 31 December

	Note	Group 2015 £000	restated Group 2014 £000	Scottish Friendly 2015 £000	restated Scottish Friendly 2014 £000
Fund for Future Appropriations		**147,639**	97,451	**147,639**	97,451
Technical Provisions	11				
With-profit Insurance Contract Liabilities		**748,820**	312,485	**748,820**	312,485
Non profit Insurance Contract Liabilities		**731,770**	234,438	**731,770**	234,438
Unit-linked Insurance Contract Liabilities		**119,297**	24,152	**119,297**	24,152
Claims Outstanding		**20,032**	12,463	**20,032**	12,463
Investment Contract Liabilities	11	**669,655**	285,205	**669,655**	285,205
Creditors					
Creditors arising out of Direct Insurance Operations	19	**3,884**	1,755	**3,884**	1,755
Other Creditors including Taxation & Social Security	20	**10,502**	2,971	**10,397**	2,225
Deposit Received from Reinsurers	18	**52,882**	–	**52,882**	–
Accruals and Deferred Income		**5,190**	1,445	**5,190**	1,445
Pension Scheme Deficit	13	**1,404**	–	**1,404**	–
		2,511,075	972,365	**2,510,970**	971,619

Approved by the Directors and signed on 31 March 2016 on their behalf by:

MJ Walker
Chairman

FC McBain
Director and Chief Executive

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

1. GENERAL INFORMATION

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

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

2. ACCOUNTING POLICIES

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

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

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

These financial statements cover the Group and Scottish Friendly for the year ending 31 December 2015.

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

Basis of consolidation
The Group accounts consolidate the assets, liabilities and income and expenditure account transactions of Scottish Friendly together with its subsidiary undertakings. The ongoing results of subsidiary undertakings are included within Investment Income, Other Technical Income and Other Technical Charges. The net results are included in the Fund for Future Appropriations for the Group. The activities of Scottish Friendly and the Group are accounted for in the Income and Expenditure Technical Account – Long Term Business.

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

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

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

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

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.

2. ACCOUNTING POLICIES *continued*

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

Valuation of 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.

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. Although the significance of insurance risk is assessable contract by contract, Scottish Friendly has carried out its assessment by considering homogenous product classes, as each of these will have 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.

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 become payable.

Investment contracts

Premiums and claims relating to investment contracts are not recognised in the Technical Account but are recorded as contributions to and deductions from the investment contract liabilities recorded in the Balance Sheet. This has resulted in a restatement of the prior year as noted in Note 9.

Investment income and expenses

Investment income and expenses include dividends, interest, rents, gains and losses on the realisation of investments and the related expenses. Dividends are included as investment income on the date on which the shares are quoted 'ex-dividend'. Interest, rents and expenses are accounted for on an accruals basis. Realised gains and losses on investments are calculated as the difference between net sales proceeds and the original cost.

Unrealised investment gains and losses

Unrealised investment gains and losses are calculated as the difference between the valuation at the balance sheet date and the valuation at the last balance sheet date or purchase price, if acquired during the year. The movement in unrealised gains and losses recognised in the year also includes the reversal of unrealised gains and losses recognised in earlier years in respect of investment disposals in the current period. All unrealised gains and losses are included in the Technical Account.

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.

2. ACCOUNTING POLICIES *continued*

Claims

Insurance contracts

Claims incurred, which include related claims handling expenses, are accounted for, in the case of death claims and surrenders, when they are notified to Scottish Friendly and, in the case of maturities and annuities, when they become due. Claims on participating business include bonuses payable. Reinsurance recoveries are credited to match the relevant gross amounts.

Investment contracts

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

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.

Acquisition costs

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

Taxation

The charge for taxation in respect of business that falls outside the tax-exempt limit is based on the rules for the taxation of friendly societies, as applied to items included in the long-term business technical account for the year. It also takes into account deferred taxation arising from timing differences between the recognition of gains, losses and certain items of expenditure in the financial statements and recognition for tax purposes. Deferred tax assets are recognised to the extent that they are judged to be recoverable in future periods.

Financial investments

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

Financial investments at fair value through profit or loss

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

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

Land and buildings occupied by Scottish Friendly are valued at fair value at 31 December 2015 as determined by an independent valuation specialist in accordance with the guidance issued by the Royal Institute of Chartered Surveyors. 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 the net asset value.

2. ACCOUNTING POLICIES *continued*

Loans and receivables
Loans and receivables are non-derivative financial investments, with fixed or determinable payments, that are not quoted in an active market and are not held with the intention to sell in the short-term. Loans and receivables are recognised at the fair value of the consideration paid for the acquisition of the investment less any accumulated impairment losses.

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

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.

Cash and cash equivalents
Cash and cash equivalents comprise cash at bank, 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.

Tangible assets
Depreciation is provided so as to write off the cost less the estimated residual value of tangible assets by equal instalments over the estimated useful economic lives as follows:

Computer Equipment	4 years
Motor Vehicles	4 years
Fixtures & Fittings	10 years

Fund for Future Appropriations
The balance on this account represents funds that have not been allocated to specific policyholders. Transfers to and from the fund reflect the excess of income over outgoings in each accounting year arising from participating business.

Technical provisions
In accordance with FRS103, liabilities relating to participating contracts are calculated on a realistic basis. Provision is made for all bonus payments. In accordance with FRS103, investment contracts have been excluded. The realistic liabilities are based on the aggregate value of policy asset shares reflecting the premiums, investment return, expenses and charges applied to each policy. Allowance is made for policy-related liabilities, such as guarantees and future bonuses, typically calculated using a stochastic model simulating future investment returns, asset mix and bonuses.

The present value of future profits (PVFP) for the non-participating business is deducted from the participating liabilities; the PVFP is determined in accordance with the Prudential Regulation Authority's realistic capital regime.

Unit-linked liability calculations are based on the fund value at the valuation date plus a reserve where, on a prudent basis, it is estimated that future cash outflows can not be covered by future cash inflows.

For conventional non-profit business, a gross premium valuation method is used with an explicit expense reserve.

Guarantees
Some participating contracts contain guarantees that can increase the benefits payable to the policyholder. A market consistent stochastic model is used to determine the potential liability for the following guarantees:

- the sum assured and declared reversionary bonuses on with-profits policies; and
- unitised with-profits plans containing guarantees that the market adjustments will not be applied at specific times.

Bonuses
Vested reversionary bonuses, including the current declaration, are dealt with in the technical account under 'change in other technical provisions'. Terminal bonuses paid during the year are included as part of claims incurred.

Pensions
Scottish Friendly operates a money purchase group personal pension scheme. Employer's contributions in respect of eligible employees are charged to the Technical Account (operating expenses) based upon a fixed percentage of pensionable remuneration.

Notes to the Accounts

continued

2. ACCOUNTING POLICIES *continued*

Scottish Friendly Assurance Society Pension and Life Assurance Scheme

Scottish Friendly operated a defined benefit pension arrangement called the Scottish Friendly Assurance Society Pension and Life Assurance Scheme (the Scheme). The Scheme provided benefits based on final salary and length of service on retirement, leaving service or death. The Scheme wound up in May 2015, after having secured insurance policies in individual members' names during February 2015, therefore leaving the Scheme with no further liability for pension benefits.

The Scottish Legal Life Pension Scheme

Following the transfer of Scottish Legal Life, Scottish Friendly took over operation of The Scottish Legal Life Pension Scheme ("SLL Scheme"), a defined benefit pension scheme. All member benefits were fully insured with third party annuity providers in 2014, leaving the SLL Scheme with no further liability for pension benefits. The SLL Scheme had no assets or liabilities at the end of 2014, and formal wind up was completed in May 2015.

MGM Assurance Staff Pension Plan

Following the transfer of M&GM, Scottish Friendly sponsors the MGM Assurance Staff Pension Plan ("the Plan"), a funded defined benefit pension scheme in the UK. The Plan is administered within a trust which is legally separate from Scottish Friendly. Trustees are appointed by both Scottish Friendly and the Plan's membership and act in the interest of the Plan and all relevant stakeholders, including the members and Scottish Friendly. The Trustees are also responsible for the investment of the Plan's assets. The Plan closed to new entrants on 1 July 2006 and ceased to future accrual with effect from 30 April 2010. Existing members accrued an annual pension of 1/60th of final pensionable salary for each year of pensionable service, increasing in line with inflation whilst in payment. The Plan also provides a lump sum and a spouse's pension on the death of a member. 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.

Responsibility for making good any deficit within the Plan lies with Scottish Friendly and this introduces a number of risks for Scottish Friendly. The major risks are: interest rate risk; investment risk; longevity risk. Scottish Friendly and the Trustees are aware of these risks and manage them through appropriate investment and funding strategies. The Trustees manage governance and operational risks through a number of internal controls policies, including a risk register.

The Plan is subject to regular actuarial valuations, which are usually carried out every three years. A formal actuarial valuation was carried out as at 31 December 2012. The results of that valuation have been projected to 31 December 2015 by a qualified independent actuary using the Projected Unit Method.

Foreign currencies

The functional currency is sterling and 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.

Transfer of undertaking

The assets at the date of transfer were taken on at fair value and the valuation of the technical provisions for contract liabilities was revised to reflect the reduced expense basis on transfer. Accounting policies were aligned with Scottish Friendly's which led to the write off of deferred acquisition expenses. The costs of the transfer were expensed. The net gain is included in the Technical Account.

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.

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	
	2015 £000	2014 £000	**2015 £000**	2014 £000	**2015 £000**	2014 £000
Annual	**63,645**	54,060	**1,469**	1,734	**65,114**	55,794
Single	**1,231**	2,299	**–**	–	**1,231**	2,299
	64,876	56,359	**1,469**	1,734	**66,345**	58,093
Comprising:						restated
Premiums for participating contracts					**43,127**	48,734
Premiums for non-participating contracts					**9,360**	8,269
Premiums from linked contracts					**13,858**	1,090
Gross Earned Premiums					**66,345**	58,093
Reinsurance Premiums on Insurance Contracts					**(10,935)**	(6,620)
Earned Premiums, net of reinsurance					**55,410**	51,473

Where policy holders have the option of investing premiums in either linked funds or accumulating with-profits funds, these premiums are included above as premiums from linked contracts.

Gross new business premiums

	Scottish Friendly 2015		Scottish Friendly 2014	
	Annual £000	**Single £000**	Annual £000	Single £000
New Business premiums	**24,799**	**6,673**	20,628	10,726

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

	Group		Scottish Friendly	
	2015 £000	2014 £000	**2015 £000**	2014 £000
Annual Contributions	**2,937**	3,039	**–**	–
Single Contributions	**1,643**	1,069	**–**	–

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

Notes to the Accounts

continued

4. INVESTMENT INCOME

	Group		Scottish Friendly	
	2015 £000	2014 £000	**2015 £000**	2014 £000
Income from land & buildings	**125**	119	**125**	119
Income from other investments	**33,447**	17,121	**35,188**	17,978
Net gains on the realisation of investments	**30,136**	10,589	**30,136**	10,589
Net (loss) on pension scheme	**(56)**	(229)	**(56)**	(229)
	63,652	27,600	**65,393**	28,457

5. CLAIMS INCURRED

Group and Scottish Friendly

	Ordinary Assurance		Industrial Assurance		Total	
	2015 £000	restated 2014 £000	**2015 £000**	2014 £000	**2015 £000**	restated 2014 £000
Deaths	**12,885**	6,649	**3,274**	3,076	**16,159**	9,725
Maturities	**45,998**	42,471	**1,723**	2,317	**47,721**	44,788
Surrenders	**9,974**	6,019	**523**	649	**10,497**	6,668
Annuities	**36,611**	6	**–**	–	**36,611**	6
	105,468	55,145	**5,520**	6,042	**110,988**	61,187
Claims handling expenses					**475**	343
					111,463	61,530
Aggregate recoveries received from reinsurers					**(43,250)**	(3,642)
Net Claims Paid on Insurance Contracts					**68,213**	57,888

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

6. OPERATING EXPENSES AND EXCEPTIONAL COSTS

Group and Scottish Friendly

Operating Costs

	2015 £000	2014 £000
Acquisition costs	**13,901**	14,858
Administration expenses	**6,818**	6,067
Information Technology Infrastructure	**1,658**	2,676
Renewal commission	**9,078**	5,322
	31,455	28,923

Exceptional costs of £2,277,000 (2014: £nil) related to funding the deficit in the MGM Assurance Staff Pension Plan (see Note 13).

6. OPERATING EXPENSES AND EXCEPTIONAL COSTS *continued*

Remuneration of Auditors (included within administration expenses on page 30).

	2015 £000	2014 £000
Fees payable to the auditor for audit of annual accounts	**135**	120
Fees payable to the auditor for other services:		
The audit of subsidiary companies pursuant to legislation	**8**	8
Other services pursuant to legislation	**29**	20
Other services	**–**	36
Fees in respect of the Scottish Friendly Pension & Life Assurance Scheme audit	**3**	3

7. STAFF COSTS

Group and Scottish Friendly

Staff numbers and costs

The average number of persons, excluding directors, employed by Scottish Friendly during the year was 96 (2014: 88). The aggregate payroll costs of these persons were as follows:

	2015 £000	2014 £000
Wages and salaries	**3,078**	2,797
Social security costs	**325**	287
Other pension costs	**220**	201
	3,623	3,285

Remuneration of Directors

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

8. TAXATION

	Group		Scottish Friendly	
	2015 £000	2014 £000	2015 £000	2014 £000
Corporation Tax and irrecoverable income tax	**267**	147	**–**	(8)

Scottish Friendly also has an unrecognised deferred tax asset of £1,417,078 (2014: £6,366,000) with regards to carried forward excess management expenses, unrealised capital losses and other items, that is not considered sufficiently likely to be recoverable to be included here.

Corporation tax is charged at the standard rate of 20% for 9 months, 21% for 3 months (2014: 21%) on the profit on ordinary activities of the subsidiaries SFAM £815,000 (2014: £694,000) and SFIS £503,000 (2014: £47,000) with adjustments in respect of prior years being nil (2014: nil).

9. FINANCIAL INVESTMENTS

	Group				Scottish Friendly			
	Carrying Value		Cost		Carrying Value		Cost	
	2015 £000	2014 £000	**2015 £000**	2014 £000	**2015 £000**	2014 £000	**2015 £000**	2014 £000
Non-linked and linked financial investments								
Non-linked financial investments	**769,774**	487,509	**617,467**	327,228	**773,506**	491,205	**619,573**	329,347
Linked financial investments	**604,203**	251,542	**453,558**	197,681	**604,203**	251,542	**453,558**	197,681
Total financial investments	**1,373,977**	739,051	**1,071,025**	524,909	**1,377,709**	742,747	**1,073,131**	527,028
Of which financial investments designated as:								
(a) Financial investments designated at fair value	**1,293,672**	738,965	**1,029,606**	524,823	**1,297,404**	742,661	**1,031,712**	526,942
(b) Derivatives	**38,209**	–	**–**	–	**38,209**	–	**–**	–
(c) Loans and receivables	**42,096**	86	**41,419**	86	**42,096**	86	**41,419**	86
Total financial investments	**1,373,977**	739,051	**1,071,025**	524,909	**1,377,709**	742,747	**1,073,131**	527,028
Non-linked financial investments								
(a) Financial investments designated at fair value;								
Shares, other variable yield securities and units in OEICs and unit trusts	**527,937**	474,885	**360,851**	314,611	**527,838**	474,802	**360,757**	314,530
Debt securities and other fixed income securities	**182,356**	9,238	**233,977**	7,528	**182,356**	9,238	**233,977**	7,528
Private equity investments	**1,458**	–	**1,409**	–	**5,289**	3,779	**3,609**	2,200
Land and buildings	**3,325**	3,300	**5,003**	5,003	**3,325**	3,300	**5,003**	5,003
	715,076	487,423	**601,240**	327,142	**718,808**	491,119	**603,346**	329,261
(b) Derivatives								
Derivative assets	**38,209**	–	**–**	–	**38,209**	–	**–**	–
(c) Loans and receivables								
Policyholder loans	**35**	–	**35**	–	**35**	–	**35**	–
Deposits with credit institutions	**16,368**	–	**16,106**	–	**16,368**	–	**16,106**	–
Loans secured by mortgages	**86**	86	**86**	86	**86**	86	**86**	86
	16,489	86	**16,227**	86	**16,489**	86	**16,227**	86
Total non-linked financial investments	**769,774**	487,509	**617,467**	327,228	**773,506**	491,205	**619,573**	329,347
Linked financial investments								
(a) Financial investments designated at fair value;								
Shares, other variable yield securities and units in OEICs and unit trusts	**510,918**	251,542	**361,792**	197,681	**510,918**	251,542	**361,792**	197,681
Debt securities and other fixed income securities	**67,678**	–	**66,574**	–	**67,678**	–	**66,574**	–
	578,596	251,542	**428,366**	197,681	**578,596**	251,542	**428,366**	197,681
(b) Derivatives								
Derivative assets	**–**	–	**–**	–	**–**	–	**–**	–
(c) Loans and receivables								
Deposits with credit institutions	**25,607**	–	**25,192**	–	**25,607**	–	**25,192**	–
Total linked financial investments	**604,203**	251,542	**453,558**	197,681	**604,203**	251,542	**453,558**	197,681

9. FINANCIAL INVESTMENTS *continued*

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

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

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

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

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

Fair value hierarchy

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

9. FINANCIAL INVESTMENTS *continued*

Fair value hierarchy

	Group				Scottish Friendly			
	Level 1 £000	Level 2 £000	Level 3 £000	**Total £000**	Level 1 £000	Level 2 £000	Level 3 £000	**Total £000**
Financial instrument assets 2014								
Financial investments designated at fair value;								
Shares, other variable yield securities and units in OEICs and unit trusts	726,427	–	–	**726,427**	726,344	–	–	**726,344**
Debt securities and other fixed income securities	9,238	–	–	**9,238**	9,238	–	–	**9,238**
Private equity investments	–	–	–	**–**	–	–	3,779	**3,779**
Land and buildings	–	3,300	–	**3,300**	–	3,300	–	**3,300**
	735,665	3,300	–	**738,965**	735,582	3,300	3,779	**742,661**
Derivative assets	–	–	–	**–**	–	–	–	**–**
Financial assets measured at fair value through profit and loss	735,665	3,300	–	**738,965**	735,582	3,300	3,779	**742,661**
Loans and receivables;								
Deposits with credit institutions				**–**				**–**
Loans secured by mortgages				**86**				**86**
Policyholder loans				**–**				**–**
				86				**86**
Total financial assets				**739,051**				**742,747**
Financial instrument liabilities 2014				**restated**				**restated**
Derivatives liabilities	–	–	–	**–**	–	–	–	**–**
Investment contract liabilities	(285,205)	–	–	**(285,205)**	(285,205)	–	–	**(285,205)**
	(285,205)	–	–	**(285,205)**	(285,205)	–	–	**(285,205)**

Liabilities have been restated for investment contracts, as stated in Note 2.

Financial instruments have been categorised between Levels 1, 2 and 3 for the fair value hierarchy on a consistent basis between 2014 and 2015. There have been no changes to the valuation methods of Levels 1, 2 or 3 in 2015 and no change in the nature of the financial instruments held other than the addition of derivatives, on the transfer of M&GM, held to hedge against economic exposure of assets held (see overleaf). All changes in fair value of financial instruments have resulted directly from trading in 2015 and market movement. On this basis, no reconciliation for movements between Level 1, 2 and 3 is required.

9. FINANCIAL INVESTMENTS *continued*

Derivatives to hedge against economic exposure of assets held by Scottish Friendly.

	Non-linked Derivative assets £000	Non-linked Derivative liabilities £000	Linked Derivative assets/ (liabilities) £000	Total £000
2015				
Interest rate swaps, interest rate swaptions and inflation swaps	38,209	(2,884)	–	35,325
Currency forwards	–	(46)	–	(46)
Total	**38,209**	**(2,930)**	**–**	**35,279**
2014				
Interest rate swaps, interest rate swaptions and inflation swaps	–	–	–	–
Currency forwards	–	–	–	–
Total	–	–	–	–

10. TANGIBLE ASSETS

Group and Scottish Friendly

	Computer equipment £000	Motor vehicles £000	Fixtures & fittings £000	Total £000
Cost				
At 1 January 2015	932	101	449	1,482
Additions	213	–	3	216
Disposals	(2)	–	–	(2)
At 31 December 2015	**1,143**	**101**	**452**	**1,696**
Depreciation				
At 1 January 2015	823	62	312	1,197
Charge for year	68	18	31	117
Disposals	(2)	–	–	(2)
At 31 December 2015	**889**	**80**	**343**	**1,312**
Net Book Value at 31 December 2015	**254**	**21**	**109**	**384**
Net Book Value at 31 December 2014	109	39	137	285

Notes to the Accounts

continued

11. TECHNICAL PROVISIONS

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

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

2014	Non-profit Insurance Contracts Gross £000	Non-profit Insurance Contracts Reinsured £000	With-Profits Insurance Contracts Gross £000	With-Profits Insurance Contracts Reinsured £000
1 January	152,984	(69,958)	320,374	–
Premiums received	8,269	(6,620)	48,734	–
Liabilities paid by claims	(6,228)	3,642	(54,384)	–
Business transfer in	–	–	–	–
New Business	73,034	(71,061)	3,624	–
Experience variations and assumption changes	6,379	(2,716)	(5,863)	–
31 December	234,438	(146,713)	312,485	–

	Unit-Linked Insurance Contracts 2015 £000	Unit-Linked Insurance Contracts 2014 £000
1 January	**24,152**	22,909
Premiums received	**13,858**	1,090
Liabilities paid by claims	**(11,737)**	(918)
Business transfer in	**94,180**	–
New Business	**2,618**	1,940
Fees deducted	**(568)**	(91)
Change in investment value of contracts	**(3,206)**	(778)
31 December	**119,297**	24,152

11. TECHNICAL PROVISIONS *continued*

	Investment Contracts	
	2015	2014
	£000	£000
1 January	**285,205**	286,128
Premiums received	**14,949**	12,008
Liabilities paid by claims	**(46,577)**	(30,884)
Business transfer in	**389,722**	–
New Business	**1,142**	5,157
Fees deducted	**(3,064)**	(857)
Change in investment value of contracts	**28,278**	13,653
31 December	**669,655**	285,205

The principal assumption underlying the calculation of the technical provisions is that future interest earnings will be 2% for all assurance business. The mortality table used for ordinary assurance was the AM00 and the Table English Life No.16 (Males) was used for industrial assurance. For the business acquired from M&GM, the mortality table used for unit-linked was AM80, for unitised with-profits table AM92, for term assurance table TM92 and for other business table PNMA00.

12. COSTS OF BONUSES

Group and Scottish Friendly

Total bonuses attributable to the year are as follows:

	2015	2014
	£000	£000
Year end reversionary bonus declared (included in change in other technical provisions)	**2,722**	2,959
Reversionary and terminal bonuses paid (included in claims)	**11,492**	11,200
Total bonuses	**14,214**	14,159

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 2015, the charge included in the technical account relating to the employer's contributions to this scheme was £220,000 (2014: £201,000). There were no outstanding or prepaid contributions at the date of the Balance Sheet.

Defined benefit schemes

Scottish Friendly Assurance Society Limited Pension and Life Assurance Scheme

Scottish Friendly operated a defined benefit pension arrangement called the Scottish Friendly Assurance Society Pension and Life Assurance Scheme ("the Scheme"). The Scheme provided benefits based on final salary and length of service on retirement, leaving service or death. The Scheme wound up during May 2015, after having secured insurance policies in individual members' names during February 2015, therefore leaving the Scheme with no further liability for pension benefits.

13. PENSIONS *continued*

The Scheme had no remaining assets or liabilities at the year end. The principal assumptions used to calculate the Scheme's liabilities at the previous year end include:

	2015 %	2014 %
Discount rate	n/a	3.4
Inflation	n/a	3.05
Revaluation in deferment (CPI)	n/a	2.25
RPI max 5% pension increases	n/a	3.05
RPI max 2.5% pension increases	n/a	2.5
Post retirement mortality assumption	n/a	2000 series, Medium cohort Minimum improvement: 1.5% males, 1.0% females

The purchase of individual annuities with Scottish Friendly has been accounted for as a settlement during 2015. Before the benefits were secured by annuities in February 2015 the assets consisted solely of an insurance policy held with Scottish Friendly.

The market values of the policy and the expected rates of return were:

	Long-term expected rate of return %	Value at 31 December £000
31 December 2015	**n/a**	**–**
31 December 2014	3.4	12,197
31 December 2013	4.4	10,332
31 December 2012	4.1	10,153

The Scheme had no remaining assets or liabilities at the year end. No amount is therefore recognised in the Balance Sheet.

Amounts recognised in the Technical Account – long term business

	2015 £000	2014 £000
Past service cost	–	83
Total operating charge (included in operating expenses)	–	83

There are no net actuarial gains or losses to report following the wind up of the Scheme.

Summary of prior year amounts

	2015 £000	2014 £000	2013 £000	2012 £000	2011 £000
Experience gains/(losses) on Scheme liabilities	–	(395)	(2)	(184)	68
Changes in assumptions used to value Scheme liabilities	–	(1,503)	(75)	(838)	(374)
Loss (gain) on scheme assets in excess of interest	–	1,898	77	1,023	305

13. PENSIONS *continued*

The Scottish Legal Life Pension Scheme

Following the transfer of Scottish Legal Life, Scottish Friendly took over operation of The Scottish Legal Life Pension Scheme ("SLL Scheme"), a defined benefits pension scheme.

The SLL Scheme wound up in May 2015 having fully insured all members' benefits with third party annuity providers, leaving the SLL Scheme with no further liability for pension benefits.

The SLL Scheme had no remaining assets or liabilities at the year end. No amount is therefore recognised in the Balance Sheet.

	2015 £000	2014 £000
Fair value of scheme assets	–	–
Present value of funded liabilities	–	–
Net (deficit)/surplus	–	–

There were no amounts recognised in the Technical Account during 2015.

	2015 £000	2014 £000
Interest cost	–	1,417
Expected return on scheme assets	–	(1,419)
Scheme expenses	–	231
	–	229
Actuarial gains	–	185

There were no changes in the present value of the defined benefit liabilities:

	2015 £000	2014 £000
Opening defined benefit liability	–	32,430
Interest cost	–	1,417
Actuarial losses/(gains)	–	4,571
Liabilities extinguished on settlements	–	(37,973)
Benefits paid	–	(445)
	–	–

There were no changes in the fair value of the SLL Scheme assets:

	2015 £000	2014 £000
Opening fair value of scheme assets	–	32,474
Expected return	–	1,419
Actuarial gains	–	4,756
Assets distributed on settlements	–	(37,973)
Contributions by employer	–	–
Scheme expenses	–	(231)
Benefits paid	–	(445)
	–	–

13. PENSIONS *continued*

MGM Assurance Staff Pension Plan

Following the transfer of M&GM, Scottish Friendly sponsors the MGM Assurance Staff Pension Plan ("the Plan"), a defined benefit pension scheme in the UK. The Plan is administered within a trust which is legally separate from Scottish Friendly. Trustees are appointed by both Scottish Friendly and the Plan's membership and act in the interest of the Plan and all relevant stakeholders, including the members and Scottish Friendly. The Trustees are also responsible for the investment of the Plan's assets.

The Plan closed to new entrants on 1 July 2006 and ceased to future accrual with effect from 30 April 2010. Existing members accrued an annual pension of 1/60th of final pensionable salary for each year of pensionable service, increasing in line with inflation whilst in payment. The Plan also provides a lump sum and a spouse's pension on the death of a member.

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.

Responsibility for making good any deficit within the Plan lies with Scottish Friendly and this introduces a number of risks. The major risks are: interest rate risk; investment risk; longevity risk. Scottish Friendly and Trustees are aware of these risks and manage them through appropriate investment and funding strategies. The Trustees manage governance and operational risks through a number of internal controls policies, including a risk register.

The Plan is subject to regular actuarial valuations, which are usually carried out every three years. A formal actuarial valuation was carried out as at 31 December 2012. The results of that valuation have been projected to 31 December 2015 by a qualified independent actuary. The figures in the following disclosure were measured using the Projected Unit Method.

The amounts recognised in the Balance Sheet are as follows:

	2015 £000	2014 £000
Present value of plan liabilities	(93,738)	n/a
Fair value of plan assets	90,134	n/a
Funded Status	(3,604)	n/a
Additional contributions pledged	2,200	n/a
Net amount recognised at year end	(1,404)	n/a

The amounts recognised in the Technical Account are as follows:

	2015 £000	2014 £000
Interest cost	56	n/a
Remeasurements of the net liability:		
Return on Plan assets (excluding amount included in interest expense)	2,307	n/a
Gain arising from changes in financial assumptions	(1,185)	n/a
Loss arising from changes in demographic assumptions	721	n/a
Experience loss	378	n/a
Charge recorded within the Technical Account	2,277	n/a

13. PENSIONS *continued*

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

	2015 £000	2014 £000
Liabilities at start of period	93,175	n/a
Interest cost	3,306	n/a
Remeasurement losses/(gains):		
Actuarial gains arising from changes in financial assumptions	(1,185)	n/a
Actuarial losses arising from changes in demographic assumptions	721	n/a
Other experience items	378	n/a
Transfer in liability	35	n/a
Benefits paid	(2,692)	n/a
Liabilities at end of period	93,738	n/a

Change in the present value of assets over the period:

	2015 £000	2014 £000
Fair value of assets at start of period	91,348	n/a
Interest income	3,250	n/a
Investment return loss on scheme assets (excluding amount included in interest expense)	(2,307)	n/a
Contributions from the employer	500	n/a
Transfer in liability	35	n/a
Benefits paid	(2,692)	n/a
Fair value of assets at end of period	90,134	n/a
Actual return on assets over the period	943	n/a

The principal assumptions used to calculate Plan liabilities were:

	2015 %	2014 %
Liability discount rate	3.70%	n/a
Inflation assumption – RPI	3.50%	n/a
Inflation assumption – CPI	2.80%	n/a
Revaluation of deferred pensions:		
GMP	Fixed rate	n/a
Excess of GMP	2.80%	n/a
Increase for pensions in payment:		
Pre 88 GMP	–	
Post 88 GMP	3.00%	n/a
Excess of GMP (RPI capped at 5%)	3.40%	n/a
Mortality assumption – pre retirement	SAPS S1 PxA CMI 2013 1.25% ltr	n/a
Mortality assumption – male post retirement	SAPS S1 PMA CMI 2013 projections 1.25% long term reduction	n/a
Mortality assumption – female post retirement	SAPS S1 PFA CMI 2013 projections 1.25% long term reduction	n/a

13. PENSIONS *continued*

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

	2015	2014
Male aged 65 at year end	22.4	n/a
Female aged 65 at year end	24.7	n/a
Male aged 45 at year end	24.2	n/a
Female aged 45 at year end	26.6	n/a

The Plan has no investments in Scottish Friendly or in the property occupied by Scottish Friendly. Scottish Friendly expects to make a further £2.7m in contributions to the Plan during year ending 31 December 2016.

The split of the Plan's liabilities by category of membership is as follows:

	2015 £000	2014 £000
Active members	–	n/a
Deferred pensioners	64,461	n/a
Pensions in payment	29,242	n/a
Transfer in liability	35	n/a
Liabilities at end of period	93,738	n/a

	2015	2014
Average duration of the Plan's liabilities at the end of the year	22	n/a

The major categories of Plan assets are as follows:

	2015 £000	2014 £000
Return Seeking		
UK Equities	1,026	n/a
Overseas Equities	3,078	n/a
Hedge Funds	11,388	n/a
Commodities	1,141	n/a
Return Seeking Total	16,633	n/a
Debt Instruments		
Corporates	–	n/a
Gilts	9,223	n/a
Index Linked	59,395	n/a
Debt Instrument Total	68,618	n/a
Other		
Property	3,506	n/a
Cash	1,377	n/a
Other Total	4,883	n/a
Total market value of assets	90,134	n/a

13. PENSIONS *continued*

Sensitivity of the liability value to changes in the principal assumptions
If the discount rate was 0.25% higher (lower), the Plan liabilities would decrease by £9,297,000 (increase by £10,800,000) if all the other assumptions remained unchanged.

If the inflation assumption was 0.25% higher (lower), the Plan liabilities would increase by £4,444,000 (decrease by £4,184,000). In this calculation all assumptions related to the inflation assumption have been appropriately adjusted, that is the deferred pension and pension in payment increases. The other assumptions remain unchanged.

If life expectancies were to increase by 1 year, the Plan liabilities would increase by £3,207,000 if all the other assumptions remained unchanged.

14. WITH-PROFITS ACTUARY

Mr DJ Lechmere of OAC plc served as the With-profits Actuary for the financial year ending 31 December 2015.

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 £84,224 (2014: £96,421).

15. TRANSACTIONS WITH RELATED PARTIES

The aggregate premiums payable for the year by five Directors in respect of Scottish Friendly's products amounted to £17,994 (2014: £17,804).

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

The Executive Directors' pension rights were transferred from the Scheme (defined in Note 13), which was wound up in 2015, into policies with Scottish Friendly; the aggregate amount transferred was £3,268,498.

16. CAPITAL MANAGEMENT

(a) Capital management policies and objectives
Scottish Friendly's capital management objectives are:

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

The capital position of Scottish Friendly is monitored on a regular basis and reviewed formally by the Board. The PRA's capital requirement is that Scottish Friendly must hold capital in excess of the higher of two amounts – the Pillar 1 and Pillar 2 requirements. The Pillar 1 capital requirement is calculated as the higher of two prescribed tests, Peak 1 and Peak 2, which are outlined as follows:

- Peak 1 – prudent valuation of the guarantees of the Group's life funds; and
- Peak 2 – a realistic, market-consistent valuation of the expected future cash flows of Scottish Friendly's life funds.

The Pillar 2 capital requirement is based on Scottish Friendly's Individual Capital Assessment which is reported privately to the PRA. It is broadly equivalent to the capital needed to cover adverse experience likely to occur once in every 200 years, based on Scottish Friendly's actual portfolio of risks having regard to Scottish Friendly's own risk controls.

16. CAPITAL MANAGEMENT *continued*

(b) Realistic balance sheet

A summary realistic balance sheet is shown below, split between the Main Fund, which is open to new business, and its sub-funds that are closed. The closed funds are the Rational Shelley sub-fund, LANMAS (London Aberdeen and Northern Mutual Assurance Society) sub-fund, the Scottish Legal sub-fund, and the M&GM sub-fund; the latter was formed on the transfer of Marine & General Mutual Life Assurance Society to Scottish Friendly by way of a Part VII transfer on 1 June 2015.

Realistic available capital for both the open and closed funds of Scottish Friendly is determined in accordance with the PRA's realistic balance sheet methodology. This can be broadly described as placing a market value on both the assets and participating liabilities, including both benefits already guaranteed and future discretionary benefits. Additionally, the value of future profits on acquired in-force long-term business within Scottish Friendly as well as on non-participating business issued by the Group may be included as an asset.

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

There are two principal types of financial option and guarantee:

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

  – a guaranteed income specified in the contract; and

  – guaranteed terms for converting lump sum maturity benefits into an income at maturity.

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

(c) Capital statement

Available capital resources

	2015			2014		
	Main fund £000	Closed sub-funds £000	Total £000	Main fund £000	Closed sub-funds £000	Total £000
Fund for future appropriations	**147,639**	**–**	**147,639**	97,451	–	97,451
Adjustments to assets onto regulatory basis	**20,312**	**150,030**	**170,342**	35,876	50,086	85,962
Total available capital resources	**167,951**	**150,030**	**317,981**	133,327	50,086	183,413

The total available capital resources for the closed sub funds include £100,734,000 in respect of the M&GM sub fund (2014: nil).

Analysis of contract liabilities net of reinsurance

	2015 £000	2014 £000
With Profits Insurance	**314,848**	312,485
Non-Profit Insurance	**145,466**	87,725
Investment	**669,655**	285,205
Unit Linked Insurance	**119,297**	24,152

16. CAPITAL MANAGEMENT *continued*

(d) Movement in available capital resources

	2015 £000	2014 £000
Opening capital resources	**183,413**	168,410
Transfer of engagements	**147,067**	–
Change in assumptions	**3,764**	(719)
Change in management policies	**(19,935)**	3,533
New business and other factors	**3,672**	12,189
Closing capital resources	**317,981**	183,413

There were no significant changes in regulation or other similar external developments.

(e) 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 presence of guarantees and options in the underlying contracts, and any change in assets within the working capital. Currently, a fall in equity/property values would reduce available capital for the Scottish Friendly Main Fund.

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

Scottish Friendly holds guarantees in respect of sums assured and reversionary bonus guarantees on with-profits contracts. Under the PRA realistic regime, these are explicitly calculated using a stochastic valuation model.

17. TRANSFER OF ENGAGEMENT

Transfer of Engagement for M&GM

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

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

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

17. TRANSFER OF ENGAGEMENT *continued*

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

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

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

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

18. 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.

	2015 £000	2014 £000
Collateral deposits for:		
'Select' annuity (Hannover Re)	**46,134**	–
'Standard' annuity (RGA)	**6,748**	–
	52,882	–

At the year-end Scottish Friendly had pledged £5,891,000 (2014: nil) to Pacific Life Re as collateral for a longevity swap reinsurance arrangement.

19. CREDITORS ARISING OUT OF DIRECT INSURANCE OPERATIONS

Group and Scottish Friendly

	2015 £000	2014 £000
Due to reinsurers	**2,097**	102
Due to intermediaries	**1,248**	1,471
Other insurance payables	**539**	182
	3,884	1,755

20. OTHER CREDITORS INCLUDING TAXATION AND SOCIAL SECURITY

	Group		Scottish Friendly	
	2015 £000	2014 £000	**2015 £000**	2014 £000
Trade Creditors	**323**	155	**323**	155
Investments Creditors	**3,987**	–	**3,987**	–
Taxation	**87**	49	**–**	–
Derivative Liabilities (see Note 9)	**2,930**	–	**2,930**	–
Other payables	**1,625**	2,129	**1,451**	628
HMRC payments PAYE and VAT	**1,550**	638	**1,706**	1,442
	10,502	2,971	**10,397**	2,225

21. RISK MANAGEMENT

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

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

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

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

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

With profits contracts

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

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

21. RISK MANAGEMENT *continued*

The key insurance risk factors of with-profit 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 mitigates these risks by charging premium rates it believes are sufficient to meet expenses while remaining competitive for the protection provided, and by the use of third-party reinsurers.

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

The key insurance risk factors of annuity contracts are:

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

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

21. RISK MANAGEMENT *continued*

The key insurance risk factors are:

- *persistency 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 Fund for Future Appropriations (FFA) of applying stress scenarios in line with the Standard Formula under Solvency II:

	2015 Impact on the FFA £m	2014 Impact on the FFA £m
Increase in expenses	**(2.2)**	(0.6)
Increase in assurance mortality rates	**(0.7)**	(0.4)
Reduction in persistency	**(2.9)**	(2.7)

Credit risk is the risk of loss arising in the event of the failure of third parties to meet their financial obligations in a timely manner. Scottish Friendly's key exposures relate to holdings in corporate bonds and cash deposits, and defaults in reinsurers and key counterparties. Over the period, the risk has increased with the transfer of significant volumes of business from M&GM that is reinsured. 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.

21. RISK MANAGEMENT *continued*

Group 2015

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

Group 2014

	AAA £000	AA £000	A £000	BBB and below £000	Not rated £000	Not subject to credit risk	Value in the balance sheet £000
Non-linked assets subject to credit risk:							
Financial investments – debt and fixed income securities	129	914	2,087	63,497	2,043	–	68,670
Cash and cash equivalents	–	7,069	13,342	58,907	500	–	79,818
Reinsurers' share of technical provisions	–	146,713	–	–	–	–	146,713
Other assets	–	–	–	–	6,783	–	6,783
Linked assets not subject to credit risk	–	–	–	–	–	251,542	251,542
Non-linked assets not subject to credit risk	–	–	–	–	–	418,839	418,839
Total assets	129	154,696	15,429	122,404	9,326	670,381	972,365

The derivative investments require the Group and Scottish Friendly to pledge collateral for derivative liabilities and for third parties to pledge collateral for the derivative assets. To help protect against the credit risk, all collateral is held by an intermediary company and at the end of the year Scottish Friendly had pledged £nil (2014: £nil) in cash margin collateral in respect of derivative investments.

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

Other assets include premium debtors all of which are less than three months old. Scottish Friendly has never 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 (2014: £nil).

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

21. RISK MANAGEMENT *continued*

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 £209,943,000 (2014: £60,483,000) and £459,712,000 (2014: £224,722,000) respectively.

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

	Group		Scottish Friendly	
	2015 £000	2014 £000	**2015 £000**	2014 £000
Other financial liabilities	**93,896**	18,634	**93,786**	17,888

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

Group and Scottish Friendly

	0-5 years £000	5-10 years £000	10-15 years £000	15-20 years £000	Over 20 years £000	Total £000
2015						
Liabilities subject to liquidity risk:						
Insurance contracts – guaranteed component	181,557	89,568	23,512	12,919	32,909	340,465
Total	**181,557**	**89,568**	**23,512**	**12,919**	**32,909**	**340,465**
2014						
Liabilities subject to liquidity risk:						
Insurance contracts – guaranteed component	179,837	116,170	24,546	13,439	33,791	367,783
Total	179,837	116,170	24,546	13,439	33,791	367,783

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

21. RISK MANAGEMENT *continued*

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 of the significant inputs is not based on observable market data, the instrument is included in Level 3.

Specific valuation techniques used to value financial instruments include:

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

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

Market risk sensitivity analysis:

The following table illustrates the impacts on the Fund for Future Appropriations (FFA) of applying stress scenarios in line with the Standard Formula under Solvency II.

	2015 Impact on the FFA £m	2014 Impact on the FFA £m
Equity Fall	**(7.0)**	(3.9)
Property Fall	**(0.6)**	(0.4)
Interest Rate Fall	**(5.1)**	(4.0)
Interest Rate Rise	**2.3**	1.5

22. TRANSITION TO FRS 102 AND FRS 103

The Group and Scottish Friendly transitioned to FRS 102 and FRS 103 from previously extant UK GAAP as at 1 January 2014.

The impact on the Group and Scottish Friendly is as follows:

Financial instruments

Under FRS 102, Scottish Friendly and the Group measure debt and equity securities at fair value. Under previous UK GAAP, Scottish Friendly and group assets were measured at market value. There has been no impact on the value of assets at 1 January and 31 December 2014. The assets transferred from M&GM were already recorded at fair value.

Under FRS 103, Scottish Friendly's business has been categorised as either insurance contracts or investment contracts. Premiums and claims relating to investment contracts are not recognised in the Technical Account but are recorded as contributions to and deductions from the investment contract liabilities recorded in the Balance Sheet. The technical provisions have been reanalysed accordingly:

	2015 £000	2014 £000
Technical Provisions under former UK GAAP		
Long term business provision	**1,677,714**	607,735
Claims Outstanding	**20,032**	12,463
Technical Provision for Linked Liabilities	**591,828**	248,545
	2,289,574	868,743
as analysed under FRS 102, 103		
Technical Provisions		
With-profit Insurance Contract Liabilities	**748,820**	312,485
Non-profit Insurance Contract Liabilities	**731,770**	234,438
Unit linked Insurance Contract Liabilities	**119,297**	24,152
Claims Outstanding	**20,032**	12,463
Investment Contract Liabilities	**669,655**	285,205
	2,289,574	868,743

Premiums and Claims have been restated as follows:

	2015 £000	2014 £000
Gross Earned Premiums under former UK GAAP	**81,294**	70,101
Under FRS 103 exclude:		
Premiums Earned on Investment Contracts	**(14,949)**	(12,008)
Earned premiums as restated	**66,345**	58,093
Claims Incurred Net of Reinsurance as previously stated	**114,790**	88,772
add back recoveries received from reinsurers	**43,250**	3,642
	158,040	92,414
Under FRS 103 exclude:		
Deposit Element of Claims in Investment Contracts	**(46,577)**	(30,884)
Claims Incurred as restated	**111,463**	61,530

22. TRANSITION TO FRS 102 AND FRS 103 *continued*

Fee income from investment contracts has been separately recorded in other technical income. Income has been restated as follows:

	Group		Scottish Friendly	
	2015 £000	2014 £000	**2015 £000**	2014 £000
Other Technical income under former UK GAAP				
income from activities of subsidiaries	**2,633**	2,147	**0**	0
add: fee income from investment contracts	**3,064**	857	**3,064**	857
Other Technical Income under FRS 103	**5,697**	3,004	**3,064**	857

These changes re premiums, claims and other technical income noted above affected the change in other technical provisions as follows:

	2015 £000	2014 £000
Change in Other Technical Provisions	**(58,775)**	(2,870)
under former UK GAAP, exclude:		
Premiums Earned on Investment Contracts	**(14,949)**	(12,008)
Deposit Element of Claims in Investment Contracts	**46,577**	30,884
add: fee income from investment contracts	**3,064**	857
	(24,083)	16,863

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