

## Accounting policies

### (a) Basis of preparation

The Group's consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) and interpretations issued by the International Accounting Standards Board (IASB) as endorsed by the European Commission (EC) for use in the European Union (EU). All relevant standards and interpretations have been endorsed by the EU. The IASB has published an amendment to IAS 19 *Employee Benefits (2004)* and amendments to IAS 39 *The Fair Value Option (2005)*. These amendments are not mandatory until 2006 but the Group has chosen to adopt them early and they are reflected in the consolidated financial statements.

The consolidated financial statements have been prepared under the historical cost convention, as modified by the revaluation of financial assets and liabilities (including derivative instruments) at fair value through profit or loss (FVTPL), property and investment property. These are the Group's first consolidated financial statements under IFRS and IFRS 1 *First time Adoption of International Financial Reporting Standards* has been applied. The principal accounting policies set out below have been consistently applied to all financial reporting periods presented in these consolidated financial statements and by all Group entities, unless otherwise stated. Unless otherwise stated in the notes to these financial statements all amounts are expected to be settled/recovered after more than 12 months.

The Standard Life Assurance Company (the 'Company') has taken advantage of the exemption under Section 230 of the Companies Act 1985 from presenting its own Income Statement.

### Comparatives

The Group has taken advantage of the exemption in IFRS 1, paragraph 36A, which allows certain comparative information presented in the first year of adoption of IFRS not to comply with IFRS 4 *Insurance Contracts*. The Accounting Standards Board (ASB) in the United Kingdom has issued Financial Reporting Standard 27 *Life Assurance (FRS 27)*, which the Group has adopted from 1 January 2005.

### Estimates

The preparation of financial statements, in conformity with generally accepted accounting principles (GAAP), requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Consistent with IFRS 1, any estimates included in the Group's opening IFRS Balance Sheet have been made by considering the information that existed at the time the estimate was made under previous GAAP, rather than information that became available after that date, after taking into account any applicable adjustments resulting from differences in accounting policies.

### Change of the year-end reporting date

The Group changed its year-end reporting date during 2004 to 31 December 2004. The comparative period in these financial statements is therefore the period from 16 November 2003 to 31 December 2004.

### Change in accounting policies during the period

In accordance with IFRS 4, the Group continues to apply the same accounting policies for the recognition and measurement of obligations arising from insurance contracts and investment contracts with discretionary participation features (DPF) that it used for the preparation of its published financial statements for the period ended 31 December 2004. The only exception is that the recognition and measurement requirements of FRS 27 have been adopted, as an improvement to the Group's accounting policies. The ASB issued FRS 27 on 13 December 2004 for mandatory application for accounting periods ending on or after 23 December 2005. As acknowledged within FRS 27 its retrospective application is difficult. The Group has assessed that it is impractical to restate the Balance Sheet at 16 November 2003 and the Income Statement for the period to 31 December 2004 for the impact of FRS 27. The Balance Sheet at 31 December 2004 has been restated. In accordance with FRS 27 participating contract liabilities are determined on a realistic basis and are reduced by the PVFP on non-participating contracts written in the with profits fund. DAC is only held on non-participating investment contracts to the extent of the DIR recognised. This has resulted in an increase in participating contract liabilities of £409m and a reduction in deferred acquisition costs of £1,788m at 31 December 2004. The participating contract liabilities are offset by the present value of future profits on non-participating contracts of £1,041m. The effect of these adjustments is to decrease deferred tax liabilities by £124m and deferred tax assets by £53m, offset by an increase to reinsurance assets of £6m. Corresponding amounts have been adjusted to the unallocated divisible surplus in accordance with FRS 27 resulting in a decrease of £1,079m at 31 December 2004 for Group. The impact for Company is a decrease to unallocated divisible surplus of £1,012m at 31 December 2004. FRS 27 requires insurance contracts to be classified into their participating and non-participating components and reflected as such on the Balance Sheet. A presentational adjustment has been made to reflect this classification for insurance and investment contracts.

## Accounting policies (continued)

FRS 27 requires cost of guarantees to be valued on a fair value approach. FRS 27 permits the PVFP on the non-participating business written within the with profits fund to be deducted from the realistic liability as this value is included within the realistic liability calculation.

### Standards, interpretations and amendments to published standards that are not yet effective

Certain new standards, amendments and interpretations to existing standards have been published that are mandatory for the Group's accounting periods beginning on or after 1 January 2006 or later periods. The Group has not early adopted these standards, amendments, and interpretations as described below:

IAS 21 (Amendment), *The effects of changes in foreign exchange rates: Net investment in a foreign operation* (effective from 1 January 2006): The amendment alters the requirement for a monetary item that forms part of a reporting entity's net investment in a foreign operation to be denominated in the functional currency of either the reporting entity or the foreign operation. This will be applied by the Group from annual periods beginning 1 January 2006 and is not considered to have a material impact on the Group's results.

IAS 39 (Amendment), *Cash Flow Hedge Accounting of Forecast Intragroup Transactions* (effective from 1 January 2006): The amendment allows the foreign currency risk of a highly probable forecast intragroup transaction to qualify as a hedged item in the consolidated financial statements, provided certain conditions are met. The Group is not currently planning to take advantage of this amendment.

Amendment to IAS 39 and IFRS 4 – *Financial guarantee contracts*: The amendment clarifies whether financial guarantees fall within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 4 and stipulates the measurement method to be applied to such guarantees. The Group has not early adopted this amendment and therefore it will be applied from annual periods beginning 1 January 2006. The amendment is not considered to have an impact at Group level and Management is currently assessing the impact at company level.

IFRS 7 *Financial Instruments: Disclosures* and a complementary amendment to IAS 1 *Presentation of Financial Statement*: Revised guidance on implementing IFRS 4, *Presentation of Financial Statements – Capital Disclosures* (effective from 1 January 2007). IFRS 7 introduces new disclosures to the information on financial instruments and the revision to IFRS 4 reflects the changes made by IFRS 7 and affects the disclosure section of the guidance. The amendment to IAS 1 introduces disclosures on the level of management of capital resources. This will be applied by the Group from annual periods beginning 1 January 2007. The Standard has no financial impact but will change the disclosures surrounding the Group's Financial Instruments and Insurance Contracts.

Interpretations that are not relevant to the Group's operations: IFRIC 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*, IFRIC 4, *Determining whether an Arrangement contains a Lease* (all effective from 1 January 2006), IFRIC 7, *Applying Hyperinflationary economies for the first time* (effective 1 March 2006) and IFRIC 6, *Waste Electrical and Electronic Equipment* (effective 1 December 2005) are not relevant to the Group's operations.

### Key judgements made in selecting accounting policies

In selecting accounting policies where IFRS permits a choice of policy, management have applied judgement in determining the most appropriate policy to be applied, as detailed below:

- Designation of financial assets:  
Policy choice made on the basis of achieving the best matching with the associated liabilities.
- Recognition of actuarial gains and losses on defined benefit plans:  
Policy choice made in order to minimise Income Statement volatility.
- Unallocated divisible surplus:  
Policy choice made not to recognise any guaranteed element separately and thus record the full unallocated divisible surplus as a liability.
- Cash Flow Statement:  
Indirect method chosen on the basis that it is simpler than the direct method and consistent with the approach adopted by our peers.
- Deferred acquisition costs (DAC):  
Policy choice made to include DAC on non-profit contracts in the with profit fund implicitly in the present value of future results (PVFP) up to the extent of the deferred income reserve (DIR) on investment contracts (written in the with profit fund) on the basis of simplicity.

## Accounting policies (continued)

- Exclude PVFP on insurance subsidiaries owned by the with profits fund:  
Policy choice made on the basis of simplicity and relevance post demutualisation.
- Accounting for property:  
Policy choice made on the basis of consistency with previous policy and in order to achieve the best matching with the associated liabilities.

In addition management has applied judgement in estimating balances in particular around the valuation of actuarial liabilities (refer Notes 20 and 22), the valuation of the defined benefit pension obligation (Note 26) and the valuation of unlisted securities.

### (b) Basis of consolidation

The Group financial statements consolidate the Income Statements and Balance Sheets of the Company and its subsidiary undertakings. Associate and joint venture undertakings are accounted for using the equity method from the date that significant influence or joint control (respectively) commences until the date this ceases.

### Investments in subsidiaries

Subsidiaries are all entities (including special purpose entities) over which the Group has the power to govern the financial and operating policies. Such power, generally but not exclusively, accompanies a shareholding of more than one half of the voting rights. Subsidiaries are fully consolidated from the date on which control is transferred to the Group, through until the date that control ceases.

The Group uses the purchase method of accounting for the acquisition of subsidiaries. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition.

The Group has three categories of investment in subsidiaries: those that are deemed operating subsidiaries as they undertake the activities of the Group; those that raise finance for the Group's operating subsidiaries; and those that are investment companies as their primary function is to generate capital or income growth through holding investments. In the financial statements of the Company subsidiaries held for investment purposes are classified as FVTPL (as they are managed on a fair value basis). All other subsidiaries are accounted for at cost.

Any impairment on individual investments in subsidiaries held at cost is determined, at each reporting date, by an evaluation of the exposure on a case-by-case basis.

Impairment losses are calculated and recorded on an individual basis in a manner consistent with the impairment policy described in section (g) below.

The same approach is used for investments in associates and joint ventures.

### Investments in associates and joint ventures

Associates are entities over which the Group has significant influence but not control, generally accompanying a shareholding of between 20% and 50% of the voting rights.

Where the Group has a significant holding in an investment vehicle that meets the definition of an associate or joint venture and that investment in associates backs policyholder liabilities including the unallocated divisible surplus, that investment is accounted for at fair value through profit and loss in accordance with IAS 39.

All other associates and joint ventures are equity accounted for and in this case, the Group's investment in associates and joint ventures includes goodwill (net of any impairment loss) identified on acquisition.

Investments in associates and joint ventures that are equity accounted for are initially recognised at cost and adjusted thereafter for the post-acquisition change in the Group's share of net assets of the associate. The Group's share of post-acquisition results of its associates is recognised in the Income Statement. The Group's share of any post-acquisition movements in reserves, where the associate recognised a gain or loss directly in equity, is recognised in unallocated divisible surplus. The cumulative post-acquisition movements are adjusted against the carrying amount of the investment.

Where the Group's share of losses in an associate equals or exceeds its interest in an associate, including any other unsecured receivables, the Group's carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations in connection with or made payments on behalf of an associate.

## Accounting policies (continued)

### (c) Classification of insurance and investment contracts

The measurement basis of assets and liabilities of long-term business contracts is dependent upon the classification of those contracts into either insurance or investment contracts depending upon whether significant insurance risk exists. For those investment contracts containing discretionary participating features (e.g. with profits business) IFRS 4 permits the continued application of previously applied GAAP, except where a change is deemed to make the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable, and no less relevant to those needs. The Group has chosen to apply this approach, which therefore includes the requirements of FRS 27 to its UK with profits fund.

Generally, product classes are sufficiently homogeneous to permit a single classification at the level of the product class. However, in some cases, a product class may contain individual contracts that fall across multiple classifications ('hybrid contracts'). For certain significant hybrid contracts the product class is separated into the insurance element, a non-participating investment element and a participating investment element so that each element is accounted for separately.

### (d) Revenue Recognition

#### Deposit accounting for non-participating investment contracts

Contributions received in respect of investment contracts are treated as policyholder deposits and not reported in the Income Statement. Claims paid to policyholders are treated as a reduction to these deposits. The change in policyholder liabilities is reflected each period in the Income Statement.

Investment contracts not classified as unit linked are measured at amortised cost. Amortised cost is calculated as the fair value of policyholder contributions at the date of initial recognition, less the net effect of payments such as transaction costs and front-end fees, plus or minus the cumulative amortisation (using the effective interest rate (EIR) method) of any difference between that initial amount and the maturity value, and less any write-down for surrender payments. The EIR is the rate that equates the discounted cash payments to the initial amount.

All contractual initial fees and incremental transaction costs directly attributable to the issue of the contract are deemed to be attached to issuing the financial liability and are included within the EIR calculation.

Deposit accounting is also applied to reinsurance contracts that do not qualify as insurance contracts under section (c) above.

The fees and transaction costs associated with investment contracts are treated in accordance with the policy described below for investment income.

#### Premiums

Premium income on insurance contracts and participating investment contracts are recognised when due for payment.

General insurance premiums are accounted for when written. Premiums are recognised as earned income over the period of the policy having regard to the incidence of risk.

#### Investment income

Investment gains and losses resulting from changes in both market value and foreign exchange on investments classified as FVTPL are recognised in the Income Statement in the period in which they occur.

Changes in the fair value of derivative financial instruments that are not hedging instruments are recognised immediately in the Income Statement.

Realised gains and losses are calculated as the difference between net sales proceeds and the amount paid to acquire the investment, including the initial transaction costs. Unrealised gains/losses reflected in the Income Statement are calculated as the difference between the current valuation of investments and their valuation at the last Balance Sheet date or the amount paid to acquire them at subsequent acquisition during the period. Unrealised gains and losses are adjusted each period for gains and losses realised through sale.

For loans and receivables measured at amortised cost, interest income is calculated using the EIR method and is recognised in the Income Statement.

Dividend income is recognised when the right to receive payment is established.

## Accounting policies (continued)

Rental income is recognised in the Income Statement on a straight-line basis over the term of the lease.

### Fee and commission income

Commissions received or receivable, are recognised as revenue on the commencement or renewal date of the related policies. However, when it is probable the Group will be required to render further services during the life of the policy, the commission is deferred as a liability and is recognised as the services are provided.

### Non-participating investment contracts and fund management business

All fees and costs are deemed to be associated with the provision of investment management services and are recognised, subject to recoverability, as the services are provided. Front-end fees, which are charged on the inception of investment management contracts, are deferred as a liability and recognised over the life of the contract. Ongoing fees that are charged periodically, either directly or by making a deduction from invested funds, are recognised as received, which corresponds to when the services are provided.

#### (e) Expense recognition

##### Claims and benefits paid

###### Life assurance

Maturity claims and annuities are accounted for when due for payment. Surrenders are accounted for when paid or, if earlier, on the date when the policy ceases to be included within the calculation of the insurance liability. Death claims and all other claims are accounted for when notified.

Claims payable include the direct costs of settlement. Reinsurance recoveries are accounted for in the same period as the related claim.

###### General insurance

Claims are accounted for when there is sufficient evidence of their existence and a reasonable assessment can be made of the monetary amount involved. Provision is made at the Balance Sheet date for the total expected cost of settlement of all claims incurred in respect of events up to that date, whether reported or not, together with related claims handling expenses, less amounts already paid.

#### (f) Foreign currency

Foreign currency transactions and fair values are translated using the exchange rates applying to the functional currency, prevailing at the dates of the transactions or at the date the fair value was determined with related foreign currency exchange gains or losses reflected in the Income Statement. Translation differences on non-monetary items such as equities held at fair value through profit or loss, are reported as part of the fair value gain or loss. Translation differences on non-monetary items, such as owner-occupied properties, are included in the fair value reserve in the unallocated divisible surplus. Refer to the paragraph on owner-occupied properties in section (h) below.

##### Group companies

The Income Statements of foreign subsidiaries and branches are translated into the presentation currency of the Group at average exchange rates for the year. Assets and liabilities of foreign subsidiaries and foreign branches are translated at the closing rate at the Balance Sheet date. On consolidation, exchange differences arising from the translation of the net investment in foreign subsidiaries, foreign branches, and of borrowings and other currency instruments designated as hedges of such investments, are taken to the unallocated divisible surplus.

#### (g) Impairment of non-financial assets

The carrying amounts of non-financial assets are reviewed at each Balance Sheet date to determine whether there is any indication of impairment. An impairment loss is recognised in the Income Statement for the amount by which the asset's carrying amount exceeds its recoverable amount.

The recoverable amount of an asset is the greater of its net selling price (fair value less costs to sell) and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit, or group of units, to which the asset belongs.

## Accounting policies (continued)

### (h) Property and equipment

Owner-occupied properties and properties under development are recognised initially at cost and subsequently at depreciated fair value. Properties are valued, at least annually, by external independent qualified valuers.

Movements in the fair value of owner-occupied properties and properties under development are taken to the revaluation reserve in the unallocated divisible surplus. Reductions below cost are reflected in the Income Statement.

Owner-occupied properties are depreciated on a straight-line basis over their estimated useful lives, generally between thirty and fifty years. The depreciable amount of an asset is determined by the difference between the fair value and the residual value. The residual value is the amount that would be received on disposal if the asset was already at the age and condition expected at the end of its useful life. Properties under development are not depreciated.

Computer equipment, motor vehicles and other property is capitalised at cost and depreciation is charged to the Income Statement, within administration expenses, on a straight-line basis, over their estimated useful lives of between two and four years.

### (i) Investment property

Property held for long-term rental yields or investment gain that is not occupied by companies in the Group is classified as investment property.

Investment property is initially recognised at cost including any directly attributable transaction costs. Subsequently investment property is measured at fair value. Fair value is determined without any deduction for transaction costs that may be incurred on sale or other disposal, unless the property is under development with a view to resale. Gains or losses arising from changes in fair value are accounted for in the Income Statement.

Investment properties are valued, on the same basis as owner-occupied properties.

Property located on land that is held under an operating lease is classified as investment property as long as it is held for long-term rental yields and is not occupied by the companies in the Group. The initial cost of the property is the lower of the fair value of the property and the present value of the minimum lease payments.

Rental income from investment property is recognised in the Income Statement on a straight-line basis over the term of the lease. Lease incentives granted are recognised as an integral part of the total rental income, and are also spread over the term of the lease.

### (j) Income tax

#### Current tax

The current tax expense is based on the taxable results for the year, using tax rates enacted or substantially enacted at the Balance Sheet date, including any adjustments in respect of prior years.

#### Deferred tax

Deferred tax is provided in full, using the Balance Sheet liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred tax assets are recognised to the extent that it is probable that future taxable results will be available against which the temporary differences can be utilised.

Temporary differences arising from investments in subsidiaries and associates give rise to deferred tax in the Company Balance Sheet only to the extent that it is probable that the temporary difference will reverse in the foreseeable future or the Company does not control the timing of the reversal of that difference

Deferred tax is recognised in the Income Statement except when it relates to items recognised directly in the Statement of Recognised Income and Expense in which case it is credited or charged directly to the unallocated divisible surplus through the Statement of Recognised Income and Expenses.

## Accounting policies (continued)

### (k) Reinsurance assets

Reinsurance assets primarily include balances due from both insurance and reinsurance companies for ceded insurance liabilities. Amounts recoverable from reinsurers are estimated in a manner consistent with the assumptions used for ascertaining the underlying policy benefits, subject to the terms of the contract. Reinsurance assets that do not qualify as insurance contracts, under the classification requirements described in section (c) above, are classified as financial assets and measured in accordance with IAS 39 at FVTPL.

Amounts due from reinsurers in respect of claims incurred are separately recognised in 'Other debtors' and are accounted for on a basis consistent with loans and receivables. Refer to the accounting policy in section (m) below.

If a reinsurance asset is considered to be impaired, the carrying amount is reduced to the recoverable amount and the impairment loss is recognised in the Income Statement. The recoverable amount is determined as the carrying amount less any impairment losses. Impairment losses are determined using the process adopted for assessing the impairment of financial assets held at amortised cost on an individual basis. Refer to the accounting policy in section (m) below.

### (l) Deferred acquisition costs (DAC)

#### Investment contracts

Incremental costs directly related to the cost of acquiring new business (i.e. commission) are deferred, to the extent that they are deemed recoverable from future charges. The recoverability test takes account of any front-end fees that have been deferred and the Present Value of Future Profits (PVFP) asset recognised on these contracts.

For those investment contracts written within the with profit fund of the Company and its branches, the Group has chosen not to recognise deferred acquisition costs separately from the associated PVFP asset except to the extent of any Deferred Income Reserve (DIR) on those contracts.

The DAC asset is amortised on a consistent basis with the DIR liability in line with the expected emergence of profits from the underlying product grouping. Refer to section (u) for the accounting policy on DIR.

#### Participating insurance and investment contracts (i.e. with profit contracts)

Acquisition costs are not capitalised in respect of participating contracts in line with realistic valuation requirements.

#### Non-participating insurance contracts

For those insurance contracts falling within the scope of the FSA realistic capital regime (i.e. written within the with profit fund of SLAC and all branches) the Group has chosen not to recognise deferred acquisition costs separately from the associated PVFP asset.

Implicit allowance is made for DAC with the Canadian Asset Liability Valuation Model (CALM) thus no explicit DAC asset has been included in the Balance Sheet for insurance written by the Canadian subsidiary in the Group financial statements.

### (m) Loans and receivables

Deposits with credit institutions, mortgage assets and other financial asset balances, such as other debtors are classified as Loans and receivables.

Loans and receivables are measured on origination at fair value less directly attributable transaction costs. Subsequently, the asset is measured at amortised cost, using the EIR method, less any impairment losses.

Impairment on individual loans is determined, at each reporting date, by an evaluation of the exposure on a case-by-case basis. The impairment loss is calculated as the difference between the present value of future cash flows, discounted at the loan's original effective rate, and the loan's current carrying value. The amount of any impairment loss is recorded in the Income Statement.

If there is no evidence of impairment on an individual basis, a collective impairment review is undertaken whereby the assets are grouped together, on the basis of similar credit risk characteristics, in order to calculate a collective impairment loss. This process accounts for impairments existing at the Balance Sheet date that are not evident until a future date.

## Accounting policies (continued)

### (n) Intangible assets

Intangible assets, including internally developed software and software purchased from third parties, are recognised in the Balance Sheet if it is probable that the relevant future economic benefits attributable to the asset will flow to the Group and its cost can be measured reliably.

Internally developed software and software purchased from third parties are capitalised as intangible assets and amortised over their estimated useful life when they are either identified as separable (i.e. capable of being separated from the entity and sold, transferred, rented, or exchanged) or they arise from contractual or other legal rights, regardless of whether those rights are transferable or separable.

Intangible assets are carried at cost less accumulated amortisation and any accumulated impairment losses. Amortisation is charged to the Income Statement on a straight-line basis over the estimated useful lives of the relevant software. Impairment losses are calculated and recorded on an individual basis in a manner consistent with the impairment policy described in section (g) above.

### (o) Investment securities and derivatives

#### Designation as fair value through profit or loss (FVTPL)

Financial assets and liabilities are designated at FVTPL where the asset or liability is part of a group of assets that are evaluated and managed on a fair value basis. The Group holds a portfolio of equities and debt securities that are managed and monitored, through quarterly investment reports, on a fair value basis so as to maximise returns for with profits policyholders. The Group uses derivative financial instruments including forwards, swaps, futures, and options for the purposes of matching contractual liabilities, reducing investment risks and for efficient portfolio management activities. In accordance with its treasury policy, the Group does not hold or issue derivative financial instruments for speculative trading purposes.

All investment securities and derivatives are designated as FVTPL.

#### Fair value measurement

The Group recognises these assets at fair value on the trade date of the transaction. In the case of derivatives where no initial premium is paid or received the initial measurement value is nil. Directly attributable transaction costs are not included in the initial measurement value but are recognised in the Income Statement.

Fair values are based upon the current quoted bid price where an active market exists. Where a quoted price in an active market cannot be obtained an appropriate market consistent valuation technique (for example discounted cash flows and recent market transactions) is used to determine fair value. If a price/technique is not available to provide a reliable fair value the investment is carried at cost less a provision for impairment.

#### Designated as held to maturity (HTM)

The Group classifies certain government bonds, held for regulatory purposes, as held to maturity (HTM) financial assets. HTM financial assets are recognised as assets on the trade date and initially measured at fair value plus any directly attributable transaction costs incurred on recognition. At each subsequent reporting date, the Group measures the HTM investments at amortised cost, using the EIR method, less any impairment losses identified. Interest revenue on HTM financial assets is calculated on an EIR basis and is recognised in the Income Statement.

#### Hedge accounting

The Group has designated certain derivative positions as fair value hedging instruments where the derivative financial instrument hedges the changes in fair value of a recognised asset or liability, or an identified portion of such an asset or liability, that is attributable to particular risk and could affect the Income Statement. The change in fair values of both the hedging instruments and the underlying asset or liability are recognised in the Income Statement.

Where a derivative financial instrument is designated and qualifies as a hedge of the variability in cash flows of a recognised asset or liability, or a highly probably forecasted transaction, the effective part of any gain or loss resulting from the change in fair value of the derivative financial instrument is recognised directly in the unallocated divisible surplus.

## Accounting policies (continued)

Hedge accounting is discontinued in the event that the hedge relationship is ineffective, expires, matures or is terminated. The gain or loss relating to the ineffective portion is recognised immediately in the Income Statement. A hedge is ineffective if the change in the fair value/cash flows of the hedging instrument does not significantly offset the changes in the fair value/cash flows of the hedged item.

The Group documents at the inception of the transaction the relationship between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The Group also documents its assessment, both at hedge inception and on an ongoing basis, the effectiveness of the hedging relationship.

### Embedded derivatives

Options, guarantees and other derivatives embedded in a host contract are separated and recognised as a derivative unless they are considered closely related to the host contract, meet the definition of an insurance contract or if the host contract itself is measured at fair value with changes in fair value recognised in income.

#### (p) Cash and cash equivalents

Cash and cash equivalents include cash in hand, deposits held at call with banks, any highly liquid investments which have a maturity date within three months of the date of acquisition and bank overdrafts that are repayable on demand and form an integral part of the Group's cash management.

#### (q) Interest bearing loans and borrowings

Interest bearing loans and borrowings are recognised initially at fair value, less attributable transaction costs. Subsequent to initial recognition, interest bearing loans and borrowings are carried at amortised cost with any difference between the carrying value and redemption value being recognised in the Income Statement over the period of the borrowings on an EIR basis.

The interest arising from interest bearing loans and borrowings is classified on a basis consistent with the classification of the underlying debt, being that which supports the Group's operating activities.

#### (r) Subordinated liabilities and subordinated members' accounts

Subordinated liabilities and subordinated members' accounts are initially included in the Balance Sheet at the value of proceeds received net of issue expenses. The total finance costs are charged to the Income Statement over the relevant term of the instrument using the effective interest rate. The carrying amount of the debt is increased by the finance cost in respect of the reporting period and reduced by payments made in respect of the debt in the period.

#### (s) Leases

Leases, where a significant portion of the risks and rewards of ownership are retained by the lessor, are classified as operating leases. Payments made as lessees under operating leases (net of any incentives received from the lessor) are charged to the Income Statement on a straight-line basis over the period of the lease.

Lease income from operating leases is recognised in the Income Statement on a straight-line basis over the lease term. Initial direct costs incurred in arranging an operating lease are added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income.

There are no material finance leases affecting the group as either lessor or lessee.

#### (t) Pension costs and other post retirement benefits

The Group operates a number of defined benefit and defined contribution plans, the assets of which are held in separate trustee-administered funds. The pension plans are funded by payments from employees and by the relevant Group companies, determined by periodic actuarial calculations.

For defined benefit plans the liability recognised in the Balance Sheet is the present value of the defined benefit obligation less the fair value of plan assets, together with adjustments for past service costs. Plan assets exclude any insurance contracts or non-transferable financial instruments issued by the Group. The defined benefit obligation is calculated annually by independent actuaries using the projected unit credit method whereby estimated future cash outflows are discounted using interest rates of high quality corporate bonds denominated in the currency in which the benefits will be paid of similar term as the pension liability.

## Accounting policies (continued)

Actuarial gains and losses are recognised in the Statement of Recognised Income and Expense in the period in which they occur.

For defined contribution plans, the Group pays contributions to publicly or privately administered pension insurance plans. The Group has no further payment obligations once the contributions have been paid. The contributions are recognised in staff expenses when they are due.

### (u) Deferred income reserve (DIR)

Front-end fees on financial instrument transactions (including bid-offer spread) are deferred as a liability and recognised over the period services are provided. The DIR liability is amortised on a basis consistent with the associated DAC asset. Refer to section (l) for the accounting policy on DAC.

### (v) Insurance and investment contract liabilities

#### Participating insurance and investment contracts (with profit contracts)

Liabilities arising from with profits contracts are measured on an FSA realistic basis. Under this approach the value of liabilities is calculated as

- A with profits benefits reserve (WPBR); plus
- Future policy related liabilities (FPRL); plus
- The realistic current liabilities of the fund; less
- Projected non-participating policyholder benefits included in the FSA calculation.

The WPBR is primarily based on the retrospective calculation of accumulated asset shares, adjusted for future expected policyholder benefits and other outgoings. A market consistent stochastic valuation of the cost of options and guarantees is included in the calculation of the FPRL.

#### Non-participating insurance contracts

In accordance with Group policy for overseas subsidiaries, the method used to determine the insurance contract liabilities for the Canadian business (in the Group financial statements) is based on Canadian accounting and regulatory valuation principles (CALM). The Canadian regulations set the value of policy liabilities equal to the value of a set of supporting assets just sufficient with reinvestment and disinvestments to meet all policy liabilities when due. Generally, Canadian GAAP measures assets at cost or amortised cost, however, as the Group's policy is to measure investment securities at FVTPL an adjustment is made to the CALM liabilities to reflect the impact of the measurement change in the backing assets.

The insurance contract liabilities for conventional business are calculated using the gross premium method. In general terms, a gross premium valuation basis is one in which the premiums brought into account are the full amounts receivable under the contract. The method includes explicit estimates of premiums, expected claims, costs of maintaining contracts and future renewal expenses. Cash flows are discounted at the valuation rate of interest prescribed by the FSA.

The PVFP recognised on non-participating contracts is treated as part of the liability under participating contracts and presented separately on the face of the Balance Sheet. The PVFP is the estimated value of in force associated with non-participating business written in the with profits fund. It is calculated by considering discounted future expected cash flows arising from net business.

#### Non-participating investment contracts

Unit linked non-participating investment contracts are designated as FVTPL as they are implicitly managed on a fair value basis as their value is directly linked to the market value of the underlying portfolio of assets. The fair value of a unit linked liability is equal to the value of the (funded) units allocated to the contracts. The unit value is based on the bid value of the fund assets at the reporting date before expenses of selling or buying the underlying assets.

Liabilities for non-linked investment contracts are measured at amortised cost. Amortised cost is calculated as the fair value of premiums received at the date of initial recognition, less the net effect of principal payments such as transaction costs and front-end fees, plus or minus the cumulative amortisation (using the EIR method) of any difference between that initial amount and the maturity value, and less any write-down for surrender payments. At each reporting date, the amortised cost liability is determined as the value of future best estimate cash flows discounted at the EIR.

## Accounting policies (continued)

### Healthcare and general insurance

All healthcare and general insurance contracts are short-term contracts, generally of duration no longer than a year. Claims outstanding comprise provisions representing the estimated ultimate cost of settling, including claims notified but not settled by the Balance Sheet date ('outstanding claims'), and claims incurred as a result of events up to the Balance Sheet date not notified as at that date ('IBNR' claims).

A provision is made at the Balance Sheet date for the total expected cost of settlement of all claims incurred in respect of events up to that date, together with related claims handling expenses, less any amounts already paid. Unearned premiums represent that proportion of premiums received on in force contracts that relate to unexpired risks at the reporting date and are recognised as a liability.

### Liability Adequacy Test

The Group applies a Liability Adequacy Test at each reporting date to ensure that the insurance liabilities are sufficient. This test is performed by comparing the carrying value of the liability and the discounted projections of future cash flows (including premiums, claims, expenses, investment return and other items), using best estimate assumptions.

If a deficiency is found in the liability (i.e. the carrying value amount of its insurance liabilities is less than the future expected cash flows) that deficiency is provided in full. The deficiency is recognised in the Income Statement by setting up a provision in the consolidated Balance Sheet.

### (w) Unallocated divisible surplus (UDS)

The unallocated divisible surplus, which represents the excess of the assets held by the with profits fund over the liabilities under in force contracts calculated in accordance with the requirements of FRS 27, and other liabilities of the with profit fund is treated as part of the liability under participating contracts and presented separately on the face of the Balance Sheet.

### (x) Segment reporting

A business segment is a group of assets and operations engaged in providing products or services that are subject to risks and returns that are different from those of other business segments. Segments have been separately identified after consideration of the various regulatory reporting regimes, the nature of the products sold, distribution channels, customer segments and management's view of the relative risks and rewards associated with each segment.

A geographical segment is engaged in providing products or services within a particular economic environment that is subject to risks and returns that are different from those of segments operating in other economic environments.

All inter-segment transactions are priced on an arm's length basis under normal terms and conditions.