FRIENDS LIFE HOLDINGS PLC

(formerly Friends Life Group plc)

ANNUAL REPORT AND ACCOUNTS
FOR THE YEAR ENDED
31 DECEMBER 2014

REGISTERED NUMBER: 06986155
REGISTERED OFFICE:
Friends Life Holdings plc
Pixham End
Dorking
Surrey
RH4 1QA

Strategic Report
Overview

Our Strategy

2014 has been a year of unprecedented change for both the UK life and pensions industry and Friends Life itself. Throughout this time, the company has been consistent in the execution of its strategy that can be summarised in three main principles:

- To maximise the value of the Heritage book through efficient management of legacy products, innovative capital and revenue optimisation initiatives and a focus on deepening the relationship with our significant customer base;
- To participate in key growth areas in the UK life and pensions market, where we have scale and a demonstrable competitive advantage, focusing on our existing customers; and
- To look for opportunities to enhance or accelerate value through inorganic activities.

The sweeping reforms to the pensions market resulting from the UK Chancellor's 2014 Budget have meant that every pensions provider, including Friends Life, has needed to adapt to a new approach to retirement provision. I have been extremely pleased with how we have responded to these challenges, making great improvements by enhancing our customer engagement, taking the time to understand our customers' needs and focusing on developing the products and services our customers will require as the pension reforms come into force in April 2015.

Our new individual customer platform My Savings is on track to launch in April 2015. It will enable our existing customers to make the most of the new pension freedoms whilst providing an online system to manage their pensions and other savings in one place. Our goal is to help our customers make informed choices and decisions based on their personal circumstances. We will offer a range of products including flexi-access drawdown, NISAs, and a general investment account alongside our standard and enhanced annuity offerings. This will be complemented by a range of other tools and services including an income tool to help customers understand the potential income from the different options available, investment risk appetite assessments, retirement planning, accumulation modelling, and tax information and tools to assist our customers in understanding the tax implications of taking cash from their pension.

Given the volume of legislative and regulatory change to pensions and workplace savings, customers will need more support than ever before to clarify their options. We have enhanced and strengthened our customer service teams, who are well equipped to anticipate, prompt and resolve all kinds of customer enquiries, from the simple to the complex. We know that around half a million of our current customers will be in a position to take advantage of the pension rule changes in April 2015 so we have dedicated significant resources to create a Retirement Information Centre to support customers and intermediaries.

Friends Life has successfully managed a number of major change programmes and their impact on customers in recent years. Following the changes brought about by the Budget, our UK business has already been restructured into a more customer centred model, fostering better collaboration across the business and enabling us to engage better with our customers.

In October 2014, we announced the completion of the disposal of the Lombard business to the Blackstone Group. Lombard, although a good business, has always had a different profile to the rest of the Group. The disposal was in the best interests of both Friends Life and Lombard and allowed us to deliver on our commitment to secure maximum value for shareholders.

Our other international business, Friends Provident International, has faced a number of challenges this year, particularly in Asia where difficult market conditions impacted the business performance in the first half of the year. However, I have been encouraged by how the team responded to these challenges and we have started to see improved momentum in the business in the second half, particularly in the Middle East.

Our journey so far

The amount of change we have undergone this year is substantial but it is not dissimilar to the transformation the business has been undergoing over the last four years.

Beyond the cost synergies, we have delivered substantial capital synergies. Through the capital optimisation programme, in which the seven UK life companies were re-organised into two UK life companies for closed and open business, we drove significant efficiencies.

To enhance value further, our Heritage management team has carried out revenue optimisation initiatives since 2012, including:

- The reallocation of three tranches of annuity policies from with-profits funds to the shareholder fund;
- The strategic partnership with Schroders;
- The establishment of Friends Life Investments Limited ("FLI") for the management of fixed income assets; and
- The recapture of £1.6 billion of assets backing annuities in November 2014.

For the last of these revenue optimisation initiatives, our Heritage division has undertaken the recapture in November 2014 of £1.6 billion of assets backing annuities. This clearly demonstrates the skills and capabilities that the Friends Life team has in enhancing value for shareholders.

Strategic Report
Overview continued

We have rationalised our open business in the UK, reducing the number of open lines of business to three. The UK division is focused on Retirement Income, Corporate Benefits and Protection, where we have the scale and expertise to grow new business and where we have delivered a turnaround in value generation.

Outlook

Looking back over what we have achieved in 2014, I have absolute confidence in Friends Life's strategy and future prospects. However it would be remiss of me not to mention the Proposed Acquisition of Friends Life Group Limited by Aviva plc ("Aviva"). My belief is that the standalone future of Friends Life is attractive, but the opportunity to accelerate the Friends Life strategy through the combination with Aviva is even more attractive. The combination is expected to create the leading player in the UK life and pensions market, with even greater scale in the key markets that Friends Life already participates in.

The combined entity is expected to have the UK's largest back book[i] and the combined group could potentially release substantial capital synergies through:

- Diversification of economic capital with general insurance and international businesses;
- Optimisation of the Friends Life businesses on an economic basis;
- Further capital initiatives on the combined back book; and
- Leveraging Friends Life's capital strength as part of a larger group.

Furthermore, the combined group expects to have a significant scale advantage and hence, post-delivery of synergies, significant cost advantage.

The combination of Aviva and Friends Life also offers attractive growth opportunities for the UK open businesses, as the increased scale will drive better profitability and improved service to customers with easier access to a broader range of products. The deal creates the UK's leading insurance, savings and asset management business with leadership positions in Corporate Benefits and Protection and one in four retiring defined contribution pension customers. All of this is underpinned by an in-house asset manager, with a broad product set, and an established track record.

The complementary benefits of the Proposed Acquisition from both a financial and strategic perspective are compelling and with our proven track record in the successful integration of UK Life businesses, we would be well placed to ensure the successful integration of the two businesses.

All in all it has been a good year for Friends Life and I would like to give my thanks to all of our staff, whose dedication and hard work have made Friends Life the success it is.

Strategic Report

The Strategic Report, set out on pages 1 to 21 has been approved by the Board.

On behalf of the Board

Andy Briggs

Director

4 March 2015

(i) Based on analysis of 2013 PRA returns of UK gross reserves. Back book defined as per Friends Life's methodology and includes with-profits products, unit-linked bonds and other legacy products.

Strategic Report
Business model

Friends Life Group's operating model is structured around three distinct divisions: Heritage, UK and International.

The **Heritage** division has around 3.6 million customers, a large set of products which are either closed to new business or are not actively marketed, and complex legacy systems.

The **UK** division comprises open market operations in Corporate Benefits, Retirement Income and Protection:

- The **Corporate Benefits** business focuses on UK retirement saving through employer-sponsored schemes. As at 31 December 2014 the business had £22.0 billion of assets under administration, making it the number two player in this part of the market, which is one set for fast growth.
- The **Retirement Income** business provides annuities for individual retirees, both retiring Friends Life pension customers and those who saved with other providers. As a result of the changes announced in the UK Chancellor's 2014 Budget, we expect annuity sales to be lower going forward. In response, the Group is developing a new range of products and services as part of a comprehensive retirement proposition.
- The **Protection** business includes life assurance, income protection and critical illness policies for individual customers and group schemes for companies.

The **International** division offers a range of products including single premium investment products, regular premium savings plans and individual assurance policies. International's products are distributed worldwide by independent financial advisers, with a focus on affluent expatriate individuals, via distribution hubs in Hong Kong, Singapore and Dubai.

	How we make money	**Success factors**
Heritage 3.6 million customers	• Taking a share of bonuses allocated to with-profits policyholders • Taking a regular charge on assets under administration or collecting regular policy fees • Releasing capital held against risks as business runs off	• Effective management of customer service and costs as policy numbers reduce over time • Risk management expertise to manage complex portfolio of exposures • Capital management capability for business restructuring
UK 1.6 million customers	**Corporate Benefits** • Taking a regular charge on assets under administration • Administering growing assets for existing members and scheme joiners • Winning new schemes on terms acceptable to employers, customers and the business	• Ease of doing business for members and employers through automation and technology • Critical scale achieved on a low cost administration platform, competitive charging rates • Reputation with key intermediaries
Corporate Benefits: 1.3 million customers Retirement Income: 0.1 million customers	**Retirement Income** • Winning new business by offering competitive rates to customers allowing for risks taken on • Releasing capital held against carefully managed and suitably priced risks as business runs off • Investing assets to optimise long-term returns and investment risk	• Ability to engage with Friends Life existing pension customers approaching retirement • Relationships with intermediaries in the retirement market • Ability to offer better prices based on individual customers' health
Protection: 0.3 million customers	**Protection** • Winning new business by offering competitive rates to customers allowing for risks taken on • Releasing capital held against carefully managed and suitably priced risks as business runs off	• Relationships with key intermediaries in individual and group markets • Pricing flexibility, adaptability, speed to market • Reinsurance know-how to optimise retention and transfer of risk
International 0.2 million customers	• Winning new business by offering competitive rates to customers allowing for risks taken on • Releasing capital held against carefully managed and suitably priced risks as business runs off • Taking a regular charge on assets under administration, and/or regular policy fees	• Offer wide fund choice at competitive rates • Nimble operational structure to react to developments in diverse markets • Governance expertise to work with multiple regulators

Strategic Report
Financial review

Introduction

2014 has provided many new challenges for the Group and I am proud of how we have been able to react quickly and decisively. IFRS based operating profit is up strongly and once again, the strict financial discipline that underpins everything that we do has also ensured that our balance sheet has stayed both strong and resilient.

Financial performance

£m (unless otherwise stated)		2014	Restated(i) 2013
KPI(ii)	IFRS based operating profit	579	427
KPI	IGCA surplus coverage ratio(iii)	240%	238%

(i) The 2013 IFRS based operating profit has been restated to exclude the results of Lombard, which has been classified as discontinued within the year.
(ii) Key performance indicator.
(iii) The IGCA surplus coverage ratio provided is based on the estimated and unaudited Friends Life Group Limited position.

IFRS based operating profit has grown by 36% to £579 million (2013: £427 million). The growth was positively impacted by a number of one-off benefits including a change to annuitant longevity assumptions (£103 million), the recapture of £1.6 billion of assets backing annuities (£90 million) and a reallocation of annuities from with-profits funds (£19 million). Notwithstanding the benefits from these one-off items, IFRS in-force surplus has increased by £31 million, which principally reflects the benefit from management actions undertaken during 2013 and improved economic conditions.

Operating expenses

I am pleased to confirm that our operating expenses have reduced by 2% in 2014 to £524 million (2013: £536 million). The reduction in 2014 represents the continued realisation of benefits from the integration programme including contractual savings arising from the outsourcing agreement with Diligenta. This more than offsets the modest cost increases to support new business growth in the UK and International divisions in addition to further improvements made to customer service and engagement in the year. This demonstrates that efficient management of the cost base is a core competence of the Group.

Consistent with previous communications, all costs associated with new retirement income product and platform development have been reported within non-recurring items.

Capital strength

Our consistent financial discipline across all areas of the business has maintained the strong balance sheet and robust capital position of the Group. Our estimated IGCA coverage ratio, measured at the Friends Life Group Limited level, is higher at 240% (31 December 2013: 238%).

Regulatory developments

2014 has been a year which has seen some major regulatory developments in the industry. I am pleased with how we have been able to respond to these developments and I believe we are well positioned to benefit from them.

We remain fully engaged with the Financial Conduct Authority ("FCA") on their legacy review. Our Heritage division was established specifically to cater to the needs of legacy business customers so we have been in a good position to respond to the FCA's questions and we look forward to learning the outcomes of their review.

The 2014 Budget dramatically changed the UK pensions market landscape and I am pleased with the way we have been able to adapt in the 12 months since the announcement. As referred to in the Overview, we have developed new products and a new platform, all designed specifically for the new world of retirement provision. Our strong customer service and engagement model is an area of focus for the Group and we expect this to be an even greater differentiator in the new world. On 27 February, we received final rules from the FCA (PS15/4: "Retirement reforms and the guidance guarantee") requiring providers to give appropriate risk warnings to customers accessing their pension savings. This Policy Statement also sets out how this interacts with the new free guidance regime and with customers who have received independent regulated advice. We are adapting our processes and procedures to meet these significant additional requirements which take effect from 6 April, with the aim of providing our customers with the support they require to navigate through the choices and flexibility available to them.

We have made good progress in the year in preparation for the move to the Solvency II regime in 2016. As previously announced, we intend to use the standard formula from the beginning of 2016 and apply for internal model approval subsequent to this. In light of the Proposed Acquisition by Aviva, we are reviewing our Solvency II programme and internal model application plans.

Strategic Report
Financial review continued

Sesame

In February 2013, we commenced a strategic review of the businesses of the Sesame Bankhall Group, including Sesame Limited. This strategic review is still ongoing with a number of potential options and outcomes being considered. There remains the risk of further adverse financial and reputational impacts to the Group, due to the ongoing trading performance of Sesame Limited, the potential future liabilities of the Sesame business and the outcomes of the strategic review.

Outlook

Our rigorous financial discipline and strong balance sheet have underpinned this delivery, and by carefully selecting the markets that we play in, we have the right strategy to build further on our success in the future.

Tim Tookey

Director

4 March 2015

Strategic Report
Business review

2014 highlights

Heritage division

- Phase 2 reallocation of with-profits fund annuities completed in the third quarter of 2014, with £760 million of annuities transferred from with-profits funds to non-profit funds.
- Phase 3 reallocation of with-profits fund annuities to non-profit funds has been completed in the first quarter of 2015, which transferred a further £665 million of annuities.
- The transfer of investment management of assets to Schroders was completed in the fourth quarter of 2014 with £12 billion of equity and multi-asset funds transferred from F&C. As part of this transaction a further £2 billion of fixed interest assets was transferred from F&C to Friends Life Investments.
- Recapture of £1.6 billion of assets backing annuities in November 2014 where the investment risk was previously reinsured.

UK division

- New business APE up 5% from increased sales in the Corporate Benefits and Protection businesses and a lower than expected fall of 15% in annuity sales despite the UK Chancellor's 2014 Budget announcement.
- Strong Protection business IRR of 19.2% (2013: 13.8%) delivered through pricing discipline and optimisation of reinsurance arrangements. Retirement Income IRR at 14.6% (2013: 25%+) despite improvements in the competitiveness of the annuity proposition.
- Positive net fund flows in Corporate Benefits of £0.6 billion despite the previously announced loss of one very large scheme, taking assets under administration to £22.0 billion.
- IFRS based operating profit up £65 million to £105 million driven by a revision to long-term longevity assumptions.

International division

- International assets under administration continue to grow and total £7.0 billion (31 December 2013: £6.6 billion).
- Full year performance in 2014 continues to reflect the difficult market conditions throughout the business' regions. As a result, sales volumes have fallen by 13% to £110 million. However, sales volumes in the second half of the year are up 34% compared with the first half of 2014 to £63 million.
- IFRS based operating profit of £54 million is £9 million lower than in 2013 due to reduced in-force surplus resulting from increased expenses and adverse experience.
- Following the re-platforming of new business, the International division is on track for re-platforming in-force business during 2015.

Strategic Report
New business profitability

2014	APE £m	IRR %
Protection	**89**	**19.2**
Retirement Income	**56**	**14.6**
Corporate Benefits	**614**	**8.3**
Total UK	**759**	**13.0**
Heritage	**43**	**(2.7)**
International	**110**	**9.4**
Total Group	**912**	**16.7**

2014 Group IRR of 16.7% includes the benefit of discretionary investment of shareholder assets in the with-profits annuity reallocation and the recapture of £1.6 billion of assets backing annuities. Excluding these, the Group IRR is 10.5%.

The open insurance business (UK Protection, UK Retirement Income and International) IRR in 2014 is 15.1% (2013: 18.1%), in line with the performance ambition of 15% set a year ago.

Restated(i) 2013	APE £m	IRR %
Protection	84	13.8
Retirement Income	66	25+
Corporate Benefits	574	8.4
Total UK	724	15.3
Heritage	68	(1.0)
International	127	11.0
Total Group	919	15.4(ii)

(i) 2013 results have been restated to reflect the transfer of OLAB from the International to Heritage division and to exclude the results of Lombard, which has been classified as discontinued in the year.

(ii) 2013 Group IRR includes the benefit of discretionary investment of shareholder assets in the with-profits annuity reallocation. Excluding this, the Group IRR was 11.0%.

UK

The UK division delivered good growth in volumes during 2014, with APE up 5% to £759 million. Growth has been delivered in the Corporate Benefits and Protection business units, up 7% and 6% respectively. Retirement Income volumes are showing a smaller fall than expected, outperforming the market.

Protection

The Protection business has delivered growth in sales volumes of 6% compared to 2013, with much of this driven through strengthened relationships with financial advisers. The IRR has improved significantly from 13.8% to 19.2% driven by pricing discipline and optimisation of reinsurance arrangements, including the use of a modest amount of financial reinsurance.

Retirement Income

The Retirement Income business has delivered strong new sales, with volumes down just 15% on the previous year, despite changes announced in the UK Chancellor's 2014 Budget. This compares favourably to the market where overall annuity sales were down 38% in the first three quarters of 2014 compared to the equivalent period last year. The favourable comparison partly reflects the relatively high proportion of vesting pension policies with guarantees, which represented 51% of new business volumes in 2014. We continue to believe that annuity volumes will fall further and in the fourth quarter Retirement Income sales volumes were 14% down on the third quarter.

Strategic Report
New business profitability continued

Corporate Benefits

The Corporate Benefits business has delivered positive net fund flows of £0.6 billion contributing to assets under administration reaching £22.0 billion. This is despite the previously communicated disinvestment of one very large scheme for £0.4 billion which left to pursue an investment only proposition. Even allowing for this disinvestment, outflows have reduced compared to 2013.

Inflows have benefitted from strong new business volumes, in particular regular premiums have grown from £1,760 million in 2013 to £1,946 million in 2014, in part resulting from auto-enrolment activity which has contributed to a net increase in members of 169,000 in the year taking the total member count to 1,312,000.

Corporate Benefits assets under administration

£bn	**2014**	2013
1 January	**20.1**	17.8
Inflows	**2.5**	2.0
Outflows	**(1.9)**	(2.2)
Net fund flows	**0.6**	(0.2)
Net investment return	**1.3**	2.5
31 December	**22.0**	20.1

Heritage

The Heritage division specifically focuses on those products no longer actively marketed. Despite not actively seeking new business, the Heritage book delivers ongoing incremental business written across all product types. The reduction in APE reflects the lower sales volumes following the cessation of new business sales within the transferred OLAB business.

International

APE volumes have fallen by 13% to £110 million reflecting difficult market conditions across the regions, especially in the first half of 2014. However, volumes in the second half of the year are up 34% compared with the first half of 2014 to £63 million due to higher bond sales and regulatory changes in UAE and Hong Kong.

Recent regulatory changes in the Middle East to prevent sales by unlicensed companies are expected to strengthen our competitive position in that region. Elsewhere, the regulators in Hong Kong and Singapore have initiated changes to their respective unit-linked markets which will see a move away from upfront commission. Whilst we see this as a positive move for the long-term benefit of both customers and providers, it will cause some challenges and market disruption in the short term.

Strategic Report
IFRS based operating profit

	2014				
£m	**Heritage**	**UK**	**Int'l**	**Corporate**	**Total**
New business strain	**(24)**	**(28)**	**(21)**	**–**	**(73)**
In-force surplus	**323**	**92**	**89**	**–**	**504**
Long-term investment return	**(61)**	**16**	**3**	**(2)**	**(44)**
Principal reserving changes and one-off items	**190**	**49**	**(4)**	**–**	**235**
Development costs	**(14)**	**(19)**	**(13)**	**–**	**(46)**
Other income and charges	**7**	**(5)**	**–**	**1**	**3**
IFRS based operating profit/(loss) before tax	**421**	**105**	**54**	**(1)**	**579**

	Restated(i) 2013				
£m	Heritage	UK	Int'l	Corporate	Total
New business strain	(41)	(1)	(24)	–	(66)
In-force surplus	304	69	100	–	473
Long-term investment return	(84)	13	(1)	1	(71)
Principal reserving changes and one-off items	159	8	(3)	–	164
Development costs	(10)	(30)	(7)	–	(47)
Other income and charges	2	(19)	(2)	(7)	(26)
IFRS based operating profit/(loss) before tax	330	40	63	(6)	427

(i) 2013 results have been restated to reflect the transfer of OLAB from the International to Heritage division and to exclude the results of Lombard, which has been classified as discontinued in the year.

Heritage

The 2014 Heritage IFRS based operating profit of £421 million is £91 million higher than in 2013. This improvement has been driven by lower new business strain, higher in-force surplus and improved long-term investment return as a result of higher expected rates of return.

The reduction in new business strain reflects the cessation of new business sales within the transferred OLAB business.

In-force surplus is favourable compared to 2013 with the run-off of the closed book of business being more than offset by the benefit from the first phase of the with-profits annuity reallocation programme, the benefit of partial repayment of a previous loan to a with-profits fund and higher management charges, due to improved economic conditions. In-force surplus has been further increased by a reduction in the level of provision movements in respect of operational items, arising from the review of the legacy business, noted in 2013.

Principal reserving changes and one-off items are higher than in 2013 with the key items in 2014 being a recapture of £1.6 billion of assets backing annuities generating a £90 million benefit alongside £19 million from the second phase of the with-profits annuity reallocation programme. There was a favourable impact from assumption changes, principally resulting from changes to annuitant longevity assumptions (£65 million).

UK

IFRS based operating profit of £105 million has increased by £65 million compared to 2013 driven by a revision to the long-term longevity assumptions in the Retirement Income business, higher in-force surplus due to the growth of the business and lower development costs. This is partly offset by an increase in new business strain principally driven by improvements made to the competitiveness of the Retirement Income business' annuity proposition.

Strategic Report
IFRS based operating profit continued

International

IFRS based operating profit was lower in 2014 at £54 million (2013: £63 million) due to reduced in-force surplus primarily as a result of increased expenses and adverse experience. This was partially offset by a £3 million reduction in new business strain due to lower volumes.

Increased development costs relate to investment in the new International IT platform.

Corporate

The Corporate IFRS based operating result is principally driven by external finance costs and corporate costs, offset by interest on internal debt. The £5 million improvement in 2014 is primarily due to a lower level of holding company costs in 2014.

Strategic Report
Operating expenses

	2014				Restated(i) 2013			
£m	**Heritage**	**UK**	**Int'l**	**Total**	Heritage	UK	Int'l	Total
Acquisition	**30**	**112**	**22**	**164**	37	99	21	157
Maintenance	**225**	**63**	**25**	**313**	254	48	23	325
Development	**14**	**19**	**13**	**46**	10	30	7	47
	269	**194**	**60**	**523**	301	177	51	529
Corporate				**1**				7
Total				**524**				536

(i) 2013 results have been restated to reflect the transfer of OLAB from the International to Heritage division and to exclude the results of Lombard, which has been classified as discontinued in the year.

Consistent with previous communications, the costs associated with new retirement income product and platform development have been reported within non-recurring items and are therefore excluded from the table above.

Heritage

2014 acquisition costs are lower than 2013, mainly driven by the cessation of new business sales within the transferred OLAB business.

Maintenance costs of £225 million are lower than 2013 due to contractual savings in expenses achieved through the Diligenta partnership and a reduction in costs following the successful completion of the separation programme to move all IT infrastructure and business applications hosted by AXA to Friends Life in 2013.

Development spend of £14 million is higher than 2013 reflecting the cost of the transfer of investment management of assets to Schroders and FLI, together with improvements to existing products and systems to support the in-force business.

UK

Acquisition costs have increased by £13 million compared to 2013 driven by structural changes within the UK division to build capability pending the new pension related freedoms from April 2015, and an expected movement in overheads from maintenance to acquisition as the Heritage book runs off. Maintenance costs have increased by £15 million reflecting growth in each of the three business units. This increase is in line with our expectations as the business grows.

Despite reduced overall development spend, there has been considerable investment in the Retirement Income proposition and in enhancing the Protection proposition and the auto-enrolment hub in Corporate Benefits. As mentioned above, the costs associated with new retirement income product and platform development have been reported within non-recurring items and are therefore excluded from the table above.

International

Acquisition and maintenance costs have increased marginally despite lower new business volumes, reflecting increases in regional branch costs and maintenance project spend.

Development expenses amounting to £13 million principally reflect investment in the new International IT platform. Following the re-platforming of new business, the division is on track for re-platforming in-force business during 2015.

Corporate

Corporate expenses are those incurred at holding company level. Lower costs were incurred in 2014 principally due to changes made to the corporate governance structure during 2013.

Strategic Report
Non-operating results

£m	2014	Restated[i] 2013
IFRS based operating profit before tax	**579**	427
Short-term fluctuations in investment return	**(206)**	185
Gain on sale of associates (AmLife)	–	20
Other non-recurring items	**(184)**	(151)
STICS[ii] interest adjustment to reflect IFRS accounting for STICS as equity	**31**	31
IFRS profit before acquisition accounting adjustments and shareholder tax	**220**	512
Amortisation and impairment of acquired in-force business	**(302)**	(342)
Amortisation and impairment of other intangible assets	**(52)**	(63)
IFRS (loss)/profit before shareholder tax from continuing operations	**(134)**	107
Shareholder tax	**88**	173
IFRS (loss)/profit after tax from continuing operations	**(46)**	280
Loss after tax from discontinued operations	**(71)**	(24)
IFRS (loss)/profit after tax	**(117)**	256

(i) 2013 results have been restated to exclude the results of Lombard, which has been classified as discontinued in the year.
(ii) Step-up Tier one Insurance Capital Securities.

Short-term fluctuations in investment returns on assets backing the shareholder and non-profit funds amounted to £(206) million in 2014. This principally reflects £(104) million due to the incomplete trading of gilt assets into higher yielding assets as part of the recapture of £1.6 billion of assets backing annuities in November 2014 (this variance is expected to reverse as the assets are reinvested in 2015). There was a further negative impact due to reductions in long-term interest rates during the year.

Other non-recurring items of £(184) million include:

- outsourcing implementation costs, net of provision releases, of £(71) million;
- finance transformation costs, largely relating to Solvency II and net of provision movements, of £(36) million;
- costs relating to the Sesame strategic review, of £(25) million;
- project costs incurred in responding to significant regulatory changes in the year, of £(21) million;
- separation and integration programme costs of £(11) million; and
- other strategic project costs of £(20) million, including costs incurred in relation to the Proposed Acquisition by Aviva.

The costs reported above in respect of separation and integration complete this programme and no future costs are anticipated relating to the activities of bringing together the entities and operations that form Friends Life today.

We are pleased with the progress on the outsourcing implementation work which is being undertaken in conjunction with Diligenta and a number of successful migrations have completed in 2014. Total spend under this programme to date amounts to £261 million. As a result of the new pensions and annuity legislation, we have decided to defer parts of the programme until later in 2015. This deferral is expected to result in a modest increase in total programme spend compared to the most recent guidance given in March 2013 of circa £280 million.

As communicated in August 2014, the Group's intention is to report the costs associated with the new retirement income product and platform development within non-recurring items. Given the UK Chancellor referred to the changes announced in his 2014 Budget as "the most far-reaching reform to the taxation of pensions since the regime was introduced in 1921", the Group believes this approach is appropriate in this instance. In accordance with this intention, £21 million of costs associated with responding to significant regulatory changes in the year have been reported within other non-recurring items.

Strategic Report
Capital

Insurance Groups Capital Adequacy

In addition to individual company requirements, the Group is required to meet the IGCA requirements of the Insurance Groups Directive. The Group's capital policy is to maintain sufficient Group capital resources to cover 150% of the Group Capital Resource Requirement ("CRR") (excluding WPICC).

The balance sheet remains strong with an estimated and unaudited IGCA surplus, at a Friends Life Group Limited level, of £2.3 billion at 31 December 2014 (1 January 2014: £2.2 billion), with Group capital resources being 240% of the CRR (1 January 2014: 238%) (excluding WPICC of £4.3 billion (1 January 2014: £4.2 billion)).

The sensitivities to market shocks show that IGCA surplus at 31 December 2014 would change by:

- an estimated £(0.1) billion in the event of a combined 40% fall in equity markets and a 30% fall in property markets;
- an estimated £0.3 billion in the event of a 200bps rise in interest rates; and
- an estimated £(0.5) billion in the event of a widening of corporate bond spreads of 200bps (of which one-third is assumed to relate to defaults).

The sensitivities reflect investment activities, the recapture of £1.6 billion of assets backing annuities, the with-profits annuity reallocation and modelling changes implemented since 31 December 2013.

Financial strength ratings

The Group targets financial strength ratings in the single "A" range for its principal life business and expects them to remain there for the foreseeable future. Current financial strength ratings are set out below.

	Friends Life Limited
Fitch	A+ (strong)
Moody's	A3 (strong)
Standard & Poor's	A – (strong)

Strategic Report
Financing and interest costs

The Group has a number of debt instruments and the operating costs of financing these for the year ended 31 December 2014 are presented below.

Finance costs

£m (unless otherwise stated)	Coupon	Principal	Clean market value of debt[i]	IFRS
LT2 subordinated debt 2021	12.00%	162	228	(20)
LT2 subordinated debt 2022	8.25%	500	613	(41)
UT2 reset perpetual subordinated debt[ii]	7.875%	369	417	(28)
STICS 2003	6.875%	210	227	(14)
STICS 2005	6.292%	268	272	(17)
Total 31 December 2014		**1,509**	**1,757**	**(120)**
Total 31 December 2013		1,496	1,616	(120)

(i) Market value is based on listed ask price, at 31 December 2014, excluding accrued interest.

(ii) The UT2 reset perpetual subordinated debt is a $575 million US Dollar denominated instrument. The principal and clean market values represent Sterling equivalent values as at 31 December 2014. The finance cost of £28 million is based on the Sterling equivalent principal on the day of issue of £356 million.

Corporate gearing and liquidity

IFRS gearing (£m)	2014	2013
Equity attributable to equity holders of the parent	**4,375**	5,065
Loans and borrowings[i]	**1,051**	1,050
	19.4%	17.1%

(i) IFRS debt gearing excludes the 2003 and 2005 STICS, as these securities are classified as equity in IFRS.

At 31 December 2014, the ratio of debt to IFRS equity attributable to equity holders of the parent, gross of debt, was 19.4% (31 December 2013: 17.1%), with the fall in equity principally reflecting the payment of dividends in the period and the loss after tax for the year.

Strategic Report
Discontinued operations – Lombard

On 30 October 2014 the Group completed the sale of its Luxembourg based business, Lombard. The financial impact of the sale, including the operating and non-operating results for the period, is included below:

Financial performance

£m	2014[i]	2013
Operating results	**23**	34
Non-operating results	**(88)**	(80)
Loss on remeasurement to fair value	**(14)**	n/a
Taxation	**8**	22
Loss after tax from discontinued operations	**(71)**	(24)

(i) 2014 figures are up to and including 30 October 2014.

Lombard generated an IFRS based operating profit before tax of £23 million in the first ten months of 2014, £11 million lower than in 2013. The decrease principally reflects one-off costs incurred as a result of the expected sale of the business and lower fee income. The lower fee income results from lapses experienced in 2013 and 2014 and also that the 2014 profit only relates to ten months of the year.

The IFRS non-operating result of £(88) million principally reflects the £(46) million recycling of cumulative foreign exchange adjustments required on disposal and £(35) million amortisation of acquired value of in-force business and other intangible assets.

Strategic Report
Principal risks and uncertainties

The Group actively identifies, assesses and monitors current and emerging principal risks. These are regularly reviewed by the Executive and Risk and Compliance Committees. The following risks present the principal risks deemed to be facing the Group at the current time:

Risk	Description and impact	How we manage
Regulatory change, including tax and Solvency II	The Group operates in a highly regulated financial services market both in the UK and internationally. In recent years, there have been significant changes in relevant legislation and regulation, a number of which have had a significant impact on the life assurance industry. It is impossible to predict fully the nature of the regulatory changes which may occur in the future or the impact that such changes may have on the Group and its strategic objectives. Some changes in legal requirements (including taxation) and regulatory regimes, or the differing interpretation and application of regulation over time, may have detrimental effects on the Group. The risk of the regulatory environment having a detrimental impact on the Group is believed to be increasing. Specific items of current note are:	The Group has processes in place to identify regulatory and legislative change and to monitor the timely implementation of new requirements. There is often only limited opportunity to influence regulatory change outcomes and therefore the Group's response is to base its business strategy on prevailing regulation as well as both known and planned change. The Group's business plans are stressed against extreme events, including regulatory change, to give confidence as to the strength of the capital position and our ability to deliver on our strategic objective, now and over the planning horizon.
	Solvency II Solvency II, which comes into effect on 1 January 2016, will have implications for the whole industry as to the way in which companies calculate capital resources and capital requirements. Solvency II continues to be viewed as potentially having a significant impact on the Group.	There remains further work to transition the Group across to a Solvency II basis. Our internal programme is fully mobilised and on track to transition. With greater certainty around the implementation dates, detailed planning work has been completed to ensure readiness. In the absence of final technical implementation standards and guidelines, we will continue to adapt our plans as specific requirements are confirmed. Nonetheless, as we transition, there will be an impact in terms of the way in which the Group needs to hold capital against a Solvency II balance sheet and we will consider how to optimise this in the manner that best serves our customers and shareholders.
	Pension reforms The UK government has introduced greater flexibility for customers to access their pension savings without the effective requirement to buy an annuity. This means that, from April 2015, people can choose how they access their defined contribution pension savings; for example they could take all their pension savings as a lump sum, draw them down over time, or buy an annuity with part, or all, of their pension. Alongside this, the government is introducing a new requirement to make sure that everyone retiring with a defined contribution pension pot has access to free and impartial guidance on the choices they face when deciding how to use their retirement savings. The guidance on pension	These developments present both an opportunity and a threat to the Group. Our New World Retirement programme is targeted with developing a range of propositions in response to the increased flexibility. The programme is developing a new individual customer platform and is making enhancements to customer service teams to help customers make appropriate decisions. We are also working to develop our operational capability to ensure that features, such as request withdrawals and the provision of appropriate information, are implemented in accordance with requirements which is challenging due to the short implementation

Strategic Report
Principal risks and uncertainties continued

Risk	Description and impact	How we manage
Regulatory change, including tax and Solvency II continued	choices will be provided by independent organisations rather than pension schemes or providers. On 27 February, the FCA issued final rules which take effect from 6 April 2015, placing additional requirements on pensions providers to ensure customers understand the implications of the choices they are making in accessing their savings, including tax issues that customers may not anticipate.	time since receiving the final regulatory requirements. Furthermore, it is difficult to predict the levels and nature of our customer interaction at the point the changes come into effect and it is possible that there may be some disruption to the provision of customer services.
	OFT/DWP workplace pensions consultation	
	Following a review by the Office of Fair Trading and the Department of Work and Pensions, it has been confirmed that, from April 2015, a 0.75% charge cap will come into effect on auto-enrolment schemes. The cap will cover all member-borne deductions which include all charges on member savings other than transaction costs. Other measures will be implemented in successive years.	The implementation of the OFT and DWP reviews of workplace pension arrangements remains uncertain. The extent of the changes, including the impact from the charge cap (and any consequent increased requirement to hold capital) on providers of workplace pensions together with any requirement to remove commission payments and the industry response to these measures could have a range of possible impacts on the Group's trading and financial performance in 2015 and beyond.
	FCA Legacy Review	
	In March 2014, the FCA announced that they would undertake a thematic review into the fair treatment of long standing customers in life insurance. Given the Group's significant book of legacy business within our Heritage business, we are proactively engaging with the FCA review. However, the expected outcome of this review is unclear and there is a risk that the FCA could use its powers of intervention to introduce new rules and/or require firms to take certain action in response to any issues and non-compliance identified pursuant to such review.	The FCA's work commenced in the summer and we await their findings in 2015.

Strategic Report
Principal risks and uncertainties continued

Risk	Description and impact	How we manage
Sesame Bankhall Group ("SBG")	The Group has, for some time had Sesame Limited ("Sesame"), a subsidiary of SBG, under strategic review. Due to potential liabilities from future advice related claims, Sesame is reliant on the continued financial support of the Group to be able to continue to trade. If an appropriate strategic solution cannot be agreed, there remains the risk of further adverse financial and reputational impacts to the Group.	The Group and SBG are in discussions with the FCA in connection with elements of the strategic review and the various options under consideration as part of the strategic review of the SBG businesses.
Economic conditions	Changes in economic conditions give rise to changes in the values of the assets and liabilities of the Group's insurance businesses. The Group is impacted by conditions in the UK and other European countries as a result of its operations and investment assets being predominantly focused in these countries. In the first half of 2014, weaker than expected global activity led to decreased projections for the remainder of the year through to 2015. Forward looking projections point to: potentially politically motivated changes (including those associated with campaigning for the May 2015 UK General Election), strengthening recovery in North America, revised downward prospects in Germany, France and Italy; China to stabilise at lower growth rates versus recent historical averages. This mixed economic picture paints continued challenges but also potential opportunities for the Group's international subsidiaries. We continue to be in a sustained low interest rate environment. This risk typically reduces with economic growth, which could have a material impact on the business. This is due to insurance businesses and shareholder funds being invested in corporate bonds, cash instruments and government debt which typically see yields reduce in a low interest environment.	The Group actively monitors changes in the economic environment to enable proactive management of impacts to relevant markets We mitigate the impact of economic conditions through measures such as the matching of assets and liabilities, the use of financial instruments to reduce the volatility of returns on assets, diversification in the product portfolio, and by ensuring that the Group is robustly capitalised. Specifically, our exposure to sovereign debt from all but the strongest countries in the Eurozone is modest. Stress and scenario testing is used to form a view on the implications of extreme events, such as long-term low interest rates so as to understand how best to manage that scenario. Approaches, such as further diversification into additional asset classes in which the Group invests, are being considered as part of investigating the opportunities to increase the rate of return achieved without significantly increasing the investment risks taken.
Credit Risk	The Group faces significant credit risk exposure (both from credit default and credit spread widening) as a result of its use of corporate bonds to back non-profit business and for the investment of shareholder funds. In 2014, the independent credit rating of UK government debt was affirmed and the outlook is now stable; this follows the downgrade in 2013. Given the Group's asset strategy, this had a muted effect. The shareholder funds have also taken on additional credit risk following the movement of annuities from the with-profits funds. The additional risk is commensurate with the return and appetite within the shareholder funds.	We mitigate our exposure to credit risks by adopting a relatively conservative investment policy with investment skewed towards bonds with high credit ratings. Credit risk is regularly monitored within the Group and the Group has improved its credit modelling with the implementation of a market leading credit risk model.

Strategic Report
Principal risks and uncertainties continued

Risk	Description and impact	How we manage
Variation in principal valuation assumptions	Writing life assurance and pension business requires the setting of assumptions about future experience. The factors considered in these assumptions include mortality and longevity, lapse and persistency rates, valuation interest rates, credit defaults and expense levels. Events causing a substantial change to these assumptions could require them to be recalibrated and impact the profitability, earnings and capital position of the Group.	Assumptions that are made are subject to rigorous and ongoing review and we take a prudent approach to evaluating the appropriate level of provisions and capital for each of the Group's risks. Stress and scenario testing is used to validate the appropriateness of key assumptions against single events and combinations of extreme events including economic conditions, investment performance, lapse and mortality/morbidity events.
Outsourcing	As part of the Group's strategy for increasing operational efficiency it utilises various outsourcing capabilities, including a long-term strategic partnership with Diligenta who provide specialist IT and business processing. There are risks associated with outsourcing, for example, if the outsourcer is or becomes unable to provide the expected services or does not provide them to the standards and quality expected.	The Group has comprehensive service level agreements in place with its outsource partners and actively monitors the standards of delivery against these agreements in order to mitigate the risks associated with outsourcing. The Group continues to ensure the appropriate risk framework is in place to manage and monitor operational risk, including that which falls within our outsource suppliers. In 2014 a revised Sourcing Policy was developed and a Third Party Risk Management and Control Standards will be implemented and embedded throughout 2015. The financial strength and strategic position of the Group's major outsource partners are actively monitored in order to manage potential counterparty credit and continuity of service risks.
Transaction Risk	An all share offer for all of the issued share capital of the Group was made in December 2014. The Group has long maintained a strategy of encouraging consolidation in the market and views the Proposed Acquisition as a positive for shareholders and customers. Should the Proposed Acquisition not proceed to a conclusion, there is a risk that the Friends Life would be vulnerable to adverse market perception.	The risks of the Proposed Acquisition not proceeding have been identified and assessed. Mitigation plans are being developed for such an event.

As stated in note 1 to the IFRS consolidated financial statements, the Directors have considered the Group's risk and uncertainties and are satisfied that the Group has sufficient resources to continue in operation for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the consolidated financial statements.

Strategic Report
Non-financial key performance indicators

Set out below are the Group's other, non-financial key performance indicators. These reflect our growth strategy in meeting the needs of our colleagues, customers and shareholders.

	2014	2013
Customer satisfaction (%)	**75**	72

Performance

Positives

- Our customers overall rating of the quality of our products and services has improved 3% points over the last 12 months. Three quarters now state good or very good.
- Our protection customers remain the most positive with 89% stating good or very good.
- All business areas measured now achieve at least 70% of customers stating good or very good and no more than 7% stating poor or very poor.

Negatives

- Despite the pleasing improvement since 2013, we still have work to do to achieve the 80% score we believe is achievable across all business areas measured.
- 1 in 5 of our customers gave a "neither good nor poor" response to the overall quality of products and services question. We need to understand better and address the current barriers that prevent these customers from giving Friends Life a positive rating.

Definition

We conduct over 1,500 interviews each year with customers who have recently bought, continue to hold or have recently received the benefits from their Friends Life policy.

This provides us with an overall view of all aspects of our customers experience with Friends Life from purchase to recovering the benefits of their policy.

	2014	2013
Colleague engagement (%)	**73**	67

Performance

Positives

- Group colleague engagement increased by another 6% during 2014 and is now 3% above ORC's Financial Services Index.
- 89% of colleagues surveyed took part, our best ever result.

Negatives

- The survey just preceded announcements about the Proposed Acquisition by Aviva. The Proposed Acquisition will create uncertainty for colleagues which could impact colleague engagement. However, the level of colleague engagement that preceded the announcements provides a strong cultural platform from which to take colleagues through the changes ahead.

Definition

Colleague engagement is measured across an index of 6 questions relating to advocacy, retention and effort in relation to working for Friends Life. Colleagues are surveyed twice a year.

The high level of commitment that comes from an engaged workforce is an enabler of our growth strategy.

Strategic Report
Non-financial key performance indicators continued

	2014	2013
Women in senior management (%)	**28**	26

Performance

Positives

- Andy Briggs, Group Chief Executive, continues to sponsor the Group diversity agenda and related series of activities.
- Our programme includes supporting women as they progress into senior management roles. Over 100 women were enrolled onto our mentoring programme and more than 200 managers took part in diversity and inclusion training (including our Executive Committee).

Negatives

- Friends Life aspires to a greater balance and proportion of women in senior management. We have set ourselves an aspirational target (not a quota) of 33% by the end of 2017.

Definition

This measure refers to women in senior management grades (roughly equating to our top 150 leadership positions).

We want to help female colleagues to realise their potential and remove any actual or perceived barriers to career progression, including into senior leadership roles.

	2014	2013
Equal opportunities (%)	**81**	73

Performance

Positives

- 81% of colleagues surveyed feel they have an equal opportunity for career progression and 89% feel Friends Life respects individual differences; pointing to an inclusive working culture and environment.

Negatives

- 11% of colleagues surveyed are neutral and 8% negative.

Definition

Percentage of colleagues who feel they have equal opportunity for development and career progression regardless of age, gender or cultural background.

We want all colleagues to feel they have equality of opportunity to develop, progress their careers with Friends Life and contribute fully to our business success.

	2014	2013
Community investment (£ million)	**1.9**	1.9

Performance

Positives

- 86% of colleagues feel that Friends Life is socially responsible (up 5 percentage points on 2013).
- Over £110,000 was raised with colleagues for Macmillan during 2014, towards our current challenge of £160,000 for Macmillan's information support services in the Bristol area, run in partnership with Citizens Advice Bureau.
- 750 days of colleague time was invested in local community projects.

Negatives

- There is still work to do to achieve greater levels of colleague engagement in our volunteering activities and this is being promoted as part of our Wellbeing Strategy.

Definition

Community investment refers to the total annual involvement from colleague volunteering, giving, fundraising, company matching and additional financial support via Community Foundation endowments, plus the manpower to manage our programmes.

Directors' report

The directors present their Annual Report and Accounts for Friends Life Holdings plc for the year ended 31 December 2014.

The Company is a wholly-owned UK-registered subsidiary of FLG Holdings Limited ("FLGH"). The Company's ultimate parent and controlling company is Friends Life Group Limited ("FLGL"). The combination of the Company and its subsidiary companies is referred to as the Group. Particulars of the main subsidiaries are shown in note 17.

The Company operates as the principal trading company for FLGL, a Guernsey incorporated company listed on the London Stock Exchange.

Proposed Acquisition by Aviva

On 2 December 2014 the Boards of FLGL and Aviva plc ("Aviva") announced they had reached agreement on the terms of a recommended all-share acquisition of FLGL by Aviva (the "Proposed Acquisition"). The Proposed Acquisition must be approved by FLGL's shareholders, Aviva's shareholders and the Guernsey Court. Subject to approval, the Proposed Acquisition will be completed by way of a Scheme of Arrangement ("the Scheme") in accordance with Guernsey company law. The Scheme will require FLGL shareholder approval at a meeting convened by order of the Guernsey Court ("the Court meeting") and at an extraordinary general meeting of FLGL ("the General Meeting"). The Court Meeting and the General Meeting will be held on 26 March 2015. Further information and documents relating to the Proposed Acquisition are available on the FLGL website at www.friendslifegroup.com.

Results

The results for the year ended 31 December 2014 are shown in the consolidated income statement and is more fully reviewed in the Strategic Report.

Dividends

The directors are recommending an interim dividend in respect of financial performance during the year to 31 December 2014 of £250 million, payable by the end of March 2015.

During 2014, interim dividends were paid on the following dates:

- £250 million on 27 March 2014;
- £100 million on 30 September 2014; and
- £260 million on 31 October 2014.

(2013 interim dividends: £250 million on 26 March 2013 in respect of performance during 2012, £100 million on 30 September 2013).

The directors do not recommend the payment of a final dividend.

Future developments

As a Company holding assets on behalf of FLGL, the Company's business will be developed in accordance with the needs of FLGL. This is described further in the Strategic Report.

Change of name

On 8 May 2014 the Company's name was changed from Friends Life Group plc to Friends Life Holdings plc.

Directors' report continued

Directors

The directors of the Company during the period and up to the date of these financial statements are listed below, with appointment and resignation dates detailed:

Current directors

David Allvey

Andy Briggs

Mel Carvill

Peter Gibbs

Marian Glen

Nick Lyons

Roger Perkin

Robin Phipps

Belinda Richards

Karl Sternberg

Tim Tookey

Tim Wade

Sir Malcolm Williamson

Directors who stepped down during the year

John Tiner	Resigned 8 May 2014
Clive Cowdery	Resigned 8 May 2014

Company Secretary

The Company Secretary, Victoria Hames, served throughout the year.

Share capital

The issued share capital of the Company as at 31 December 2014 consists of 515,000,000 (2013: 515,000,000) ordinary shares of £1.00 each. Information on shareholder rights, including voting rights, is included in note 36.

The Company has not obtained or held a lien or other charge over its own shares during the year.

Financial instruments

Details of the financial instruments used are set out in note 30 to the financial statements.

Post balance sheet events

Other post balance sheet events affecting the Group are disclosed in note 41 to the financial statements.

Employees

The employees of the Group have employment contracts with the wholly-owned subsidiaries, Friends Life Management Services Limited ("FLMS") and Friends Life Services Limited ("FLSL"). Accordingly, the Company has no direct employees.

Details of the number of employees within the Group and the commitment to equal opportunities employment can be found in the FLGL 2014 Report and Accounts available from www.friendslifegroup.com.

Political donations

No political donations were made by the Group during 2014 (2013: nil).

Qualifying third party indemnities

The Company maintains insurance cover with respect to the liabilities of directors and officers within the Group. In addition, qualifying third party indemnity arrangements (as defined in section 234 of the Companies Act 2006) are in force for the benefit of the directors within the Group and were in force for the benefit of former directors of the Group during 2014. Copies are available for inspection at One New Change, London, EC4M 9EF.

Directors' report continued

Related party transactions

Details of key management transactions are set out in note 40 to the Group's consolidated financial statements.

Going concern

The directors have undertaken a going concern assessment in accordance with "Going Concern and Liquidity Risk: Guidance for UK directors of UK Companies 2009", published by the Financial Reporting Council in October 2009.

As a result of this assessment, the directors have a reasonable expectation that the Group and the Company have adequate resources to continue to operate as a going concern for the foreseeable future and have prepared the financial statements on that basis. In assessing, for the Friends Life Holdings Group on a stand-alone basis, whether the going concern basis is appropriate, the directors have considered the information contained in the financial statements, the latest business plan, the profit forecasts, the latest working capital forecasts and estimated forecast solvency of the regulated subsidiaries of the Group.

These forecasts have been subject to sensitivity tests and the directors have a reasonable expectation that the Group and the Company have adequate resources to continue in operational existence for the foreseeable future.

Key information in respect of the Group's risk management framework, objectives and processes for mitigating risks including liquidity risk are set out in detail in note 30.

Statement of disclosure of information to the Company's auditor

Each of the directors of the Company as at the date of approval of this report confirms that:

- so far as each director is aware, there is no relevant audit information of which the Company's auditor is unaware; and
- each of the directors has taken all the steps that he/she ought to have taken as a director to make him/her aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

The Company's auditor, Ernst & Young LLP, has indicated its willingness to continue in office and, subject to a resolution of the shareholder, will remain in office pursuant to section 487 of the Companies Act 2006.

Statement of directors' responsibilities

The directors are responsible for preparing the Annual Report and the Group and parent company financial statements in accordance with applicable United Kingdom law and regulations.

Company Law requires the directors to prepare Group and parent company financial statements for each financial year. Under that law, the directors are required to prepare Group financial statements under International Financial Reporting Standards ("IFRS") as adopted by the European Union and have elected to prepare the parent company financial statements in accordance with United Kingdom Generally Accepted Accounting Practice ("UK GAAP") (United Kingdom Accounting Standards and applicable law).

Under Company Law the directors must not approve the Group or parent company financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and parent company and of the profit or loss of the Group and parent company for that period.

In preparing the Group and parent company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether the Group financial statements have been prepared in accordance with IFRS as adopted by the European Union, subject to any material departures disclosed and explained in the financial statements;
- for the parent company financial statements, state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the parent company financial statements; and
- prepare the Group and parent company financial statements on the going concern basis unless it is inappropriate to presume that the Group will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Group's and parent company's transactions and disclose with reasonable accuracy at any time the financial position of the Group and parent company and enable them to ensure that the financial statements comply with the Companies Act 2006 as well as Article 4 of the IAS Regulation for the Group financial statements. They are also responsible for safeguarding the assets of the Group and parent company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors are also responsible for preparing the Directors' report in accordance with the Companies Act 2006 and applicable regulations, including the requirements of the Listing Rules and the Disclosure and Transparency Rules.

Directors' report continued

Statement of directors' responsibilities pursuant to Disclosure and Transparency Rule 4

The directors confirm that, to the best of each director's knowledge:

- the Company and Group financial statements in this report, which have been prepared in accordance with IFRS and UK GAAP respectively, give a true and fair view of the assets, liabilities, financial position and results of the Company and of the Group taken as a whole; and
- the Strategic Report contained in this report includes a fair review of the development and performance of the business and the position of the Company and the Group taken as a whole, together with a description of the principal risks and uncertainties that they face.

Pixham End
Dorking
Surrey
RH4 1QA

4 March 2015

Registered number 06986155

ON BEHALF OF THE BOARD

Tim Tookey
DIRECTOR

Independent auditor's report to the members of Friends Life Holdings plc

We have audited the Group consolidated financial statements of Friends Life Holdings plc for the year ended 31 December 2014 which comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of IFRS based operating profit, the consolidated statement of financial position, the consolidated statement of changes in equity, the consolidated statement of cash flows and the related notes 1 to 41. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditor

As explained more fully in the Statement of directors' responsibilities set out on pages 24 and 25, the directors are responsible for the preparation of the Group 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 Group financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Company'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 Report and Accounts 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.

Opinion on financial statements

In our opinion the Group financial statements:

- give a true and fair view of the state of the Group's affairs as at 31 December 2014 and of its loss for the year then ended;
- have been properly prepared in accordance with IFRS as adopted by the European Union; and
- have been prepared in accordance with the Companies Act 2006 and Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion the information given in the Strategic Report and the Directors' Report for the financial year for which the Group financial statements are prepared is consistent with the Group financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Other matters

We have reported separately on the parent company financial statements of Friends Life Group plc for the year ended 31 December 2014. The opinion in that report is unqualified.

George m. Reid

George Reid
Senior statutory auditor
for and on behalf of Ernst & Young LLP
London
4 March 2015

Consolidated income statement

For the year ended 31 December 2014

	Notes	2014 £m	Restated 2013 £m
Revenue			
Gross earned premiums	3	**1,766**	1,971
Premiums ceded to reinsurers	3	**1,000**	(595)
Net earned premiums	3	**2,766**	1,376
Fee and commission income and income from service activities		**693**	715
Investment return	4	**7,588**	7,958
Total revenue		**11,047**	10,049
Other income	3	**–**	20
Claims, benefits and expenses			
Gross claims and benefits paid	5	**(4,065)**	(4,494)
Amounts receivable from reinsurers	5	**672**	688
Net claims and benefits paid	5	**(3,393)**	(3,806)
Change in insurance contract liabilities	26	**(2,729)**	2,331
Change in investment contract liabilities	27	**(2,869)**	(6,170)
Transfer (to)/from unallocated surplus		**(65)**	29
Movement in net asset value attributable to unit-holders	33	**(60)**	(89)
Movement in policyholder liabilities		**(5,723)**	(3,899)
Acquisition expenses	6	**(554)**	(554)
Administrative and other expenses	7	**(1,158)**	(1,228)
Finance costs	11	**(131)**	(141)
Total claims, benefits and expenses		**(10,959)**	(9,628)
Profit before tax from continuing operations		**88**	441
Policyholder tax	12	**(222)**	(334)
(Loss)/profit before shareholder tax from continuing operations		**(134)**	107
Total tax charge	12	**(134)**	(161)
Policyholder tax	12	**222**	334
Shareholder tax	12	**88**	173
(Loss)/profit after tax from continuing operations		**(46)**	280
Loss after tax from discontinued operations	3	**(71)**	(24)
(Loss)/profit for the year		**(117)**	256
Attributable to:			
Equity holders of the Company			
- From continuing operations		**(77)**	249
- From discontinued operations		**(71)**	(24)
Step-up Tier one Insurance Capital Securities ("STICS") holders	38	**31**	31
(Loss)/profit for the year		**(117)**	256

The consolidated income statement includes the results of Lombard as a discontinued operation. A single amount is shown on the face of the income statement representing the operation's post-tax result. 2013 results have also been restated to reflect this classification.

The notes on pages 33 to 132 form an integral part of these financial statements.

Consolidated statement of comprehensive income

For the year ended 31 December 2014

For the year ended 31 December	2014 £m	Restated 2013 £m
(Loss)/profit from continuing operations[i]	**(46)**	280
Loss from discontinued operations	**(71)**	(24)
(Loss)/profit for the year	**(117)**	256
Other comprehensive income from continuing operations:		
Items that will not be reclassified to profit and loss:		
Remeasurement gains/(losses) on the defined benefit scheme	**26**	(113)
Income tax relating to items that will not be reclassified	**–**	36
Total items that will not be reclassified to profit and loss	**26**	(77)
Items that may be reclassified subsequently to profit and loss:		
Foreign exchange adjustments[ii]	**4**	(5)
Shadow accounting[iii]	**(4)**	4
Total items that may be reclassified subsequently to profit and loss	**–**	(1)
Other comprehensive income/(loss), net of tax, from continuing operations	**26**	(78)
Other comprehensive income, net of tax, from discontinued operations[iv]	**27**	10
Total other comprehensive income/(loss), net of tax	**53**	(68)
Total comprehensive (loss)/income, net of tax, from continuing operations	**(20)**	202
Total comprehensive loss, net of tax, from discontinued operations	**(44)**	(14)
Total comprehensive (loss)/income, net of tax	**(64)**	188

(i) The (loss)/profit from continuing operations includes £31 million (31 December 2013: £31 million) attributable to STICS holders. There are no amounts included in other comprehensive income which are attributable to STICS holders (2013: £nil).

(ii) Foreign exchange adjustments relate to the translation of the results and financial position of overseas subsidiaries.

(iii) Shadow accounting that may be reclassified subsequently to profit and loss is as a result of a gain of £4 million (31 December 2013: loss of £(4) million) included within foreign exchange adjustments on translation of overseas subsidiaries held by a with-profits fund of Friends Life Limited ("FLL"). Further information is provided in note 26.

(iv) Other comprehensive income from discontinued operations includes £46 million due to the recycling of cumulative foreign exchange adjustments on disposal of a foreign operation (2013: £nil) offset by a £(19) million foreign exchange loss relating to translation of the results and financial position of the foreign operation in 2014 to the date of disposal (2013: £10 million gain).

Consolidated statement of IFRS based operating profit

For the year ended 31 December 2014

For the year ended 31 December	Notes	2014 £m	Restated 2013 £m
Profit before tax from continuing operations	3	**88**	441
Policyholder tax	12	**(222)**	(334)
(Loss)/profit before shareholder tax excluding returns generated within policyholder funds		**(134)**	107
Non-recurring items	3	**184**	131
Amortisation and impairment of acquired present value of in-force business	14	**302**	342
Amortisation and impairment of other intangible assets	14	**52**	63
Interest payable on Step-up Tier one Insurance Capital Securities ("STICS")	3	**(31)**	(31)
Short-term fluctuations in investment return	3	**206**	(185)
IFRS based operating profit before tax from continuing operations	3	**579**	427
Tax on operating profit		**(20)**	(1)
IFRS based operating profit after tax from continuing operations attributable to equity holders of the Company[(i)]		**559**	426

(i) IFRS based operating profit excludes:
(a) profit or loss from discontinued operations;
(b) investment variances on unit-linked sterling reserves and the assets backing these reserves, which in previous periods were included within operating profit. This is a change in approach for 2014 but does not materially impact the 2013 comparative results and these have not been restated for this change;
(c) investment variances from expected investment return for non-linked business which is calculated using a longer term rate of return;
(d) returns attributable to non-controlling interests in policyholder funds;
(e) significant non-recurring items;
(f) amortisation and impairment of present value of acquired in-force business and other intangible assets;
and is stated after policyholder tax and the deduction of interest payable on STICS. Given the long-term nature of the Group's operations, IFRS based operating profit is considered to be a better measure of the performance of the Group and this measure of profit is used internally to monitor the Group's IFRS results.

Consolidated statement of financial position

At 31 December 2014

As at 31 December	Notes	2014 £m	2013 £m
Assets			
Intangible assets	14	**3,110**	3,855
Property and equipment	15	**44**	50
Investment properties	16	**2,690**	2,561
Investment in associate		**4**	4
Financial assets	18	**92,768**	109,064
Deferred acquisition costs	20	**853**	897
Reinsurance assets	21	**1,231**	2,837
Current tax assets		**17**	33
Insurance and other receivables	23	**880**	1,100
Cash and cash equivalents	24	**7,503**	9,530
Total assets		**109,100**	129,931
Liabilities			
Insurance contracts	26	**35,750**	34,590
Unallocated surplus	28	**692**	627
Financial liabilities:			
– Investment contracts	27	**64,087**	83,502
– Loans and borrowings	31	**1,051**	1,050
– Amounts due to reinsurers	32	**–**	1,580
Net asset value attributable to unit-holders	33	**589**	621
Provisions	34	**176**	227
Pension scheme deficit	9	**7**	52
Deferred tax liabilities	22	**961**	980
Current tax liabilities		**–**	6
Insurance payables, other payables and deferred income	35	**1,093**	1,311
Total liabilities		**104,406**	124,546
Equity attributable to equity holders of the Company			
– Share capital	36	**515**	515
– Other reserves	37	**3,860**	4,550
		4,375	5,065
Attributable to STICS holders	38	**318**	318
		4,693	5,383
Attributable to non-controlling interests		**1**	2
Total equity		**4,694**	5,385
Total equity and liabilities		**109,100**	129,931

The financial statements were approved by the Board of Directors on 4 March 2015.

Tim Tookey
Director

Consolidated statement of changes in equity

For the year ended 31 December 2014

	Attributable to equity holders of the Company					
For the year ended 31 December 2014	**Share capital £m**	**Other reserves £m**	**Total £m**	**STICS holders £m**	**Non-controlling interests £m**	**Total £m**
At 1 January 2014	**515**	**4,550**	**5,065**	**318**	**2**	**5,385**
(Loss)/profit for the year	–	(148)	(148)	31	–	(117)
Other comprehensive income	–	53	53	–	–	53
Total comprehensive (loss)/income	–	(95)	(95)	31	–	(64)
Dividends paid	–	(610)	(610)	–	–	(610)
Interest paid on STICS	–	–	–	(31)	–	(31)
Appropriations of profit	–	(610)	(610)	(31)	–	(641)
Tax relief on STICS interest[(i)]	–	20	20	–	–	20
Share-based payments, net of settlements[(ii)]	–	8	8	–	(1)	7
Funding of Employee Benefit Trust[(iii)]	–	(13)	(13)	–	–	(13)
At 31 December 2014	**515**	**3,860**	**4,375**	**318**	**1**	**4,694**

	Attributable to equity holders of the Company					
For the year ended 31 December 2013	Share capital £m	Other reserves £m	Total £m	STICS holders £m	Non-controlling interests £m	Total £m
At 1 January 2013	515	4,729	5,244	318	3	5,565
Profit for the year	–	225	225	31	–	256
Other comprehensive loss	–	(68)	(68)	–	–	(68)
Total comprehensive income	–	157	157	31	–	188
Dividends paid	–	(350)	(350)	–	–	(350)
Interest paid on STICS	–	–	–	(31)	–	(31)
Appropriations of profit	–	(350)	(350)	(31)	–	(381)
Tax relief on STICS interest	–	7	7	–	–	7
Share-based payments, net of settlements[(ii)]	–	5	5	–	(1)	4
Other movements[(iv)]	–	2	2	–	–	2
At 31 December 2013	515	4,550	5,065	318	2	5,385

(i) Included within tax relief on STICS interest is £13 million (2013: £nil) relating to movements in deferred tax on the fair valuing of the STICS instruments on acquisition. These movements are attributable to previous years, however no prior year restatement has been recognised under *IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors*, on the grounds that there is no impact on previous years' profits and the immateriality of the amounts involved.

(ii) The movement in other reserves arising from share-based payment schemes is £8 million for the year (31 December 2013: £5 million) and relates to the expense, net of settlement, of the Group's share-based incentive schemes.

(iii) During 2014 the Company provided funding to an Employee Benefit Trust ("EBT") which purchases and holds shares of Friends Life Group Limited ("FLGL") for delivery to employees under various share-based payment schemes.

(iv) For the year ended 31 December 2013, other movements comprise the release of a share entitlement provision of £2 million. Following demutualisation of Friends Provident in 2001, share and cash entitlements that were not claimed were placed into two trusts. The trusts were wound up in 2004 and the liability for any future claims in respect of demutualisation was transferred to the Group. This provision was released following expiry of the Group's obligation on 9 July 2013.

Consolidated statement of cash flows

For the year ended 31 December 2014

For the year ended 31 December	Note	2014 £m	2013 £m
Operating activities			
(Loss)/profit for the year		**(117)**	256
Adjusted for:			
– loss on remeasurement to fair value of discontinued operations		**14**	–
– recycling of cumulative translation differences on discontinued operations		**46**	–
– profit on disposal of investment in associate		**–**	(20)
– net realised and unrealised gains on assets at fair value		**(5,610)**	(5,507)
– finance costs		**131**	142
– amortisation and impairment of intangible assets		**390**	483
– depreciation of property and equipment		**2**	5
– movement in deferred acquisition costs		**(10)**	(59)
– total tax charge		**125**	139
– purchase of shares and other variable yield securities		**(27,477)**	(23,948)
– proceeds from sale of shares and other variable yield securities		**28,653**	25,363
– purchase of loans, debt securities and other fixed income securities		**(28,520)**	(26,911)
– proceeds from sale of loans, debt securities and other fixed income securities		**29,927**	28,257
– purchase of investment properties		**(53)**	(45)
– proceeds from sale of investment properties		**214**	265
– increase/(decrease) in insurance contract liabilities		**1,160**	(2,642)
– increase in investment contract liabilities		**957**	4,840
– increase/(decrease) in unallocated surplus		**65**	(29)
– decrease in provisions		**(46)**	(51)
– net movement in receivables and payables		**583**	216
Pre-tax cash inflow from operating activities		**434**	754
Tax paid		**(27)**	(48)
Net cash inflow from operating activities		**407**	706
Investing activities			
Disposal of held for sale assets, net of cash transferred		**(1,539)**	50
Additions to internally generated intangible assets		**(2)**	(4)
Net disposals/(additions) of property and equipment		**4**	(2)
Net cash (outflow)/inflow from investing activities		**(1,537)**	44
Financing activities			
Purchase of ultimate parent company shares in settlement of incentive schemes		**–**	(1)
Purchase of ultimate parent company shares by EBT		**(13)**	–
Finance costs		**(133)**	(143)
STICS interest		**(31)**	(31)
Net movement in other borrowings, net of expenses		**(19)**	(40)
Dividends paid to equity holders of the Company		**(610)**	(350)
Net cash outflow from financing activities		**(806)**	(565)
(Decrease)/increase in cash and cash equivalents		**(1,936)**	185
Balance at beginning of year	24	**9,530**	9,313
Exchange adjustments on the translation of foreign operations		**(91)**	32
Balance at end of year	24	**7,503**	9,530

Notes to the consolidated accounts

1. Accounting policies

1.1 Basis of preparation

Friends Life Holdings plc is a public limited company registered and domiciled in England and Wales.

The financial statements of the Company as at and for the year ended 31 December 2014 comprise the consolidated financial statements of the Company and its subsidiaries (together referred to as "the Group") and the Group's interests in its associates.

The consolidated financial statements as at and for the year ended 31 December 2014 have been prepared in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union ("EU").

The presentation currency of the Group is Sterling. Unless otherwise stated the amounts shown in the consolidated financial statements are in millions of pounds Sterling (£ million).

The preparation of the financial statements under IFRS requires management to make judgements, estimates and assumptions that affect the application of policies and the reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period or in the period of the revision and future periods if the revision affects both current and future periods. Further information on the use of judgements, estimates, and assumptions is set out in note 2.

Following its classification as held for sale as at 30 June 2014 and subsequent disposal, the Lombard operating segment has been presented as a discontinued operation. A single amount is shown on the face of the consolidated income statement, comprising the post-tax result of the discontinued operation, the post-tax loss recognised on the remeasurement to fair value less costs to sell and associated corporate non-recurring costs of disposal. The consolidated income statement, consolidated statement of comprehensive income and consolidated statement of IFRS based operating profit comparatives have been restated.

The 2013 consolidated income statement includes the results of AmLife Insurance Berhad and AmFamily Berhad (collectively "AmLife") up until the date of their disposal on 4 January 2013.

The directors have, at the time of approving the financial statements, a reasonable expectation that the Company and the Group have adequate resources to continue in operational existence for the foreseeable future. Thus they continue to adopt the going concern basis of accounting in preparing the financial statements. Further detail is contained in the Directors' Report on page 24.

The International Accounting Standards Board ("IASB") issued the following new standards and changes to existing standards which are relevant to the Group and have been adopted in the Group financial statements with effect from 1 January 2014.

- IFRS 10: *Consolidated financial statements.* This standard provides a single consolidation model that identifies control as the basis for consolidation for all types of entities. It replaces the requirements in IAS 27: *Consolidated and separate financial statements* and SIC 12: *Consolidation – special purpose entities.* Under IFRS 10, an investor controls an investee when it has exposure, or rights, to variable returns from involvement with the investee and has the ability to affect those returns through its power over the investee. The application of IFRS 10 has not had a material impact on the Group.
- IAS 28 (revised): *Investments in associates and joint ventures.* This standard supersedes IAS 28: *Investments in associates* and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures. The application of IAS 28 (revised) has no impact on the Group.
- IFRS 12: *Disclosure of interests in other entities.* This standard combines, enhances and replaces disclosure requirements for subsidiaries, joint arrangements, associates and structured entities. Relevant disclosures are included in notes 2, 17 and 18.
- Amendments to IAS 32: *Financial instruments: Presentation* relating to offsetting financial assets and financial liabilities. These amendments clarify the meaning of 'currently has a legally enforceable right to set-off' and the criteria for non-simultaneous settlement mechanisms of clearing houses to qualify for offsetting. Relevant disclosures are included in note 30.

Below is a list of new standards and changes to existing standards, relevant to the Group, that have been issued by the IASB with effective dates for annual accounting periods beginning on or after 1 January 2015, unless otherwise stated, but where earlier adoption is permitted. They have been endorsed by the EU unless otherwise stated. They have not been considered for early adoption by the Group. These changes are not expected to materially impact the Group unless otherwise stated.

Notes to the consolidated accounts

1. Accounting policies continued

New standards:

- IFRS 9: *Financial instruments*. This standard reflects all phases of the IASB's work on the replacement of IAS 39: *Financial instruments: recognition and measurement*. The standard introduces new requirements for classification and measurement, impairment and hedge accounting. Classification is dependent upon the entity's business model for managing its financial instruments and the contractual cash flow characteristics of the instruments. The adoption of IFRS 9 may have a material impact on the classification and measurement of the Group's financial assets. This standard is effective for accounting periods beginning on or after 1 January 2018; it is yet to be endorsed by the EU; and
- IFRS 15: *Revenue from contracts with customers*. The objective of this standard is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer. This standard is effective for accounting periods beginning on or after 1 January 2017; it is yet to be endorsed by the EU.

The impact of these new requirements is currently being assessed by the Group.

Amendments to existing standards:

- Amendment to IAS 16: *Property, plant and equipment* and IAS 38: *Intangible assets*: In these amendments the IASB has clarified that the use of revenue-based methods to calculate the depreciation of assets and amortisation of intangible assets is not appropriate. This amendment is effective for annual periods beginning on or after 1 January 2016 but has not yet been endorsed by the EU;
- Improvements to IFRSs 2012: These annual improvements address seven standards in the 2010-2012 reporting cycle. They include changes to IFRS 2: *Share-based payment*, IFRS 3: *Business combinations*, IFRS 8: *Operating segments*, IFRS 13: *Fair value measurement*, IAS 16: *Property, plant and equipment*, IAS 24: *Related party transactions* and IAS 38: *Intangible assets*. Consequential amendments are also made to IFRS 9: *Financial instruments*, IAS 37: *Provisions, contingent liabilities and contingent assets*, and IAS 39: *Financial instruments: recognition and measurement*. The amendments are effective for annual periods beginning on or after 1 July 2014;
- Improvements to IFRSs 2013: These annual improvements address four standards in the 2011-2013 reporting cycle. They include changes to IFRS 1: *First time adoption*, IFRS 3: *Business combinations*, IFRS 13: *Fair value measurement*, and IAS 40: *Investment property*. The amendments are effective for annual periods beginning on or after 1 July 2014; and
- Improvements to IFRSs 2014: These annual improvements address four standards in the 2012-2014 reporting cycle. They include changes to IFRS 5: *Non-current assets held for sale and discontinued operations*, IFRS 7: *Financial instruments: disclosures*, IAS 19: *Employee benefits*, and IAS 34: *Interim financial reporting*. The amendments are effective for annual periods beginning on or after 1 January 2016 but have not yet been endorsed by the EU.

The impact of these amendments is currently being assessed by the Group.

The Group has not early adopted any other standard, interpretation or amendment that has been issued but is not yet effective.

The financial statements comply with the Statement of Recommended Practice issued by the Association of British Insurers in December 2005 (as amended in December 2006) insofar as these requirements do not contradict the requirements of IFRS.

The Group presents its consolidated statement of financial position in order of liquidity. Where applicable, for each asset and liability line item that combines amounts expected to be recovered or settled both within and beyond 12 months after the reporting date, disclosure of the amount due beyond 12 months is made in the respective note.

Financial assets and financial liabilities are not offset, unless there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or to realise the assets and settle the liability simultaneously. Income and expenses are not offset in the income statement unless required or permitted by an accounting standard or interpretation, as specifically disclosed in the accounting policies of the Group.

1.2 Accounting policies

The principal accounting policies have been consistently applied in these consolidated financial statements. Where an accounting policy can be directly attributed to a specific line item in the accounts, the policy is presented within the relevant note, with a view to enabling greater understanding of the results and financial position of the Group. All other significant accounting policies are disclosed below.

Notes to the consolidated accounts

1. Accounting policies continued

1.2.1 Business combinations

The consolidated financial statements incorporate the assets, liabilities, results and cash flows of the Company and its subsidiaries. The results of subsidiaries acquired or sold during the period are included in the consolidated results from the date of acquisition or up to the date of disposal. Intra-group balances and income and expenses arising from intra-group transactions are eliminated in preparing the consolidated financial statements.

Profits or losses arising from changes in holdings in subsidiaries that do not impact the Group's control over that subsidiary are recognised as changes in equity.

Business combinations are accounted for under IFRS 3: *Business combinations,* using the purchase method. The cost of a business combination is measured as the fair value of the consideration transferred. Identifiable assets acquired, including intangible assets arising on acquisition, and liabilities assumed in a business combination are measured initially at their fair value at the business combination date.

Any excess of the cost of the business combination over the fair value of the net assets acquired is recognised in the statement of financial position as goodwill. To the extent that the fair value of the acquired entity's net assets is greater than the cost of the acquisition, a gain is recognised immediately in the income statement. Acquisition related costs are expensed as incurred except insofar as they relate to the raising of debt or equity when such expenses are capitalised.

For further details on accounting policies for subsidiaries, see note 17.

a) Associates

Associates are all entities over whose operating policies the Group has significant influence but not control, generally arising from holding between 20% and 50% of the voting rights. Investments in associates are accounted for by the equity method of accounting and are initially recognised at cost. The Group's investment in associates includes goodwill (net of any impairment loss) identified on acquisition.

Under the equity method, an investment is included as a single line item in the consolidated statement of financial position as the Group's share of the fair value of the investee undertaking's net assets plus goodwill. The Group's share of post-tax profits or losses is presented as a single line item in the consolidated income statement, adjusted for the effect of measuring assets and liabilities to fair value on acquisition.

b) Classification of a non-current asset or disposal group as held for sale and discontinued operations

Where the Group holds a non-current asset or disposal group which is held exclusively with a view to its disposal in the near future, then it is classified as an asset held for sale. Non-current assets or disposal groups that are classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell.

A discontinued operation is a component of an entity that has either been disposed of, or is classified as held for sale, and represents a separate major line of business or geographical area of operations, or is a subsidiary acquired exclusively with a view to resale.

1.2.2 Impairment

The Group assesses at each reporting date whether there is an indication that an asset (other than those assets recognised at fair value) may be impaired.

If any such indication exists, or when annual impairment testing for an asset is required, the Group makes an estimate of the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash generating unit's ("CGU") fair value less costs to sell and its value in use, and is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount.

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. Impairment losses on continuing operations are recognised in the income statement in those expense categories consistent with the function of the impaired asset.

An assessment is made at each reporting date as to whether there is any indication that previously recognised impairment losses may no longer exist or may have decreased. If such indication exists, the recoverable amount of the asset is estimated. A previously recognised impairment loss is reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If that is the case, the carrying amount of the asset is increased to its recoverable amount.

Notes to the consolidated accounts

1. Accounting policies continued

That increased amount cannot exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognised for the asset in prior years. Such a reversal is recognised in the income statement. After such a reversal the depreciation charge is adjusted in future periods to allocate the asset's revised carrying amount, less any residual value, on a systematic basis over its remaining useful life.

Further detail on the impairment testing of intangible assets is provided in note 14.

1.2.3 Financial liabilities

The Group classifies financial liabilities as either financial liabilities at fair value through profit or loss or financial liabilities at amortised cost. The Group's principal financial liabilities at fair value through profit or loss are classified in notes 27 and 32 and at amortised cost in note 31.

A financial liability is recognised when, and only when, the Group becomes a party to the contractual provisions of a financial instrument.

A financial liability is derecognised when, and only when, the obligation specified in the contract is discharged, cancelled or expires.

1.2.4 Foreign currency translation

a) Foreign currency transactions

Transactions in foreign currencies are translated to the functional currency of each company in the Group at the foreign exchange rates ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the reporting date are translated to the functional currency at the exchange rate ruling at the reporting date, and any exchange differences arising are taken to the income statement. Non-monetary assets and liabilities measured at historical cost in a foreign currency are translated using the exchange rate at the date of the transaction and are not subsequently restated. Non-monetary assets and liabilities stated at fair value in a foreign currency are translated at the rate on the date the fair value was determined.

When a gain or loss on a non-monetary item is recognised directly in equity, any exchange component of that gain or loss is recognised directly in equity. Conversely, when a gain or loss on a non-monetary item is recognised in the income statement, any exchange component of that gain or loss is recognised in the income statement. Foreign exchange adjustments recognised in equity are reported in the Group's foreign currency translation reserve within retained earnings and reported in the consolidated statement of comprehensive income.

b) Overseas subsidiaries and associates

The assets and liabilities of overseas subsidiaries and associates, including goodwill and intangible assets attributable to the acquisition of the overseas subsidiary or associate, and fair value adjustments arising on consolidation, are translated to Sterling (the presentational currency of the Group) at foreign exchange rates ruling at the reporting date. The revenues and expenses of overseas subsidiaries and associates are translated to Sterling at average foreign exchange rates for the period.

Foreign exchange differences arising on the translation to Sterling are classified as equity movements and recognised in the Group's foreign currency translation reserve, and reported in the statement of comprehensive income. These exchange differences are recognised in the income statement in the period in which the overseas subsidiary or associate is sold.

1.2.5 Financial instruments treated as equity

A financial instrument is treated as equity if:

- there is no contractual obligation to deliver cash or other financial assets or to exchange financial assets or liabilities on terms that may be unfavourable; and
- the instrument is not a derivative and contains no contractual obligations to deliver a variable number of shares or is a derivative that will be settled only by the Group exchanging a fixed amount of cash or other assets for a fixed number of the Group's own equity instruments.

Notes to the consolidated accounts

2. Use of judgements, estimates and assumptions

The Group makes judgements in the application of critical accounting policies that affect the reported amounts of assets and liabilities. The Group also makes key assumptions about the future and other sources of uncertainty. These are continually evaluated and based on historical experience and other factors, including expectations of future events that are considered to be reasonable under the circumstances.

a) Consolidation principles

Subsidiaries are investees which the Group controls. An investor controls an investee when it has exposure, or has rights, to variable returns from involvement with the investee and has the ability to affect those returns through its power over the investee.

The majority of the Group's subsidiaries are wholly-owned entities where determination of control does not involve significant judgement. However, the Group's insurance entities invest in various vehicles, such as limited partnerships, open-ended investment companies ("OEICs") and unit trusts where control is often determined through the exercise of judgement.

Control of limited partnerships is assessed on an individual holding basis and is determined by reference to the terms of each partnership agreement. These investments are usually established with the Group as a limited partner and the general partner being responsible for managing and operating the partnership with full discretion and authority to select and/or terminate the appointment of any investment manager. Critical factors to consider when assessing control include whether the Group has the power to remove the general partner without cause and has rights to variable returns.

The Group invests in the underlying funds of OEICs and unit trusts, but does not act as an authorised corporate director or fund manager, responsible for day-to-day operations and fund performance. The Group is considered to control underlying funds where it has the ability to change the investment objectives or policies of a fund.

b) Product classification

IFRS 4: *Insurance contracts* requires judgement in classifying contracts as either "insurance contracts" or "investment contracts" based on the significance of insurance risk present in the contract with consequential impacts on the accounting policies applied to the valuation of policyholder liabilities, deferral of acquisition costs and pattern of revenue recognition.

c) Liabilities arising from insurance contracts and investment contracts with DPF

A contract with Discretionary Participation Features ("DPF") is a contractual right held by a policyholder to receive, as a supplement to guaranteed minimum payments, additional payments:

- that are likely to be a significant portion of the total contractual payments; and
- whose amount or timing is contractually at the discretion of the issuer and that are contractually based on:
- the performance of a specified pool of contracts, or a specified type of contract; or
- realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
- the profit or loss of the company that issues the contracts.

Determination of the ultimate liabilities of insurance contracts or investment contracts with DPF arising is a critical accounting estimate. There are several sources of uncertainty that need to be considered in determining the key assumptions made in estimating the liabilities that the Group will ultimately pay on claims made and on maturity of the policies.

The most significant assumptions are:

- mortality, morbidity, persistency and expense assumptions;
- for with-profits policies, the stochastic models used to value liabilities are sensitive to risk-free rates, assumed asset volatilities and the assumed correlation between asset volatilities. Risk-free rates are set in accordance with current market swap rates;
- for Overseas Life Assurance Business ("OLAB") policies with return of premium guarantees, the stochastic models used to value the cost of the guarantee are sensitive to risk-free rates, assumed asset volatilities and the assumed correlation between asset volatilities. Risk-free rates are set in accordance with current market swap rates. The cost also depends on assumptions such as the level of policy discontinuance;

Notes to the consolidated accounts

2. Use of judgements, estimates and assumptions continued

- valuation interest rate for annuities in payment – fixed interest assets, predominantly corporate bonds, are held to match the expected annuity portfolio benefits payable. The excess yields on corporate bonds over that on gilts are called bond spreads and these reflect compensation for the higher risk of default (credit risk premium) and lower liquidity (illiquidity premium) compared to gilts. One of the key judgements is the assessment of how much of the spread is attributable to credit default, as benefit cannot be taken for this element when determining the valuation interest rate. The valuation interest rate is derived by deducting the allowance for defaults, based on an analysis of historical defaults, from the total bond yield. This approach is consistent with current industry practice;
- other valuation interest rates have been calculated by reference to changes in consistent economic indices. The impact of all interest rate changes on liabilities is included within the impact of economic basis changes in note 26(a). The impact of these liability changes on surplus is generally to offset some or all of the corresponding impact on the value of fixed interest assets backing the liabilities;
- for guaranteed annuity options (one of the principal guarantees written by the Group) the cost depends on assumptions such as the level of policy discontinuance and the tax-free cash take-up rate; and
- changes in assumptions behind the valuation techniques for assets that are not quoted in active markets could have a significant impact on the value of assets that are backing insurance and investment contract liabilities, and therefore could have a subsequent impact on the valuation of the liability itself.

Details of insurance and investment contract liabilities are given in notes 25, 26 and 27.

d) AVIF and other intangible assets

The determination of the present value of future profits on a portfolio of long-term insurance and investment contracts, acquired through the purchase of a subsidiary, and recognised as an intangible asset, is subject to judgement and estimation. The Group's policy is to calculate acquired value of in-force business ("AVIF") balances arising on acquisition by reference to a Market Consistent Embedded Value ("MCEV") methodology. Information relating to the methods used to value other intangible assets is set out in note 14.

e) Fair value determination of financial instruments at fair value through profit or loss

Financial assets are designated at fair value where they are managed on a fair value basis or at amortised cost. Financial liabilities such as investment contracts are designated at fair value to eliminate mismatch with corresponding assets which are managed on a fair value basis.

Fair values of financial instruments that are quoted in active markets are based on bid prices for the assets held. When independent prices are not available, fair values are determined by using valuation techniques which refer to market observable data. These include comparison with similar instruments when market observable prices are available.

Valuation methodologies are detailed in note 19.

An analysis of assets and liabilities by category is also disclosed in note 19.

f) Staff pension schemes assumptions

In assessing the pension benefit obligation, assumptions are made as to the life expectancy of all deferred and retired members, interest and inflation rates. Material assumptions used and sensitivities are explained in detail in note 9. Estimates are made for the recoverability of any surplus through a potential refund should the scheme be wound up when in surplus.

g) Deferred tax assets and liabilities and unit-linked tax loss provisions

In assessing deferred tax assets, an estimate of probable future taxable profits is made, against which the temporary differences, being the carry forward of excess tax expenses, and tax losses are utilised. These involve management's best estimate based on past profit experience, adjusted for possible future deviations that management considers might occur. Details of deferred tax assets and liabilities are provided in note 22.

The principal deferred tax liabilities relate to deferred tax on purchased value of in-force business which are subsequently being amortised in line with the run-off of the underlying assets. The deferred tax assets and liabilities were calculated using detailed actuarial forecast cash flows.

Notes to the consolidated accounts

2. Use of judgements, estimates and assumptions continued

In assessing investment and insurance contract liabilities in respect of unit-linked tax loss provisions, the most significant assumptions are in relation to estimates of future fund growth rates; these are aligned with the Group's MCEV reporting assumptions, as provided in the MCEV supplementary information within the FLGL Report and Accounts. Provision is required where future investment return assumptions suggest linked funds will use their carried forward tax losses. Where growth rate assumptions for equities and property are less than RPI assumptions, no provision is made in respect of capital gains tax losses because no future taxable growth is anticipated against which losses can be used.

h) Fair value determination of investment properties and owner-occupied properties

Investment properties and properties occupied by the Group are measured at fair value at the reporting date by external independent valuers using methods set out in the Royal Institution of Chartered Surveyors ("RICS") Red Book.

The valuations are based on valuation techniques using multiples of future rental incomes. The rental multiples are based on multiples observed in recent similar transactions in the market. Key assumptions include occupancy and rental income.

i) Longer term shareholder investment return – IFRS based operating profit

In assessing the longer term investment return used in arriving at IFRS based operating profit before tax, assumptions are made as to the appropriate gilt and cash returns to apply, adjusted where appropriate to reflect the additional risks associated with other types of investment class.

Material assumptions used and sensitivities are detailed in note 4.

j) Provisions

The amounts recognised as provision liabilities are the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. All estimates are based on management's knowledge of current circumstances and predictions of future events. Actual experience may differ from these estimates.

Provisions are detailed in note 34.

Notes to the consolidated accounts

3. Segmental information

Segmental information is presented on the same basis as internal financial information used by the Group to evaluate operating performance.

An operating segment is a component of the Group that engages in business activities from which it earns revenues and incurs expenses.

The Group's reportable segments under IFRS 8: *Operating segments* are as follows:

- UK comprising Corporate Benefits, Protection and Retirement Income market-facing businesses and Sesame Bankhall Group ("SBG");
- Heritage, comprising the bulk of the UK business that is no longer actively marketed, OLAB within the UK life and pensions subsidiaries and Friends Life Investments ("FLI"); and
- FPI comprising Friends Provident International Limited ("FPIL").

Lombard has been classified as a discontinued operation with a single amount shown on the face of the consolidated income statement comprising the post-tax loss for the period, the post-tax loss recognised on the remeasurement of its net assets to fair value less costs to sell, loss on disposal, cumulative exchange difference arising on translation to Sterling, associated corporate non-recurring costs of disposal and any profit/loss on remeasurement of contingent consideration subsequent to disposal. Lombard's result has been excluded from IFRS based operating profit in 2013 and 2014, to better reflect the expected ongoing performance of the Group.

Corporate functions are not strictly an operating segment, but are reported to management and are provided in the analysis below to reconcile the Group's reportable segments to total profit.

In previous reporting periods, OLAB was managed and reported within the FPI segment. Following the decision to stop writing new business in 2013, OLAB was transferred to the Heritage segment in January 2014 and comparatives for the full year to 31 December 2013 have been restated.

a) Operating segment information

(i) IFRS based operating profit

For the year ended 31 December 2014	UK £m	Heritage £m	FPI £m	Corporate £m	Total £m
Life and pensions operating profit	113	489	64	–	666
Longer term shareholder investment return	16	(61)	3	(2)	(44)
Other (expense)/income	(5)	7	–	1	3
Development costs	(19)	(14)	(13)	–	(46)
IFRS based operating profit/(loss) before tax from continuing operations	**105**	**421**	**54**	**(1)**	**579**
Tax on operating profit					(20)
IFRS based operating profit after tax from continuing operations attributable to equity holders of the Company					**559**

Notes to the consolidated accounts

3. Segmental information continued

For the year ended 31 December 2013	UK £m	Restated Heritage £m	Restated FPI £m	Corporate £m	Restated Total £m
Life and pensions operating profit	76	422	73	–	571
Longer term shareholder investment return	13	(84)	(1)	1	(71)
Other (expense)/income	(19)	2	(2)	(7)	(26)
Development costs	(30)	(10)	(7)	–	(47)
IFRS based operating profit/(loss) before tax from continuing operations	40	330	63	(6)	427
Tax on operating profit					(1)
IFRS based operating profit after tax from continuing operations attributable to equity holders of the Company					426

(ii) Reconciliation of IFRS based operating result before tax to profit or loss after tax

For the year ended 31 December 2014	UK £m	Heritage £m	FPI £m	Corporate £m	Total £m
IFRS based operating profit/(loss) before tax from continuing operations	**105**	**421**	**54**	**(1)**	**579**
Non-recurring items[(i)(ii)(iii)(iv)]	**(62)**	**(106)**	**(4)**	**(12)**	**(184)**
Amortisation and impairment of AVIF	**(48)**	**(185)**	**(69)**	**–**	**(302)**
Amortisation and impairment of other intangible assets	**(45)**	**–**	**(7)**	**–**	**(52)**
Interest payable on STICS	**–**	**31**	**–**	**–**	**31**
Short-term fluctuations in investment return[(v)(vi)]	**11**	**(190)**	**(16)**	**(11)**	**(206)**
Loss before policyholder and shareholder tax	**(39)**	**(29)**	**(42)**	**(24)**	**(134)**
Policyholder tax	**10**	**212**	**–**	**–**	**222**
(Loss)/profit before tax from continuing operations	**(29)**	**183**	**(42)**	**(24)**	**88**
Policyholder tax	**(10)**	**(212)**	**–**	**–**	**(222)**
Shareholder tax	**2**	**69**	**3**	**14**	**88**
(Loss)/profit after tax from continuing operations	**(37)**	**40**	**(39)**	**(10)**	**(46)**
Loss after tax from discontinued operations					**(71)**
Loss after tax for the year					**(117)**

(i) UK non-recurring items of £(62) million for the year ended 31 December 2014 include separation and integration costs of £(11) million, costs of £(19) million relating to service improvement elements of the outsourcing arrangement with Diligenta, £(3) million relating to finance transformation and Solvency II costs, £(10) million in respect of the Sesame strategic review and £(19) million relating to significant regulatory change. Non-recurring costs relating to significant regulatory change primarily relate to costs associated with the new retirement income product and platform development in response to the 2014 Budget announcement.

(ii) Heritage non-recurring items of £(106) million for the year ended 31 December 2014 include costs of £(52) million in respect of the Diligenta outsourcing agreement, costs of £(2) million relating to significant regulatory change, £(1) million of costs relating to the capital optimisation programme, £(29) million of financial transformation and Solvency II costs, and £(22) million in respect of a charge for deficit funding relating to the Group's defined benefit pension scheme (the income for which is reported within the Corporate segment results).

(iii) FPI non-recurring items of £(4) million for the year ended 31 December 2014 relate to finance transformation costs.

(iv) Corporate non-recurring items of £(12) million for the year ended 31 December 2014 include £22 million income from Heritage in respect of the funding relating to the Group's defined benefit pension scheme, £(11) million costs in relation to the proposed all-share acquisition of FLGL by Aviva plc (the "Proposed Acquisition"), £(8) million relating to projects terminated as a consequence of the Proposed Acquisition, £(15) million relating to the Sesame strategic review.

(v) Includes investment variances on unit-linked sterling reserves and assets backing these reserves, which in previous periods were reported within operating profit. As this change in approach does not materially impact the 2013 comparative results, these have not been restated for this change.

(vi) Includes shareholder investment return short-term fluctuations and investment variances arising from the mismatch of fixed interest assets and the liabilities they are backing as well as the impact of credit default assumptions. This latter variance reflects profits or losses in excess of the expected investment return on the assets and the impact of the corresponding economic assumption changes on the liabilities.

Notes to the consolidated accounts

3. Segmental information continued

For the year ended 31 December 2013	UK £m	Restated Heritage £m	Restated FPI £m	Corporate £m	Restated Total £m
IFRS based operating profit/(loss) before tax from continuing operations	40	330	63	(6)	427
Non-recurring items[(i)(ii)(iii)]	(35)	(226)	18	112	(131)
Amortisation and impairment of AVIF	(47)	(221)	(74)	–	(342)
Amortisation and impairment of other intangible assets	(42)	(14)	(7)	–	(63)
Interest payable on STICS	–	31	–	–	31
Short-term fluctuations in investment return[(iv)]	19	160	3	3	185
(Loss)/profit before policyholder and shareholder tax	(65)	60	3	109	107
Policyholder tax	9	325	–	–	334
(Loss)/profit before tax from continuing operations	(56)	385	3	109	441
Policyholder tax	(9)	(325)	–	–	(334)
Shareholder tax	27	174	1	(29)	173
(Loss)/profit after tax from continuing operations	(38)	234	4	80	280
Loss after tax from discontinued operations					(24)
Profit after tax for the year					256

(i) UK non-recurring items of £(35) million for the year ended 31 December 2013 include separation and integration costs of £(14) million, costs of £(12) million relating to service improvement elements of the outsourcing arrangement with Diligenta, £(5) million in respect of Solvency II costs of which £(3) million relates to a provision for future costs, costs in respect of the capital optimisation programme of £(3) million and finance transformation costs of £(1) million.

(ii) Heritage non-recurring items of £(226) million for the year ended 31 December 2013 include costs of £(116) million in respect of a charge for deficit funding relating to the Group's defined benefit pension scheme (the income for which is reported within the Corporate segment results), £(10) million separation and integration costs, £(53) million of costs in respect of the Diligenta outsourcing agreement, £(34) million of Solvency II costs which include a provision of £(26) million for future costs, finance transformation costs of £(7) million and £(6) million of costs relating to the 2013 capital optimisation programme. Corporate non-recurring items also include costs of £(4) million relating to strategic review fees.

(iii) FPI non-recurring items of £18 million for the year ended 31 December 2013 include profits on disposal of the Group's entire 30% holding in AmLife of £20 million and finance transformation costs of £(2) million.

(iv) Includes shareholder investment return short-term fluctuations and investment variances arising from the mismatch of fixed interest assets and the liabilities they are backing as well as the impact of credit default assumptions. This latter variance reflects profits or losses in excess of the expected investment return on the assets and the impact of the corresponding economic assumption changes on the liabilities.

Notes to the consolidated accounts

3. Segmental information continued

(iii) Revenue and expenses

Premiums

Premium income in respect of single premium insurance policies and business not subject to contractual regular premiums is accounted for when the premiums are received.

For all other insurance contracts, premium income is accounted for in the year in which it falls due.

Under IFRS, investment contract premiums are not recognised as revenue but are accounted for as deposits, included within movements in investment contract liabilities.

Fee and commission income

Investment contract policyholders are charged for policy administration services, investment management services and for surrenders. Investment management services comprise primarily fees and charges from unit-linked investment contracts issued by the life and pensions business. Fees earned on investment management contracts relate to the sale and management of retail investment products and from managing investments in the institutional market. These fees and charges are recognised as revenue in the accounting period in which the services are rendered.

Front-end fees charged at the inception of certain investment contracts are recognised as income over the expected term of the contract on a straight-line basis with the unrecognised amount at the end of the year presented as a liability.

Regular fees charged to the policyholder periodically (monthly, quarterly or annually), are recognised on a straight-line basis over the period that the service is rendered.

Expenses

Details on the Group's accounting policies in respect of expense recognition are explained in notes 6, 7 and 11.

Notes to the consolidated accounts

3. Segmental information continued

For the year ended 31 December 2014	UK £m	Heritage £m	FPI £m	Corporate £m	Elimination of inter-segment amounts[(i)] £m	Total £m
Gross earned premiums on insurance and investment contracts	3,046	1,589	954	–	–	5,589
Investment contract premiums[(ii)]	(2,426)	(473)	(924)	–	–	(3,823)
Gross earned premiums	620	1,116	30	–	–	1,766
Premiums ceded to reinsurers[(iii)]	(109)	1,114	(5)	–	–	1,000
Net earned premiums	511	2,230	25	–	–	2,766
Fee and commission income	304	261	128	–	–	693
Investment return	1,694	5,591	306	78	(81)	7,588
Total revenue	2,509	8,082	459	78	(81)	11,047
Intersegment revenue	1	–	–	80	(81)	–
Total external revenue	2,508	8,082	459	(2)	–	11,047
Other income[(iv)]	–	–	–	22	(22)	–
Net claims and benefits paid	(153)	(3,226)	(14)	–	–	(3,393)
Change in insurance and investment contract liabilities	(1,662)	(3,649)	(287)	–	–	(5,598)
Transfer to unallocated surplus	–	(65)	–	–	–	(65)
Movement in net assets attributable to unit-holders	(25)	(35)	–	–	–	(60)
Acquisition expenses	(397)	(84)	(73)	–	–	(554)
Administrative and other expenses	(301)	(719)	(123)	(37)	22	(1,158)
Finance costs	–	(121)	(4)	(87)	81	(131)
Total claims, benefits and expenses	(2,538)	(7,899)	(501)	(124)	103	(10,959)
Intersegment expenses	–	(102)	–	(1)	103	–
Total external claims, benefits and expenses	(2,538)	(7,797)	(501)	(123)	–	(10,959)
(Loss)/profit before tax from continuing operations	(29)	183	(42)	(24)	–	88
Policyholder tax	(10)	(212)	–	–	–	(222)
Shareholder tax	2	69	3	14	–	88
(Loss)/profit after tax from continuing operations	(37)	40	(39)	(10)	–	(46)
Loss after tax from discontinued operations						(71)
Loss after tax for the year						(117)

(i) Eliminations include loan interest. Intersegment transactions are undertaken on an arm's length basis.
(ii) Accounted for as deposits under IFRS.
(iii) On 24 November 2014 an existing reinsurance treaty was amended such that investment risk transferred back to the Group whilst longevity risk continued to be reinsured. The amount due to reinsurers previously recognised under the agreement of £1,622 million at the amendment date was derecognised, with a corresponding credit recognised in premiums ceded to reinsurers. See note 32 for further details.
(iv) Represents internal recharges on pension deficit reductions of £22 million.

Notes to the consolidated accounts

3. Segmental information continued

For the year ended 31 December 2013	UK £m	Restated Heritage £m	Restated FPI £m	Corporate £m	Elimination of inter-segment amounts[i] £m	Restated Total £m
Gross earned premiums on insurance and investment contracts	2,887	1,942	1,115	–	–	5,944
Investment contract premiums[ii]	(2,235)	(652)	(1,086)	–	–	(3,973)
Gross earned premiums	652	1,290	29	–	–	1,971
Premiums ceded to reinsurers	(96)	(496)	(3)	–	–	(595)
Net earned premiums	556	794	26	–	–	1,376
Fee and commission income	299	306	110	–	–	715
Investment return	1,800	5,917	232	93	(84)	7,958
Total revenue	2,655	7,017	368	93	(84)	10,049
Intersegment revenue	–	–	–	84	(84)	–
Total external revenue	2,655	7,017	368	9	–	10,049
Other income[iii]	–	–	20	116	(116)	20
Net claims and benefits paid	(141)	(3,652)	(13)	–	–	(3,806)
Change in insurance and investment contract liabilities	(1,851)	(1,825)	(163)	–	–	(3,839)
Transfer from unallocated surplus	–	29	–	–	–	29
Movement in net assets attributable to unit-holders	(35)	(54)	–	–	–	(89)
Acquisition expenses	(400)	(89)	(65)	–	–	(554)
Administrative and other expenses	(284)	(909)	(139)	(12)	116	(1,228)
Finance costs	–	(132)	(5)	(88)	84	(141)
Total claims, benefits and expenses	(2,711)	(6,632)	(385)	(100)	200	(9,628)
Intersegment expenses	–	(200)	–	–	200	–
Total external claims, benefits and expenses	(2,711)	(6,432)	(385)	(100)	–	(9,628)
(Loss)/profit before tax from continuing operations	(56)	385	3	109	–	441
Policyholder tax	(9)	(325)	–	–	–	(334)
Shareholder tax	27	174	1	(29)	–	173
(Loss)/profit after tax from continuing operations	(38)	234	4	80	–	280
Loss after tax from discontinued operations						(24)
Profit after tax for the year						256

(i) Eliminations include loan interest. Intersegment transactions are undertaken on an arm's length basis.
(ii) Accounted for as deposits under IFRS.
(iii) Includes internal recharges on pension deficit reduction contribution of £116 million and profit on the disposal of AmLife of £20 million.

Notes to the consolidated accounts

3. Segmental information continued

(iv) Products and services

For the year ended 31 December 2014	Gross earned premiums £m	Net earned premiums £m	Fee and commission income £m	Total external revenue(i) £m
UK				
– Corporate benefits	–	–	113	113
– Protection	341	232	–	232
– Retirement income	279	279	–	279
– Other	–	–	191	191
Heritage				
– With-profits	291	283	–	283
– Pensions	46	44	172	216
– Investments	183	175	69	244
– Protection	295	160	–	160
– Annuities	301	1,568	–	1,568
– Other	–	–	20	20
FPI				
– Investments	12	12	128	140
– Protection	18	13	–	13
Total	**1,766**	**2,766**	**693**	**3,459**

(i) Total external revenue does not include investment return of £7,588 million.

For the year ended 31 December 2013	Gross earned premiums £m	Net earned premiums £m	Restated Fee and commission income £m	Restated Total external revenue(i) £m
UK				
– Corporate benefits	28	28	88	116
– Protection	271	175	–	175
– Retirement income	353	353	–	353
– Other	–	–	211	211
Heritage				
– With-profits	369	271	–	271
– Pensions	28	26	221	247
– Investments - restated	190	182	74	256
– Protection - restated	388	247	–	247
– Annuities	315	68	–	68
– Other	–	–	11	11
FPI				
– Investments - restated	14	14	110	124
– Protection - restated	15	12	–	12
Total	1,971	1,376	715	2,091

(i) Total external revenue does not include investment return of £7,958 million.

Notes to the consolidated accounts

3. Segmental information continued

Products and services are presented consistently with the disclosure of business segments, with each segment being broken down into the business units and products of which they comprise.

(v) Assets and liabilities

As at 31 December 2014	UK £m	Heritage £m	FPI £m	Corporate £m	Elimination of inter-segment amounts(i) £m	Total £m
Assets						
Intangible assets	**671**	**1,937**	**502**	**–**	**–**	**3,110**
Financial assets	**24,092**	**62,014**	**6,454**	**208**	**–**	**92,768**
Other assets	**1,871**	**9,632**	**1,447**	**1,599**	**(1,327)**	**13,222**
Total assets	**26,634**	**73,583**	**8,403**	**1,807**	**(1,327)**	**109,100**
Liabilities						
Insurance contracts	**3,442**	**32,138**	**170**	**–**	**–**	**35,750**
Investment contracts	**21,194**	**35,003**	**7,890**	**–**	**–**	**64,087**
Loans and borrowings	**17**	**868**	**–**	**1,311**	**(1,145)**	**1,051**
Other liabilities	**569**	**2,857**	**125**	**149**	**(182)**	**3,518**
Total liabilities	**25,222**	**70,866**	**8,185**	**1,460**	**(1,327)**	**104,406**

As at 31 December 2013	UK £m	Restated Heritage £m	Restated FPI £m	Lombard £m	Corporate £m	Elimination of inter-segment amounts(i) £m	Total £m
Assets							
Intangible assets	763	2,123	578	391	–	–	3,855
Financial assets	21,322	63,249	6,073	18,420	–	–	109,064
Other assets	1,798	11,186	1,434	1,985	2,104	(1,495)	17,012
Total assets	23,883	76,558	8,085	20,796	2,104	(1,495)	129,931
Liabilities							
Insurance contracts	3,110	31,354	126	–	–	–	34,590
Investment contracts	19,077	36,667	7,566	20,192	–	–	83,502
Loans and borrowings	13	1,178	11	2	1,031	(1,185)	1,050
Other liabilities	593	4,539	121	254	207	(310)	5,404
Total liabilities	22,793	73,738	7,824	20,448	1,238	(1,495)	124,546

(i) Eliminations mainly comprise intercompany loans.

Notes to the consolidated accounts

3. Segmental information continued

b) Geographical segmental information

In presenting geographical segment information, revenue is based on the geographical location of customers. The Group has defined two geographical areas: UK and the rest of the world.

For the year ended 31 December 2014	UK £m	Rest of the world £m	Total £m
Gross earned premiums	**1,649**	**117**	**1,766**
Fee and commission income	**547**	**146**	**693**
Revenue from external customers	**2,196**	**263**	**2,459**
Investment return			**7,588**
Premiums ceded to reinsurers			**1,000**
Total revenue			**11,047**

For the year ended 31 December 2013	Restated UK £m	Restated Rest of the world £m	Restated Total £m
Gross earned premiums	1,836	135	1,971
Fee and commission income	593	122	715
Revenue from external customers	2,429	257	2,686
Investment return			7,958
Premiums ceded to reinsurers			(595)
Total revenue			10,049

c) Disposal of discontinued operations

Following receipt of the necessary regulatory approvals, the sale of the Lombard business to the Blackstone Group LP completed on 30 October 2014.

The initial consideration received of £316 million comprised £260 million cash and deferred payment in the form of a vendor loan note with a fair value of £56 million (€70 million). The vendor loan note is denominated in Euros, has an eight year term from the completion date and bears a coupon of 7% per annum. An additional contingent element could increase or decrease the value of the vendor loan note by up to €50 million, determined with reference to Lombard's assets under administration on 30 June 2017 in the upside scenario and with reference to the assets under administration and the achievement of certain new business thresholds at 30 June 2019 in the downside scenario. The sale agreement also contains customary representations, warranties and indemnities that would be expected in a transaction of this nature.

The results of discontinued operations include all associated costs.

Notes to the consolidated accounts

3. Segmental information continued

(i) Results of discontinued operations

	2014 £m	2013 £m
Fee and commission income and income from service activities	**83**	112
Investment return	**1,300**	827
Total revenue	**1,383**	939
Movement in investment contract liabilities	**(1,215)**	(730)
Acquisition expenses	**(39)**	(49)
Administrative and other expenses	**(148)**	(205)
Finance costs	**–**	(1)
Total claims, benefits and expenses	**(1,402)**	(985)
Loss before shareholder tax	**(19)**	(46)
Shareholder tax	**8**	22
Loss after tax from discontinued operations	**(11)**	(24)
Loss on remeasurement to fair value	**(14)**	–
Recycling of cumulative translation differences	**(46)**	–
Loss from discontinued operations	**(71)**	(24)
Other comprehensive income, net of tax	**27**	10
Total comprehensive loss, net of tax	**(44)**	(14)

(ii) Cash flows of discontinued operations

	2014 £m	2013 £m
Operating cash flows	**98**	197
Investing cash flows	**(1)**	(4)
Financing cash flows	**(6)**	(23)
Total cash flows	**91**	170

Notes to the consolidated accounts

3. Segmental information continued

(iii) Major classes of assets and liabilities at disposal date

	30 October 2014 £m
Intangible assets	**338**
Financial assets	**18,254**
Other assets	**164**
Cash and cash equivalents	**1,799**
Remeasurement to fair value	**(14)**
Assets	**20,541**
Investment contracts	**19,960**
Deferred tax liabilities	**79**
Other liabilities	**191**
Liabilities	**20,230**
Equity attributable to equity holders of the Company	**311**
Total equity	**311**
Total equity and liabilities	**20,541**

d) Disposal of investment in associate undertaking

On 4 January 2013 the Group disposed of its entire holding of 30% of the ordinary share capital of AmLife to AmBank Group of Malaysia for RM 245 million (£50 million) resulting in a profit on disposal of £20 million.

The Group's share of the carrying value of AmLife at the date of sale on 4 January 2013 is shown below:

	2013 £m
Carrying value	30
Proceeds from disposal	50
Profit on disposal recognised through other income	20

4. Investment return

All investment income is recognised in the income statement and includes dividends, interest, rental income, the movement in financial assets and investment properties, at fair value through profit or loss, and realised losses.

Interest income is recognised in the income statement as it accrues, taking into account the relevant coupon rate and applicable floating rate or, for loan assets at amortised cost, the effective interest rate method. Interest income includes the amortisation of any discount or premium.

Dividend income from listed and unlisted securities is recognised as revenue when the right to receive payment is established. For listed securities this is the date the security is listed as ex-dividend.

Rental income from investment properties under operating leases is recognised in the income statement on a straight-line basis over the term of the lease. Lease incentives received are recognised in the income statement as an integral part of the total lease income.

Determination of gains and losses and the movement in investment properties and financial assets at fair value through profit or loss are explained in notes 16 and 18.

Notes to the consolidated accounts

4. Investment return continued

a) Analysis of investment return

For the year ended 31 December	2014 £m	Restated 2013 £m
Interest income on loans and receivables	**27**	20
Net interest on net defined benefit liability[(i)]	**(2)**	1
Dividend income	**1,301**	1,351
Rental income	**146**	156
Movement in fair value:		
– investment properties	**290**	46
– financial assets or financial liabilities at fair value through profit or loss:		
– financial derivative instruments	**222**	(305)
– financial assets designated on initial recognition, inclusive of interest income[(ii)]	**5,626**	6,682
Retranslation of foreign currency loans and borrowings	**(22)**	7
Total investment return	**7,588**	7,958

(i) Includes a £(2) million (2013: £(2) million) finance charge relating to penal tax recognised on the present value of pension deficit funding.
(ii) Interest income on financial assets at fair value through profit or loss is included in the movement in fair value. The 2013 comparatives have been aligned with this presentation, in addition to the restatement to reflect the disposal of the Lombard business.

b) Longer term investment return – IFRS based operating profit

The longer term investment return used in arriving at IFRS based operating profit before tax is calculated in respect of equity and fixed interest investments of shareholder funds and surplus assets held within long-term funds, by applying the longer term rate of return for each investment category to the quarterly weighted average value of the corresponding assets, after adjusting for the effect of any short-term market movements. The longer term rates of return are based on assumed gilt and cash returns, adjusted where appropriate to reflect the additional risks associated with the type of investment. The directors have determined the assumptions to be applied as follows:

For the year ended 31 December	2014 %	2013 %
Equities	**6.1**	4.9
Government fixed interest	**3.1**	1.9
Other fixed interest	**4.1**	3.4
Cash (life and pensions business)	**3.1**	1.9
Cash (corporate)	**0.7**	0.7

The rate applied to cash held in the life and pensions businesses and government fixed interest investments reflects the annualised swap curve spot rate, based on the term of the gilt portfolio (typically around 10 years). The expected rate of return applied to equities and other fixed interest investments incorporates an additional risk premium of 3% (2013: 3%) and 1% (2013: 1.5%) respectively. The rate applied to the cash held at corporate level is the one year spot rate reflecting the typically short term nature of those cash balances.

The longer term investment return also includes the return on the Group's external debt, including the STICS. The finance cost included within IFRS based operating profit reflects the actual coupon paid.

Notes to the consolidated accounts

4. Investment return continued

c) Sensitivity of shareholder longer term investment return – IFRS based operating profit

For the year ended 31 December	2014 £m	2013 £m
Shareholder longer term investment return:	**(44)**	(71)
– After the impact of a 1% increase in the longer term rates of investment return	**(16)**	(47)
– After the impact of a 1% decrease in the longer term rates of investment return	**(71)**	(91)

d) Comparison of shareholder longer term and actual investment return – IFRS based operating profit

For the year ended 31 December	2014 £m	Restated 2013 £m
Actual investment return attributable to shareholders	**(48)**	(98)
Shareholder longer term investment return	**44**	71
Deficit of actual shareholder return over longer term return	**(4)**	(27)

Short-term fluctuations in investment return reported in the consolidated statement of IFRS based operating profit of £(206) million (2013: £185 million) comprises a £(4) million deficit of actual shareholder return over longer term return (2013: £(27) million), as shown above, and a £(202) million variance arising from investment variances and economic assumption changes on assets backing long-term business (2013: £212 million).

5. Net claims and benefits paid

Insurance claims reflect the cost of all claims incurred during the year on insurance contracts, including claims handling costs. Death claims and surrenders are recognised on the basis of notifications received. Maturities and annuity payments are recorded when due. Claims and benefits recorded are accrued to the policyholder and included within insurance and investment contract liabilities, as appropriate.

Claims handling costs include internal and external costs incurred in connection with the negotiation and settlement of claims. Internal costs include all direct expenses of the claims department and any general administrative costs directly attributable to the claims function.

Reinsurance recoveries are accounted for in the same period as the related claim.

Notes to the consolidated accounts

5. Net claims and benefits paid continued

For the year ended 31 December 2014	Gross claims and benefits paid £m	Amounts receivable from reinsurers £m	Total net claims and benefits paid £m
UK			
– Corporate benefits	**3**	**–**	**3**
– Protection	**163**	**(83)**	**80**
– Retirement income	**70**	**–**	**70**
Heritage			
– With-profits	**1,815**	**(5)**	**1,810**
– Pensions	**228**	**(1)**	**227**
– Investments	**927**	**(2)**	**925**
– Protection	**188**	**(105)**	**83**
– Annuities	**654**	**(473)**	**181**
FPI			
– Investments	**12**	**–**	**12**
– Protection	**5**	**(3)**	**2**
Total	**4,065**	**(672)**	**3,393**

For the year ended 31 December 2013	Gross claims and benefits paid £m	Amounts receivable from reinsurers £m	Total net claims and benefits paid £m
UK			
– Corporate benefits	9	–	9
– Protection	138	(67)	71
– Retirement income	61	–	61
Heritage			
– With-profits	2,329	(106)	2,223
– Pensions	248	–	248
– Investments – restated	951	(1)	950
– Protection – restated	220	(130)	90
– Annuities	525	(384)	141
FPI			
– Investments - restated	12	–	12
– Protection - restated	1	–	1
Total	4,494	(688)	3,806

In previous reporting periods OLAB was managed and reported in the FPI segment. Following the decision to stop writing new business in 2013, OLAB has been transferred to the Heritage segment and full year 2013 comparatives have been restated.

Net claims and benefits are presented consistently with the disclosure of business segments, with each segment being broken down into the business units and products of which they are comprised.

Notes to the consolidated accounts

6. Acquisition expenses

For both insurance contracts and investment contracts with DPF, acquisition costs comprise all direct and indirect costs incurred during the period which arise from writing the contracts.

For investment contracts without DPF, acquisition costs comprise all incremental costs incurred during the period that are directly related to the writing of the contracts.

Where policyholder liabilities take into account all future cash flows, acquisition costs are expensed, rather than deferred. This treatment is applied to UK protection business, annuity business and all classes of business in the with-profits funds, which are accounted for on a realistic basis in accordance with UK Financial Reporting Standard ("FRS") 27: *Life assurance*. For other policyholder liabilities that do not take into account all future cash flows to recover the acquisition costs, such as investments, pensions and overseas business, acquisition costs are deferred to the extent they are recoverable and amortised over the life of the contracts.

For the year ended 31 December	2014 £m	Restated 2013 £m
Commission	**187**	217
Other acquisition expenses	**378**	395
Deferral	**(126)**	(164)
Amortisation and impairment of deferred acquisition costs[(i)]	**115**	106
Net acquisition expenses	**554**	554

(i) For the year ended 31 December 2013 this includes an impairment charge of £(5) million in respect of the Heritage segment's OLAB operations.

7. Administrative and other expenses

Ongoing administrative and other expenses are recognised as incurred.

Payments made under operating leases, including any incentive payments, are recognised in the income statement on a straight-line basis over the term of the lease. Lease incentives paid are recognised in the income statement over the term of the lease.

Recognition of provision related expenses is discussed in note 34.

a) Analysis of administrative and other expenses

For the year ended 31 December	2014 £m	Restated 2013 £m
Amortisation and impairment of intangible assets	**354**	404
Employee remuneration	**212**	200
Auditor's remuneration (note 7b)	**6**	6
Investment expenses and charges	**174**	173
Investment property expenses	**7**	6
IT costs	**39**	50
Operating lease rentals, land and buildings	**20**	19
Renewal commission	**54**	59
Non-recurring costs (note 7c)	**201**	159
Other administrative expenses	**91**	152
Total administrative and other expenses	**1,158**	1,228

Notes to the consolidated accounts

7. Administrative and other expenses continued

b) Auditor's remuneration

During the year the Group obtained the following services from the Group's auditor, Ernst & Young LLP, at costs as detailed in the table below.

For the year ended 31 December	2014 £m	2013 £m
Audit of the financial statements	**0.9**	1.0
Audit of subsidiaries	**2.5**	3.4
Total audit	**3.4**	4.4
Audit related assurance services	**1.1**	1.1
Total audit and audit related assurance services	**4.5**	5.5
Other services:		
Other assurance services	**0.1**	0.2
All taxation advisory services	**0.1**	0.1
Corporate finance services (excluding amounts included in other assurance services and all taxation advisory services)	**1.0**	0.4
Non-audit services not covered above	**–**	0.1
Total fees	**5.7**	6.3

In addition, £41,000 (2013: £45,850) was payable in respect of the audit of the Group pension schemes.

Included in the total fees above is £0.1 million (2013: £0.2 million) in respect of the audit of the Lombard business and £0.9 million in relation to the Proposed Acquisition of Friends Life Group Limited by Aviva plc (see note 41).

c) Non-recurring costs

Non-recurring costs for the year include charges related to separation and integration, charges for significant regulatory change, finance transformation costs including Solvency II, costs in respect of the transition and service improvement elements of the outsourcing arrangement with Diligenta, costs in relation to the Proposed Acquisition and strategic review costs.

The costs in respect of separation and integration complete this programme and no future costs are anticipated relating to the activities of bringing together the entities and operations that form Friends Life today.

8. Employees' and directors' remuneration

(a) Aggregate remuneration

	2014 £m	Restated 2013 £m
Wages and salaries	**170**	154
Social security costs	**19**	15
Pension cost	**19**	17
Remuneration from continuing operations	**208**	186
Remuneration from discontinued operations	**26**	30
Total remuneration	**234**	216

Employees' remuneration is reported in the consolidated income statement within acquisition expenses and administrative and other expenses.

Notes to the consolidated accounts

8. Employees' and directors' remuneration continued

(b) Average number of employees

The average number of employees, including executive directors, employed by the Group was as follows:

	2014	2013
UK life and pensions	**3,042**	2,870
FPI	**568**	604
Lombard	**330**	407
Average number of employees	**3,940**	3,881

(c) Directors' emoluments

The directors of the Company are also directors of the holding company and/or fellow subsidiaries. The total emoluments received by the directors is detailed below, all of which was paid by Friends Life Management Services Limited ("FLMS") or Friends Life Services Limited ("FLSL") for their services to the Group. The directors do not believe that it is practicable to apportion this amount between their services as directors of the company and their services as directors of the holding and fellow subsidiary companies. Amounts for annual bonus payments to the directors for the year ended 31 December 2014 have already been agreed by the Friends Life Group Limited Remuneration Committee and are therefore also included in the 2014 emoluments below. Amounts for annual bonus payments to the directors for the year ended 31 December 2013 were included in the 2013 emoluments below.

	2014 £	2013 £
Remuneration	**6,239,150**	6,114,380

The Company contributions to pension schemes in 2014 were £nil (2013: £nil).

None of the directors of the Company received accruing benefits under money purchase pension or defined benefit pension schemes in 2014 or 2013.

None of the directors exercised share options in 2014 or 2013 and none of the directors received or were entitled to receive shares under long term incentive schemes in 2014 or 2013.

(d) Highest paid director

	2014 £	2013 £
Remuneration	**2,699,589**	2,249,127

The total remuneration payable to directors includes £2,699,589 (2013: £2,249,127) in respect of the highest paid director, of which £1,060,449 (2013: £677,236) relates to contractual share awards paid in the year but granted in prior periods. This is the total of the costs incurred by the Group in respect of the highest paid director due to it being impractical to isolate the element of total remuneration relating to the Company.

Notes to the consolidated accounts

9. Staff pension schemes

Closed defined benefit scheme

The pension asset or liability recognised in the statement of financial position is the present obligation of the employer, which is the estimated present value of future benefits that employees have earned in return for their services in prior years, less the value of the plan assets in the scheme. The defined benefit scheme is closed to active membership and a pension surplus is only recognised to the extent it is recoverable through a refund upon winding up. The rate used to discount pension obligations is determined by reference to market yields at the end of the reporting period on high quality corporate bonds. A qualified actuary performs the calculation of the present value of the defined benefit obligation annually using the projected unit credit method.

The pension costs for the scheme are charged to the income statement and consist of past service cost or credit, net interest on net defined benefit liability or asset and administrative costs incurred by the scheme.

The actuarial gains and losses, included within remeasurements of the defined benefit scheme, which arise from any new actuarial valuation or from updating the latest actuarial valuation to reflect conditions at the balance sheet date and any restrictions to recognised surpluses, are taken to the consolidated statement of comprehensive income.

Defined contribution arrangements

Contributions made to these arrangements are charged to the income statement as they become payable in accordance with the rules of the arrangements.

a) Introduction

The Group has one closed defined benefit scheme: the Friends Provident Pension Scheme ("FPPS"), which closed to active membership on 31 December 2012.

On 1 January 2013, the Group set up a defined contribution scheme for UK employees, details of which are provided in section (d) of this note.

FPIL and SBG also operate defined contribution arrangements.

b) Closed FPPS defined benefit scheme overview

On an IAS 19: *Employee benefits* (Revised 2011) basis, a gross surplus of £59 million has been recognised in respect of the FPPS at 31 December 2014 (2013: deficit of £4 million).

The Trustee and the Group consider the funding position of the FPPS on more than one basis. As part of the triennial review of the FPPS as at 30 September 2011, the Trustee and the Group recognised a deficit of £185 million on a Technical Provisions basis and on this funding basis agreed a deficit reduction plan as at 2 January 2013, details of which are provided in section (c)(vii) of this note. The triennial review of the FPPS as at 30 September 2014 has commenced and in normal course the review would be completed within 15 months by 31 December 2015.

Under IFRIC 14, deficit reduction contributions are considered to be a minimum funding requirement and, to the extent that the contributions payable will not be available after they are paid into the scheme, a liability is recognised when the obligation arises. In accordance with s207(4) Finance Act 2004, an additional liability of £66 million has been recognised at 31 December 2014 (2013: £48 million), reflecting the 35% tax that would arise on any notional refund in respect of the resultant IAS 19 surplus of £190 million (£151 million of deficit reduction contributions at a present value of £131 million plus the current surplus of £59 million). A deferred tax asset of £30 million (2013: £34 million) has also been recognised to reflect tax relief at a rate of 20% (2013: 20%) that is expected to be available on the deficit reduction contributions in future periods.

Notes to the consolidated accounts

9. Staff pension schemes continued

An analysis of the amounts recognised in the financial statements in respect of the FPPS is set out below.

Amounts recognised in the consolidated statement of financial position

As at 31 December	2014 £m	2013 £m
IAS 19 surplus/(deficit) (excluding deficit reduction contribution)	**59**	(4)
Authorised payments surplus charge (penal tax) at 35% of available surplus following deficit reduction contribution, discounted to present value[(i)]	**(66)**	(48)
Net pension deficit (excluding deficit reduction contribution)	**(7)**	(52)

(i) Included in the charge for the year ended 31 December 2014 is a finance charge of £(2) million (2013: £(2) million) relating to penal tax on the present value of the pension deficit funding, which is recognised in the consolidated income statement.

Movement in IAS 19 pension surplus

For the year ended 31 December	2014 £m	2013 £m
Pension (deficit)/surplus at 1 January	**(4)**	62
Net interest on net defined benefit liability/asset[(i)(ii)]	**–**	3
Employer contributions	**23**	28
Remeasurement gains/(losses)	**41**	(96)
Administration costs[(i)]	**(1)**	(1)
Pension surplus/(deficit)	**59**	(4)
Present value of deficit reduction contributions	**131**	136
Available surplus subject to authorised payments surplus charge	**190**	132

(i) Recognised in the consolidated income statement.
(ii) The actual return on plan assets for the year ended 31 December 2014 is £252 million (31 December 2013: £81 million).

The total loss relating to the pension scheme recognised in the consolidated income statement for the year ended 31 December 2014 was £(3) million (2013: £nil). In addition to the amounts shown in the table above, a finance charge of £(2) million (2013: £(2) million charge) relating to penal tax on the present value of pension deficit funding has also been recognised in the consolidated income statement.

Analysis of net pension surplus/(deficit) and related deferred tax

As at 31 December 2014	Pension surplus /(deficit) £m	Deferred tax £m
Gross IAS 19 pension surplus and related deferred tax liability	**59**	**(12)**
Irrecoverable element of deficit reduction contributions (authorised payments surplus charge on available surplus)[(i)]	**(66)**	**–**
Restriction of asset due to authorised payments surplus charge	**–**	**12**
Tax relief available on deficit reduction contributions	**–**	**30**
Net pension deficit and related deferred tax asset	**(7)**	**30**

As at 31 December 2013	Pension deficit £m	Deferred tax £m
Gross IAS 19 pension deficit and related deferred tax asset	(4)	1
Irrecoverable element of deficit reduction contributions (authorised payments surplus charge on available surplus)	(48)	–
Restriction of liability due to authorised payments surplus charge	–	(1)
Tax relief available on deficit reduction contributions	–	34
Net pension deficit and related deferred tax asset	(52)	34

Notes to the consolidated accounts

9. Staff pension schemes continued

Remeasurement gains/(losses) of the defined benefit scheme

For the year ended 31 December	2014 £m	2013 £m
Remeasurement gains/(losses):		
– actuarial losses of the defined benefit scheme	**(149)**	(117)
– return on pension asset (excluding amounts included in net interest on net defined benefit liability/asset)	**190**	21
– irrecoverable element of deficit reduction contributions (authorised payments surplus charge on available surplus)(i)	**(15)**	(17)
Remeasurement gains/(losses) of the defined benefit scheme	**26**	(113)
Taxation	**–**	36
Remeasurement gains/(losses) of the defined benefit scheme after tax	**26**	(77)

(i) An additional finance charge of £(2) million (2013: £(2) million) is also recognised in the consolidated income statement relating to penal tax on the present value of pension deficit funding.

A tax credit of £30 million (2013: credit of £34 million) in respect of deficit reduction contributions and a further debit of £30 million (2013: credit of £2 million) in respect of other movements in the pension scheme are included in the aggregate tax line for items that will not be reclassified to profit and loss in the consolidated statement of comprehensive income.

c) FPPS additional disclosures

i) Principal assumptions used by the Scheme Actuary in calculating the scheme liabilities

For the year ended 31 December	2014 %	2013 %
Rate of increase for pensions in payment	**Relevant RPI inflation swap curve**	Relevant RPI inflation swap curve
Rate of increase for deferred benefits	**Relevant RPI inflation swap curve less 75 bps**	Relevant RPI inflation swap curve less 75 bps
Discount rate for deferred members	**3.79**	4.48
Discount rate for pensioners	**3.50**	4.31
Single equivalent discount rate	**3.67**	4.41

The inflation rate assumptions for revaluation of deferred pensions in excess of Guaranteed Minimum Pensions ("GMPs") have been based on the consumer price index ("CPI") as the statutory inflation index. The scheme applies the statutory CPI revaluation factors published by the Government with the factors based on the higher compound cap of 5% per annum applied in respect of benefits accrued up to 31 December 2010 and on the lower compound cap of 2.5% per annum applied for benefits between 1 January 2011 and 31 December 2012 (when the scheme closed to active membership).

Pensions in payment in excess of the GMPs accrued up to 31 December 2010 will increase each year in line with the RPI with a minimum of zero and a maximum of 5% and pensions accrued from 1 January 2011 to 31 December 2012 (when the scheme closed to active membership) will increase each year in line with the RPI with a minimum of zero and a maximum of 2.5%.

Notes to the consolidated accounts

9. Staff pension schemes continued

ii) Mortality assumptions

Mortality assumptions are a proportion of the "SAPS-All" series mortality tables published by the Continuous Mortality Investigation ("CMI"), with proportions varying by sex and by status determined from an analysis of the members' postcodes and the annual pension amounts:

Proportion of "SAPS-All" likelihood of death in any year:	2014 %	2013 %
Male pensioner	**83**	83
Female pensioner	**98**	98
Male non-pensioner	**90**	90
Female non-pensioner	**100**	100

In addition, allowance was made for future improvements in mortality according to each individual's year of birth through the use of the CMI's 2014 projection method, with a long-term trend parameter of 1.5% p.a. The mortality assumptions provide the following average life expectancies of future pensioners currently aged 47 retiring at the age of 60, and current pensioners aged 71.

For the year ended 31 December	2014 years	2013 years
Expected age at death of future male pensioner	**90**	90
Expected age at death of future female pensioner	**91**	92
Expected age at death of current male pensioner	**89**	89
Expected age at death of current female pensioner	**90**	90

The present value of providing an annuity of £1 per annum for members aged 60, based on the above assumptions and the assumptions below, is as follows:

Cost of annuities	2014 £	2013 £
Male annuity	**30.21**	28.32
Female annuity	**28.88**	27.25

These rates assume a monthly payments model with a discount rate of 3.79% (2013: 4.48%). The rates also assume two-thirds of the member's benefit will be paid to the spouse or civil partner on the death of the member. A guarantee is provided for pensioners who die within five years of retiring.

Cost of annuities	2014 % of total membership	2013 % of total membership
Deferred members	**70**	71
Pensioners	**30**	29
	100	100

The cost of providing pensioner benefits for members who retired before 30 June 2013 is met by the insurance contract with Aviva Annuity UK Limited ("Aviva Annuity") (see section (vii) below).

Notes to the consolidated accounts

9. Staff pension schemes continued

The sensitivities regarding the principal assumptions used to measure the scheme assets/liabilities are set out below.

	31 December 2014			31 December 2013		
Assumption	Increase/ (decrease) in assumption %	Increase in scheme liabilities £m(i)	Decrease in balance sheet surplus £m (ii)	Increase/ (decrease) in assumption %	Increase in scheme liabilities £m (i)	Increase in balance sheet deficit £m (ii)
Inflation(iii)	**0.5**	**145**	**20**	0.5	135	20
CPI(iv)	**0.5**	**70**	**70**	0.5	65	60
Pension increases in payment	**0.5**	**115**	**n/a(v)**	0.5	100	n/a(v)
Discount rate(vi)	**(0.5)**	**180**	**40**	(0.5)	165	40
Rate of mortality	**1 year**	**40**	**25**	1 year	35	20

(i) The value of the insured asset is set equal to the defined benefit obligation of the corresponding insured members. Changes to the value of the defined benefit obligation relating to these members as a result of changes to expected future inflation or interest rates (or of mortality experience differing from that expected) are completely offset by corresponding changes to the insured asset value.

(ii) In respect of assets other than the insured asset, the scheme has a liability driven investment strategy in place which aims to reduce volatility in the statement of financial position and profit and loss account. Broadly the scheme has hedges that cover 70% of the nominal swap interest rate movements and 85% of the RPI inflation movements when calculated on the assumptions used in this statement. The sensitivities assume no change to asset values other than the swap portfolio and are different if calculated on the scheme's funding basis.

(iii) Assuming that expectations of future RPI and CPI increase by 0.5%, and that expectations of future annual pension increases (LPI) in payment increase by a proportionate amount.

(iv) Assuming that expectations of future CPI increase by 0.5%, and that RPI inflation and associated RPI based increases are unchanged.

(v) Sensitivity to changes in pension increases are included in balance sheet inflation sensitivity.

(vi) Assuming a change to interest rates but no change to the implied spread between corporate bond yields and nominal swap yields (i.e. nominal swap yields also change leading to the change in swap value partially offsetting the change in liabilities. If corporate bond yields change differently to nominal swap yields this may lead to a mismatch in the change to the IAS 19 liabilities and the swap portfolio).

The sensitivity information has been derived for the FPPS using projected cash flows for the scheme valued using the relevant assumptions as at 31 December 2014. Extrapolation of these results beyond the sensitivity figures shown may not be appropriate.

The methods and types of assumptions used in preparing the sensitivity analysis did not change compared to the previous period.

In addition to the annuities held by the scheme, the scheme partially hedges its exposure to inflation risk and nominal risk for the deferred liability by investing in liability driven investments including RPI and nominal swaps. This hedging strategy serves to reduce volatility in the statement of financial position and income statement. Broadly the scheme has hedges that cover 70% of the interest rate movements and 85% of the inflation movements. As such a 0.5% increase in interest rates would reduce liabilities by £180 million and a 0.5% increase in inflation would increase liabilities by £145 million.

iii) Changes in the present value of defined benefit obligations

For the year ended 31 December	2014 £m	2013 £m
Present value of obligations at 1 January	**1,414**	1,282
Interest cost	**61**	57
Actuarial losses of the defined benefit scheme:		
– Losses from change in financial assumptions	**156**	117
– Gains from change in demographic assumptions	**(21)**	–
– Experience losses	**14**	–
Benefits paid	**(45)**	(42)
Present value of obligations at 31 December	**1,579**	1,414

Notes to the consolidated accounts

9. Staff pension schemes continued

iv) Analysis of defined benefit obligations

The profile of the obligations is analysed as follows:

As at 31 December	2014 £m	2013 £m
Deferred members	**948**	829
Pensioners	**631**	585
Wholly or partly funded plans	**1,579**	1,414

The weighted average duration of obligations is analysed as follows:

As at 31 December	2014 Years	2013 Years
Deferred members	**27**	28
Pensioners	**14**	14

The maturity profile of the obligations is analysed as follows:

Expected benefit payments for the years ending:	£m
31 December 2015	**36**
31 December 2016	**36**
31 December 2017	**37**
31 December 2018	**40**
31 December 2019	**43**
Expected benefit payments for the years ending 2020 to 31 December 2024	**255**

v) Changes in fair value of defined benefit plan assets

For the year ended 31 December	2014 £m	2013 £m
Fair value of plan assets at 1 January	**1,410**	1,344
Interest income on plan assets	**61**	60
Return on plan assets (excluding amounts included in net interest on the defined benefit liability/asset)	**190**	21
Employer contributions	**23**	28
Benefits paid	**(45)**	(42)
Administrative expenses	**(1)**	(1)
Fair value of plan assets at 31 December	**1,638**	1,410

At 31 December 2014, there are no investments in internal linked funds (2013: £nil).

Notes to the consolidated accounts

9. Staff pension schemes continued

vi) Assets in the defined benefit scheme

As at 31 December	Fair value 2014 £m	Fair value 2013 £m
Equities	**224**	206
Liability-driven investment ("LDI") pools	**575**	400
Fixed interest (LDI in specie)	**152**	196
Other fixed interest	**40**	–
Insured assets	**611**	586
Cash	**36**	22
Total fair value of plan assets	**1,638**	1,410
Present value of defined benefit obligations	**(1,579)**	(1,414)
Surplus/(deficit) in the scheme	**59**	(4)

All equities and fixed interest (LDI in specie) investments are quoted in an active market.

vii) Future funding

As stated in section (b), a deficit reduction plan was entered into during January 2013 based on the triennial valuation as at 30 September 2011, which showed a deficit on a funding basis of £185 million. That plan set out a new schedule of deficit reduction contributions of £175 million, commencing with payments of £3 million in 2013, in addition to the £20 million agreed under the previous deficit reduction plan. A further payment of £21.5 million was made in July 2014, the first of a series of eight annual payments totalling £172 million.

The next triennial valuation is being carried out and the valuation, once agreed, will assist in developing an updated funding plan and funding documents.

The scheme was closed to new members on 1 July 2007 and was closed to active membership effective from 31 December 2012.

A Statement of Funding Principles was agreed by the Group and the Trustee in January 2013. That statement provides the principles around assumption setting, in particular, choosing the discount rate, future price inflation, future pension increases, rates of mortality, pension commencement age, and typical partner or dependant information and assumes:

- the discounted value of the annuity contract with Aviva Annuity will exactly match the discounted liabilities for pensioners insured under the contract. The pensions in payment up to 30 June 2013 have been reassured by the Trustees to Aviva Annuity under a buy-in annuity contract where assets backing the premium progressively transfer from the Trustee to Aviva Annuity over the duration of the contract; and
- the discounted value of non-insured liabilities will be measured using an interest rate swap curve plus a margin of 0.75%, reflecting an expected return on the scheme's other investments equivalent to swap yields, and the strategic allocation of 25% of the scheme's non-annuity investments in return-seeking assets.

In addition the Trustee has the following objectives for investments, as set out in the Statement of Investment Principles:

- to achieve and maintain a minimum funding level of 100% on a long-term ongoing basis; and
- to agree the cost of providing the benefits and consult the Employer on any material changes that may be required to the agreed funding arrangements in light of experience.

Notes to the consolidated accounts

9. Staff pension schemes continued

Amounts paid to FPPS in the past three years and expected future payments over the next two years are as follows:

	£m
FPPS (defined benefit) contributions paid	
2012	27
2013	23
2014[i]	23
FPPS contributions expected to be paid	
2015[i]	23
2016[i]	23

(i) Includes contributions of £1 million per annum towards non investment costs incurred within the scheme.

viii) Risk management

The present value of the scheme's obligations and the market value of assets are volatile with the values at any given date being dependent on financial market conditions at that date. A number of steps have been taken to minimise the relative volatility of the scheme's obligations and the market value of assets when determining the investment strategy. The scheme's assets, which are administered by investment managers and insurers appointed by the Trustee, are held under the control of the Trustee and are used to secure benefits for the members of the scheme and their dependants in accordance with the Trust Deed and Rules. The Trustee Board consists of a chairman who is appointed by the Employer and six additional directors of which three are employer-appointed directors and three are member-nominated trustee directors.

The Trustee operates an Investment and Funding Committee ("IFC") and an Operations Committee responsible for assisting the Trustee in investment policy and monitoring the scheme's investments. The Trustee and its committees seek advice from the investment adviser, the funding adviser, the covenant adviser and the legal adviser and believe they have sufficient skills and expertise to make decisions taking into account this advice.

The Trustee sets general investment policy but delegates day-to-day responsibility for the selection of specific investments (other than investments in respect of members' voluntary contributions) to the Investment Manager.

The Trustee has set performance and risk targets for the Investment Manager on non-insured assets. The performance objectives are long-term (five years), however, the Trustee monitors the Investment Manager on a regular basis in order to ensure that it is on track to meet its long-term objectives.

Interest rate and inflation risk

The Trustee has invested in an insured bulk annuity buy-in contract that covers pensions in payment up to 30 June 2013. The buy-in contract covers market and longevity risk in addition to interest rate and inflation risk.

For non-insured liabilities, the Trustee adopts an LDI strategy to reduce exposure to interest rate and inflation risk. The LDI strategy is implemented through bespoke pooled and segregated arrangements managed by F&C Management Limited ("F&C"), in which the Trustee is the sole investor. Under the bespoke arrangements, F&C manage fixed interest securities together with interest rate and inflation swaps that can, currently, have a duration of up to 50 years.

The allocation to matched assets, including the bespoke LDI arrangements, cash and fixed interest, is 75% of the non-insured assets.

Market risk

The Trustee, with the full support of the Group, has agreed and implemented a strategic asset allocation to return-seeking assets of 25% of the non-insured fund.

Longevity risk

The Trustee, with the full support and involvement of the Group, first invested in a bulk annuity contract with Aviva Annuity as a buy-in investment in 2008 with further tranches of investment in each of the years from 2009 to 2013. No more tranches will be placed under the 2008 contract. The contract reassured benefits for pensions in payment up to 30 June 2013.

Notes to the consolidated accounts

9. Staff pension schemes continued

Currency risk

The Trustee has some exposure to currency risk where assets are invested by the appointed managers in global equities or non UK securities. The managers appointed by the Trustee take account of currency risks within their pooled fund vehicles or segregated mandates.

Operational risk

The investment managers do not directly hold the scheme's securities for non-insured assets. These non-insured assets are held in separate accounts with custodians, as appointed by the Investment Manager for pooled vehicles or by the Trustee for non-pooled investments.

d) Other pension arrangements

Contributions to the defined contribution schemes were as follows:

For the year ended 31 December	2014 £m	2013 £m
Group Personal Pension Plan	**18.5**	17.1
FPIL	**1.5**	1.2
SBG	**0.9**	0.7

On 1 January 2013, the Group set up a defined contribution arrangement for UK employees as part of the "My Money" savings and investments platform, called the Flexible Retirement Account ("FRA"). Employer contributions are typically in the range of 6.3% to 13% depending on contribution levels selected by members and the arrangement has a minimum employer plus member contribution level of 9.3% of pensionable salary (basic annual salary up to a defined earnings cap). The FRA has been used for auto-enrolment from the Group's UK staging date of July 2013 and each member has their own personal pension.

10. Share-based payments

The Group offers share-based payment plans to certain key employees. The expense charged to the income statement is based on the fair value of the options granted, the vesting period and the vesting conditions. Fair values are determined using stochastic and scenario-based modelling techniques where appropriate.

For equity-settled schemes, the fair value is determined at grant date and expensed on a straight-line basis over the vesting period in the income statement. A corresponding amount is credited to equity. At each reporting date the Group revises its estimates of the number of shares that are expected to be issued for the achievement of non-market related performance conditions: the impact of any revisions are recognised in the income statement, with a corresponding adjustment to equity over the remaining vesting period. Where a leaver is entitled to their scheme benefits, this is treated as an acceleration of vesting and hence a shortening of the period over which the expense is charged.

For cash-settled schemes, the fair value is expensed on a straight-line basis over the vesting period in the income statement and the cumulative provision for obligations under cash-settled schemes is recognised as a liability in the statement of financial position. The fair value is remeasured at each reporting date, with any changes in fair value recognised in the income statement for the period.

Friends Life Group

Description of the schemes

i) Friends Life Group plc Long Term Incentive Plan ("FLG LTIP")

The scheme was introduced in 2010 as a cash-settled share-based payment scheme, and was modified in May 2013 in order to continue to properly incentivise the Group's senior executives following the change in the Group's strategy, as announced in August 2012. The FLG LTIP terms were amended so that the implicit need for an exit event was replaced with a market value based calculation to measure performance without altering the required internal rate of return of 12%.

As part of the modification, the obligation to settle the scheme passed from the Company to FLGL. The change to the scheme was accounted for as a modification under IFRS 2: *Share-based payment*. The modified scheme is an equity-settled scheme, settled in three tranches of shares in FLGL over 2014 to 2016.

Notes to the consolidated accounts

10. Share-based payments continued

The scheme has been valued using economic scenario generators ("ESGs"), with key inputs as follows:

Volatility: 28%

Risk-free rate: 0.61% – 0.81%

Dividend yield: 7%

The terms of the FLG LTIP provide share awards if a certain market price is achieved at 30 June 2014, 30 June 2015 and 30 June 2016. The target market price was not achieved and no shares were awarded in 2014. The number of awards issued in the period was nil, 3,031 lapsed and 900 were forfeited before pro-rating (2013: 2,600 issued, nil lapsed and 450 forfeited). At 31 December 2014 there were 6,144 awards in issue before pro-rating (2013: 10,075). Awards are pro-rated according to service period. The pro-rated number of awards in issue at 31 December 2014 was 4,033 (2013: 6,354). An expense charge of £(1) million (2013: £(1) million) has been recognised in the consolidated income statement with a corresponding increase in equity included in the consolidated statement of financial position.

ii) Deferred Share Award Plan ("DSAP")

Certain key members of management have one-third of any annual bonus deferred into shares in FLGL for a period of three years. The awards are accounted for as equity-settled schemes. The fair value of these schemes is calculated at each grant date based on the unadjusted share price at the grant date multiplied by the number of shares awarded and the expense charge is recognised over the course of the vesting period.

New awards were granted on 7 April 2014; 776,339 shares were granted with a fair value of £2 million.

A charge of £(1) million (2013: £(1) million) has been recognised in the consolidated income statement in respect of these schemes with a corresponding increase in equity included in the consolidated statement of financial position.

iii) Contractual share awards

Certain directors are entitled to cash and shares in FLGL to compensate them for awards they forfeited from their previous employer as a result of joining. The share elements of these awards are treated as cash-settled schemes. The fair value of these schemes is estimated at the grant date and is recognised over the course of the vesting periods.

A charge of £(1) million (2013: £(1) million) has been recognised in the consolidated income statement in respect of these schemes with a corresponding increase in liabilities included in the consolidated statement of financial position.

iv) Friends Life Group Limited Performance Share Plan ("PSP")

The PSP was approved at the AGM on 8 May 2014 and awards were granted by FLGL on 16 May 2014. The aim of the plan is to incentivise the executives to increase the market value of FLGL over the longer term. It is accounted for as an equity-settled scheme.

Awards were granted subject to performance conditions which must be met for awards to vest: Total Shareholder Return ("TSR"), Embedded Value ("EV") and Total Group Free Surplus Generated ("FSG"), with 50%, 25% and 25% respectively of shares vesting if the performance targets are achieved. It is not necessary for all targets to be met for the shares to vest as each performance condition applies separately to the portion of the award to which it relates. All performance conditions will be measured over a three year period. The TSR performance period commenced on the grant date and the EV and FSG performance periods commenced on 1 January 2014.

For each of the three elements of the award to vest, the Remuneration Committee must be satisfied that:

- the Group's general financial performance over the vesting period is reflective of the above three conditions; and
- there have been no material risk failings within the Group during the vesting period.

50% of any shares awarded will vest on the third anniversary of the grant date; the remaining 50% of shares awarded will vest on the fourth anniversary of the grant date.

The fair value of the TSR is calculated at grant date with the expense charge recognised over the course of the vesting period. The fair values of the non-market elements (EV and FSG) are reassessed at each reporting date with any revisions to the expense charge recognised over the course of the remaining vesting period.

The number of shares over which awards were granted at grant date was 1,877,718 with a fair value of £3 million. A further award of over 35,560 shares was made during the year, nil have lapsed and 45,862 have been forfeited.

A charge of £(1) million has been recognised in the consolidated income statement in respect of the plan with a corresponding increase in equity included in the consolidated statement of financial position.

Notes to the consolidated accounts

10. Share-based payments continued

Sesame Bankhall Group

Description of the scheme

Key management of SBG were incentivised through a cash-settled scheme that entitled them to a share in the growth of SBG via ownership of shares in Friends Life Distribution Limited ("FLDL"), the immediate parent of the SBG companies. During the course of 2013 the scheme was settled via the purchase of management's shares in FLDL by Friends Provident Distribution Holdings Limited for approximate aggregate consideration of £4 million, with the potential for further contingent consideration being payable to certain ex-management shareholders in the future depending on the value generated by the SBG companies. As at 31 December 2014 it was determined that no provision was required in relation to the contingent future consideration payable.

Lombard International Assurance SA

Description of the scheme

Lombard senior management were incentivised through a Group equity-settled scheme that entitled them to share in the growth in value of Lombard. The scheme was closed prior to the disposal of the Lombard business. No shares were awarded to Lombard management during 2014.

A charge of £(1) million (2013: £(2) million) has been recognised in the consolidated income statement in respect of the scheme prior to its closure, with a corresponding increase in equity included in the consolidated statement of financial position.

11. Finance costs

Interest expense is calculated using the effective interest rate method.

For the year ended 31 December	2014 £m	Restated 2013 £m
Subordinated loan interest	**86**	87
Interest payable to reinsurers	**36**	47
Interest payable to credit institutions	**9**	7
Total finance costs	**131**	141

Interest payable to reinsurers represents payments in relation to a reinsurance treaty as detailed in note 32.

12. Taxation

Current tax is based on profits and income for the period as determined in accordance with the relevant tax legislation, together with adjustments to provisions for prior periods.

Tax payable is calculated using tax rates that have been enacted or substantively enacted by the reporting date.

The tax charge is analysed between tax in respect of income and investment return on the policyholders' interest in the with-profits and linked fund assets, representing policyholders' tax, with the balance being tax on equity holders' investment return and profits, representing shareholders' tax.

Deferred tax is recognised in the income statement for the period, except to the extent that it is attributable to items that are recognised in the same or a different period outside the income statement, in which case the deferred tax will be recognised in other comprehensive income or equity, as applicable.

Notes to the consolidated accounts

12. Taxation continued

a) Tax recognised in the consolidated income statement

For the year ended 31 December	2014 £m	Restated 2013 £m
Current tax		
UK corporation tax at 21.5% (2013: 23.25%)	**61**	6
Adjustments in respect of prior periods	**(39)**	(6)
Overseas tax	**26**	15
Total current tax charge	**48**	15
Deferred tax		
Origination and reversal of temporary differences	**100**	266
Change in tax rates	**–**	(70)
Recognition of deferred tax assets previously unrecognised	**(5)**	(50)
Adjustments in respect of prior periods	**(9)**	–
Total deferred tax charge	**86**	146
Total tax charge	**134**	161
Analysis:		
Policyholder tax	**222**	334
Shareholder tax	**(88)**	(173)
Total tax charge	**134**	161

Legislation was enacted in 2013 to reduce the rate of corporation tax to 21% from 1 April 2014 and 20% from 1 April 2015. Under IFRS, deferred tax is calculated using rates substantively enacted by the reporting date and as such the reduction to a 20% rate has been taken into account in deferred tax balances. In 2014, the average rate of corporation tax for the full calendar year is 21.5%.

b) Factors affecting tax charge for year

For the year ended 31 December	2014 £m	Restated 2013 £m
Profit before tax from continuing operations	**88**	441
Profit before tax from continuing operations determined with reference to the average rate of corporation tax in the UK of 21.5% (2013: 23.25%)	**19**	102
Effects of:		
– non-taxable income	**(85)**	(94)
– deductions not allowable for tax purposes	**11**	(9)
– overseas tax	**4**	(6)
– valuation of tax assets and liabilities	**(18)**	(49)
– adjustments in respect of prior periods	**(31)**	(21)
– impact of reduction in corporation tax rate to 20% on deferred tax asset/liability	**–**	(70)
– policyholder tax	**222**	334
– other	**12**	(26)
Total tax charge	**134**	161

Notes to the consolidated accounts

13. Appropriations of profit

Dividends approved by ordinary shareholders are recognised as a liability on the date of approval and dividends declared by directors are recognised on the date of payment. Dividends are charged directly to equity. Dividends declared after the balance sheet date are not accrued in these accounts.

The STICS are accounted for as equity instruments under IFRS, as there is no requirement to settle the obligation in cash or another financial asset. Consistent with this equity classification, interest on these instruments is not treated as an expense but as an appropriation of profit, charged directly to equity, together with the related tax relief.

	2014 **£m**	2013 £m
Ordinary dividends declared and charged to equity in the period:		
Interim 2014 – 50.48 pence per share, paid on 31 October 2014	**260**	n/a
Interim 2014 – 19.42 pence per share, paid on 30 September 2014	**100**	n/a
Interim 2013 – 48.54 pence per share, paid on 27 March 2014	**250**	n/a
Interim 2013 – 19.42 pence per share, paid on 30 September 2013	**n/a**	100
Interim 2012 – 48.54 pence per share, paid on 26 March 2013	**n/a**	250
Total dividends	**610**	350
Interest on 2003 STICS (coupon rate 6.875%)	**14**	14
Interest on 2005 STICS (coupon rate 6.292%)	**17**	17
Total appropriations of profit	**641**	381

The directors are recommending an interim dividend of £250 million to be paid in March 2015. This amount is not reflected in these financial statements.

As required by IAS 10: *Events after the reporting period*, dividends declared after the reporting date are not accrued in these accounts.

Interest on the 2003 STICS is paid in equal instalments in May and November each year at a rate of 6.875%. Interest on the 2005 STICS is paid annually in either June or July at a rate of 6.292%.

Notes to the consolidated accounts

14. Intangible assets

Goodwill

Goodwill arising on business combinations is the future economic benefit arising from assets that are not capable of being individually identified and separately recognised. After initial recognition, goodwill is stated at cost less any accumulated impairment losses, with the carrying value being reviewed for impairment at least annually and whenever events or changes in circumstances indicate that the carrying value may be impaired.

For the purpose of impairment testing, goodwill is allocated to the related CGUs. Where the recoverable amount of the CGU is less than its carrying amount, including the related goodwill, an impairment loss is recognised in the income statement.

In a business combination, where the purchase consideration is lower than the fair value of the net assets acquired, a gain on acquisition arises, sometimes referred to as negative goodwill. Such a gain on acquisition is recognised in the income statement in the period in which it arises.

AVIF

On acquisition of a portfolio of insurance contracts and/or investment contracts, either directly or through the acquisition of a subsidiary undertaking, the net present value of the Group's interest in the expected pre-tax cash flows of the in-force business is capitalised in the statement of financial position, using a MCEV methodology.

AVIF is amortised over the anticipated lives of the related contracts which typically vary between five years and 35 years, with the amortisation profile being in accordance with expected profit emergence from the contracts. Any changes in estimated useful lives are accounted for prospectively with the effect of the change being recognised in the current and future periods, if relevant.

Other intangible assets

Customer relationships, distribution relationships and brands acquired are capitalised at cost, being the fair value of the consideration paid. Software is capitalised on the basis of the costs incurred to acquire and bring it into use.

These intangible assets have finite useful lives and are consequently carried at cost less accumulated amortisation and impairment. Any changes in estimated useful lives are accounted for prospectively with the effect of the change being recognised in the current and future periods, if relevant. Amortisation is calculated using the straight-line method to allocate the cost over the estimated useful lives of the intangible assets with ranges as shown below:

	Years
Customer relationships	8 – 12
Distribution relationships	5 – 10
Brands	10 – 15
Computer software	3 – 4

Intangible assets relating to customer relationships and distribution channels have been valued using an income approach method, specifically the Multi-period Excess Earnings Method ("MEEM"). The principle behind the MEEM is that the value of an intangible asset is equal to the present value of the after tax cash flows attributable only to that intangible asset. Other intangibles include in-house developed IT systems and databases which have been valued using a replacement cost approach which assesses the cost of reproducing the equivalent technology in its current form.

Subsequent expenditure on other intangible assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

Impairment testing

All identifiable intangible assets are reviewed at each reporting date, or where impairment indicators are present, to assess whether there are any circumstances that might indicate that they are impaired. If such circumstances exist, impairment testing is performed and any resulting impairment losses are charged to the consolidated income statement.

For the purpose of impairment testing, goodwill and AVIF are allocated to the CGU, which represents the lowest level within the Group at which the intangible assets are monitored for internal management purposes.

AVIF is tested for impairment by comparing the carrying amount with its recoverable amount. The calculation of the recoverable amount is consistent with the measurement methodology for AVIF at initial recognition and is based on the current MCEV VIF balance for pre-acquisition business only, adjusted for differences between the IFRS and MCEV measurement basis for other net assets. The assumptions underpinning the Group's MCEV basis of reporting are provided in the MCEV supplementary information disclosed in the FLGL Report and Accounts.

Notes to the consolidated accounts

14. Intangible assets continued

Movements in intangible assets are as follows:

For the year ended 31 December 2014	AVIF £m	Other £m	Total £m
Cost			
At 1 January 2014	**5,520**	**560**	**6,080**
Additions	**–**	**1**	**1**
Foreign exchange adjustments	**(23)**	**(6)**	**(29)**
Transferred to operations classified as held for sale	**(576)**	**(153)**	**(729)**
At 31 December 2014	**4,921**	**402**	**5,323**
Amortisation and impairment			
At 1 January 2014	**1,893**	**332**	**2,225**
Amortisation charge for the year(i)	**324**	**60**	**384**
Impairment charge for the year(i)(ii)	**–**	**6**	**6**
Foreign exchange adjustments	**(11)**	**(5)**	**(16)**
Transferred to operations classified as held for sale	**(271)**	**(115)**	**(386)**
At 31 December 2014	**1,935**	**278**	**2,213**
Carrying amounts at 31 December 2014	**2,986**	**124**	**3,110**

For the year ended 31 December 2013	AVIF £m	Other £m	Total £m
Cost			
At 1 January 2013	5,505	560	6,065
Additions	–	4	4
Disposals(iii)	–	(8)	(8)
Foreign exchange adjustments	15	4	19
At 31 December 2013	5,520	560	6,080
Amortisation and impairment			
At 1 January 2013	1,497	247	1,744
Amortisation charge for the year(i)	381	91	472
Impairment charge for the year(i)(ii)	11	–	11
Disposals(iii)	–	(8)	(8)
Foreign exchange adjustments	4	2	6
At 31 December 2013	1,893	332	2,225
Carrying amounts at 31 December 2013	3,627	228	3,855

(i) Amortisation and impairment charges on continuing operations are included within administrative and other expenses in the consolidated income statement. Amortisation for the year of £(36) million relating to Lombard is included within loss after tax from discontinued operations in the consolidated income statement.

(ii) Impairment in 2014 of £(6) million related to intangible assets in SBG and reflects the ongoing strategic review of that business unit. AVIF impairment in 2013 of £(11) million has been recognised within OLAB as a result of worsening persistency.

(iii) Disposals in 2013 related to the sale of fully amortised software of £(8) million.

AVIF is shown gross of policyholder and shareholder tax of £544 million (2013: £693 million), with the offsetting balance included in deferred taxation.

Notes to the consolidated accounts

14. Intangible assets continued

i) AVIF

An analysis of AVIF by operating segment used for segmental reporting is set out below. The 2013 comparatives have been restated following the transfer of OLAB to Heritage in January 2014, as explained in note 3.

As at 31 December 2014	**Cost £m**	**Amortisation and impairment £m**	**Net book value £m**
UK	**896**	**(339)**	**557**
Heritage	**3,113**	**(1,176)**	**1,937**
FPI	**912**	**(420)**	**492**
Total	**4,921**	**(1,935)**	**2,986**

As at 31 December 2013	Cost £m	Amortisation and impairment £m	Net book value £m
UK	896	(291)	605
Heritage – restated	3,113	(991)	2,122
FPI – restated	912	(351)	561
Lombard	599	(260)	339
Total	5,520	(1,893)	3,627

ii) Other intangibles

Other intangibles are made up of the following:

As at 31 December 2014	**Cost £m**	**Amortisation and impairment £m**	**Net book value £m**
Customer and distribution relationships	**314**	**(191)**	**123**
Brand	**37**	**(36)**	**1**
Software	**39**	**(39)**	**–**
Goodwill	**12**	**(12)**	**–**
Total	**402**	**(278)**	**124**

As at 31 December 2013	Cost £m	Amortisation and impairment £m	Net book value £m
Customer and distribution relationships	444	(237)	207
Brand	49	(37)	12
Software	55	(46)	9
Goodwill	12	(12)	–
Total	560	(332)	228

As at 31 December 2013 other intangibles of £54 million (£41 million customer and distribution relationships; £4 million brand; £9 million software) related to Lombard.

Notes to the consolidated accounts

14. Intangible assets continued

iii) Impairment

During 2014 an impairment charge of £6 million was recognised (£5 million in respect of customer and distribution relationships and £1 million in respect of brand) relating to SBG. This impairment charge (which has reduced the value of the Sesame intangibles to £nil) reflects the outcomes identified to date from the ongoing strategic review of that business unit. Apart from this impairment charge, as at 31 December 2014, based on an impairment review of each of the CGUs, the directors are satisfied that none of the Group's intangible assets are impaired.

Following an impairment review at 31 December 2013, an impairment charge of £11 million was recognised in respect of the OLAB operation which was transferred from FPI to Heritage in January 2014. The impairment charge of £11 million was based on a recoverable amount of £25 million for OLAB AVIF. The calculation of the recoverable amount is based on value in use, determined from the current MCEV VIF balance for pre-acquisition business only, adjusted for differences between the IFRS and MCEV measurement basis for other net assets.

15. Property and equipment

Owned assets

Land and buildings are initially recognised at cost and subsequently measured at fair value. Revaluations are performed annually by independent valuers, who hold a recognised and relevant professional qualification and have recent experience in the location and category of properties being valued. Valuations are performed with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair values at the balance sheet date. The fair value is the amount for which a property could be exchanged between knowledgeable and willing parties in an arm's length transaction.

Properties occupied by the Group are held at fair value, based on highest and best use, measured at the date of revaluation. Revaluation surpluses, and their reversal, are recognised in the statement of other comprehensive income. Revaluation losses, and their reversal, are recognised in the income statement.

Equipment is recognised at cost less accumulated depreciation and impairment losses.

Depreciation

Depreciation is charged so as to write off the cost of certain assets net of the estimated residual value, using the straight-line method, over the estimated useful life of the asset, as follows:

	Years
Computer hardware and related software	1 – 4
Fixtures, fittings and office equipment	3 – 10

Residual values and useful lives are reviewed at each financial year end and adjusted if appropriate. Any changes in estimated useful lives are accounted for prospectively with the effect of the change being recognised in the current and future periods, if relevant.

Disposal and derecognition

An item of property and equipment is derecognised upon disposal or when no further future economic benefits are expected from its use. Any gain or loss arising on derecognition of the asset is included in the income statement in the year the asset is derecognised.

Any revaluation reserve relating to the particular asset being disposed of or no longer in use is transferred to retained earnings.

Notes to the consolidated accounts

15. Property and equipment continued

For the year ended 31 December 2014	Owner-occupied properties £m	Computer equipment £m	Fixtures, fittings and office equipment £m	Total £m
Fair value/cost				
At 1 January 2014	**40**	**9**	**19**	**68**
Additions	**–**	**–**	**1**	**1**
Disposals	**(5)**	**–**	**–**	**(5)**
Transferred to operations classified as held for sale	**–**	**–**	**(4)**	**(4)**
At 31 December 2014	**35**	**9**	**16**	**60**
Depreciation				
At 1 January 2014	**–**	**8**	**10**	**18**
Depreciation charge	**–**	**–**	**2**	**2**
Transferred to operations classified as held for sale	**–**	**–**	**(4)**	**(4)**
At 31 December 2014	**–**	**8**	**8**	**16**
Carrying amounts at 31 December 2014	**35**	**1**	**8**	**44**

For the year ended 31 December 2013	Owner-occupied properties £m	Computer equipment £m	Fixtures, fittings and office equipment £m	Total £m
Fair value/cost				
At 1 January 2013	40	9	17	66
Additions	–	–	2	2
At 31 December 2013	40	9	19	68
Depreciation				
At 1 January 2013	–	6	7	13
Depreciation charge	–	2	3	5
At 31 December 2013	–	8	10	18
Carrying amounts at 31 December 2013	40	1	9	50

If owner-occupied properties were measured on a cost basis, the carrying amount would be £41 million (2013: £49 million).

16. Investment properties

Investment properties comprise land and/or buildings that are not occupied by the Group and are held either to earn rental income or for capital appreciation, or for both.

Investment properties are initially included in the balance sheet at cost and subsequently measured at fair value, at least annually at the reporting date. Fair values, based on highest and best use, are measured by external independent valuers, who hold a recognised and relevant professional qualification and have recent experience in the location and category of the investment property being valued.

Movements in the fair value of investment properties are taken to the income statement in the period in which they arise.

In accordance with IAS 17: *Leases* properties held by the Group under operating leases are classified as investment properties when the properties otherwise meet the definition of investment properties.

Notes to the consolidated accounts

16. Investment properties continued

For the year ended 31 December	2014 £m	2013 £m
At 1 January	**2,561**	2,735
Purchases	**53**	45
Disposals	**(214)**	(265)
Fair value adjustments	**290**	46
At 31 December	**2,690**	2,561

Of the total, £1,316 million (2013: £1,259 million) is held in with-profits funds and £1,374 million (2013: £1,302 million) in unit-linked funds. The majority of the investment properties held in the with-profits and unit-linked funds are leased out under operating leases in order to generate a rental income to match policyholder liabilities.

Future minimum lease payments receivable under non-cancellable operating leases are as follows:

For the year ended 31 December	2014 £m	2013 £m
Due in the period:		
Not later than one year	**126**	140
Later than one year and not later than five years	**393**	458
Later than five years	**569**	633
Total	**1,088**	1,231

17. Principal Group undertakings

Subsidiaries are investees which the Group controls. An investor controls an investee when it has exposure, or has rights, to variable returns from involvement with the investee and has the ability to affect those returns through its power over the investee. Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are deconsolidated from the date on which control ceases. Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

The Group controls some structured entities. These are entities that have been designed so that the voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights generally relate to administrative tasks only and the relevant activities are directed by means of contractual relationships. Structured entities often have restricted activities and narrow, well-defined objectives. Examples can include investment funds, such as OEICs and some private equity investments, and asset-backed securities ("ABS").

Principal subsidiary undertakings of the Group as at 31 December 2014 are shown below.

Unless otherwise stated, they are undertakings incorporated and registered in England and Wales and have only one class of issued ordinary shares. The voting rights are equal to the percentage holdings unless otherwise stated.

In addition to the companies shown below, the Company also holds investments in a number of other subsidiary undertakings, which in the directors' opinion do not significantly affect the consolidated financial statements. The Company is the principal UK holding company of the Group and a full list of its subsidiaries will be annexed to the Company's annual return filed at Companies House.

On 30 October 2014 the Group disposed of its interest in Lombard International Assurance SA, a subsidiary undertaking incorporated in Luxembourg. Refer to note 3(c) for further details.

Notes to the consolidated accounts

17. Principal Group undertakings continued

Subsidiary undertaking	Activity	% held
Corporate		
Friends Life FPG Limited(i) ("FPG")	Holding company	100
Friends Life FPL Limited(ii)	Holding company	100
Life and pensions		
Friends Annuities Limited ("FAL")	Insurance	100
Friends Life Limited(iii)	Insurance	100
Friends Life and Pensions Limited ("FLPL")	Insurance	100
Friends Provident International Limited(iv)	Insurance	100
Friends Life Management Services Limited	Management services	100
Friends Life Services Limited	Management services	100
Other		
Friends Life Investments Limited(i)	Investment management	100
Sesame Bankhall Group Limited	Financial distribution business	100

(i) Held directly by the Company at 31 December 2014 (all other companies are held indirectly).
(ii) Company has both Ordinary and Deferred shares in issue.
(iii) Has a branch in Guernsey.
(iv) Incorporated in the Isle of Man. Company has both Ordinary A and Ordinary B shares in issue. Has branches in Hong Kong, Singapore and United Arab Emirates.

Certain Group subsidiaries are subject to restrictions on the amount of funds they may transfer in the form of cash dividends or otherwise to the parent company.

Under UK company law, dividends can only be paid if a UK company has sufficient distributable reserves to cover the dividend and UK insurance companies are required to maintain solvency margins in accordance with Prudential Regulation Authority ("PRA") rules.

FPIL may remit dividends to the Group, provided it has sufficient distributable reserves and capital resources exceed the capital requirements required under local regulatory regulations of the countries in which the company operates.

Note 29 includes details of the principal regulatory and intra-group arrangements restricting availability of capital.

Funds invested in private equity vehicles are generally returned through distributions of income and capital. Immediate access to these funds can be restricted and may require the disposal of illiquid assets at a discount. Total net assets of consolidated private equity vehicles at 31 December 2014 are £795 million (31 December 2013: £1,012 million).

All OEICs consolidated by the Group are structured entities. There are no other contractual arrangements that could require a Group entity to provide financial support to these structured entities. The Group has not provided any support in the period and there are no current intentions to provide support.

Notes to the consolidated accounts

18. Financial assets

The Group classifies its financial assets at fair value through profit or loss or as loans at amortised cost.

Financial assets at fair value through profit or loss comprise assets which are designated as such on initial recognition, as they are managed individually or together on a fair value basis, and derivatives, which are classified as held for trading in accordance with IAS 39: *Financial instruments: recognition and measurement.*

The fair value on initial recognition is generally the consideration given, excluding any transaction costs directly attributable to their acquisition which are expensed. Movements in fair value are taken to the income statement as investment return in the period in which they arise. Financial assets carried at fair value are initially recognised at fair value and subsequently remeasured at fair value based on quoted bid prices, where such prices are available from a third party in a liquid market. If quoted bid prices are unavailable, the fair value of the financial asset is derived from cash flow or other models designed to reflect the specific circumstances of the issuer. Securities for which fair value cannot be measured reliably are recognised at cost less impairment.

Purchases and sales of financial assets are recognised on the date the Group commits to purchase or sell the asset, generally the trade date. A transfer of a financial asset is accounted for as a derecognition if substantially all of the assets' risks and rewards of ownership are transferred, or, control of the asset is transferred to a party external to the Group. Control is deemed to have been transferred if the transferee has a practical ability to sell the asset unilaterally without needing to impose additional restrictions on any subsequent transfer.

Loans are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans are measured on initial recognition at the fair value of the consideration given plus incremental costs that are incurred on the acquisition of the investment. Subsequent to initial recognition, loans are either measured at amortised cost less impairment losses or, if they meet the criteria for designation at fair value through profit or loss (such as the elimination of, or significant reduction in, accounting mismatches) and are so designated on initial recognition, they are measured at fair value.

The amortised cost is the present value of estimated future cash flows discounted at the effective interest rate at the date of acquisition or origination of the loan. Subsequent to initial recognition, any difference between cost and redemption value is amortised through the income statement over the life of the instrument. The carrying values of loans at amortised cost are reviewed for impairment in accordance with IAS 39 at each reporting date. If there is objective evidence of impairment, for example there is a default or delinquency in payment, the impairment loss is calculated and recognised.

The Group's financial assets are summarised by measurement category as follows:

As at 31 December	2014 £m	2013 £m
Fair value through profit or loss (note 18(a)):		
– Designated on initial recognition	**92,179**	108,791
– Held for trading	**588**	265
Loans at amortised cost (note 18(b))	**1**	8
Total financial assets	**92,768**	109,064

Notes to the consolidated accounts

18. Financial assets continued

a) Analysis of financial assets at fair value through profit or loss

As at 31 December 2014	**With-profits £m**	**Unit-linked £m**	**Non-linked annuities £m**	**Non-linked other £m**	**Shareholder £m**	**Total £m**
Shares and other variable yield securities	**6,081**	**48,951**	**–**	**109**	**2**	**55,143**
Debt securities and other fixed income securities:						
– Government securities	**6,837**	**7,240**	**3,010**	**697**	**28**	**17,812**
– Corporate bonds and loans at fair value	**6,693**	**2,513**	**8,082**	**1,278**	**649**	**19,215**
Derivative financial instruments	**479**	**13**	**80**	**5**	**11**	**588**
Deposits with credit institutions	**–**	**9**	**–**	**–**	**–**	**9**
Total financial assets held at fair value	**20,090**	**58,726**	**11,172**	**2,089**	**690**	**92,767**

As at 31 December 2013	With-profits £m	Unit-linked £m	Non-linked annuities £m	Non-linked other £m	Shareholder £m	Total £m
Shares and other variable yield securities	6,803	63,145	–	122	15	70,085
Debt securities and other fixed income securities:						
– Government securities	7,084	7,181	1,044	724	78	16,111
– Corporate bonds and loans at fair value	7,388	5,466	8,115	1,297	112	22,378
Derivative financial instruments	170	66	22	5	2	265
Deposits with credit institutions	–	217	–	–	–	217
Total financial assets held at fair value	21,445	76,075	9,181	2,148	207	109,056

Included within the unit-linked and with-profits assets are a total of £582 million (2013: £614 million) of financial assets relating to the non-controlling interests in the OEICs that have been consolidated as the Group is deemed to have control. These comprise £504 million of shares and other variable yield securities, £54 million of government securities and £24 million of corporate bonds (2013: £523 million of shares and other variable yield securities, £69 million of government securities and £22 million of corporate bonds).

For unit-linked funds, the policyholders bear the investment risk and any change in asset values is matched by a broadly equivalent change in the liability.

The majority of financial assets held are readily realisable, however amounts of £82,496 million (2013: £98,798 million) are not expected to be realised for more than 12 months after the reporting date in line with the expected maturity of insurance and investment contract liabilities.

ABS (excluding those held by the unit-linked funds) amount to £4,353 million (2013: £4,124 million) and 99% (2013: 98%) of these are at investment grade as set out in note 30.

b) Loans at amortised cost

As at 31 December	**2014 £m**	2013 £m
Mortgage loans	**–**	4
Other loans	**1**	4
Total loans	**1**	8

The fair value of loans is considered to be the same as their carrying value.

Notes to the consolidated accounts

18. Financial assets continued

c) Assets backing unit-linked liabilities

The carrying value of policyholder liabilities relating to unit-linked business is shown in note 29(b). These liabilities are classified as either insurance or investment contracts. The net assets backing these liabilities are included within the relevant balances in the Group's consolidated statement of financial position and are analysed as follows:

As at 31 December	2014 £m	2013 £m
Shares and other variable yield securities	**48,951**	63,145
Debt securities and other fixed income securities	**9,753**	12,647
Derivative financial instruments	**13**	66
Deposits with credit institutions	**9**	217
Total financial assets held at fair value	**58,726**	76,075
Investment properties	**1,374**	1,302
Insurance and other receivables	**191**	639
Cash and cash equivalents	**2,743**	4,783
Total assets	**63,034**	82,799
Net asset value attributable to unit-holders[(i)] and other payables	**(1,317)**	(1,655)
Total unit-linked net assets	**61,717**	81,144

(i) Represents non-controlling interests in respect of consolidated OEICs, which the Group is deemed to control.

d) Interests in unconsolidated structured entities

The following is a summary of the Group's interest in unconsolidated structured entities as included in the Group's consolidated statement of financial position at 31 December 2014 and classified as financial assets held at fair value through profit or loss.

As at 31 December	2014 £m
Shares and other variable yield securities:	
Unit trusts and other investment vehicles	**20,221**
Private equity	**258**
Debt securities and other fixed income securities:	
Loans	**248**
Asset-backed securities	**2,988**
Total	**23,715**

IFRS 12: *Disclosure of interests in other entities* is effective for the first time in 2014 and no comparative disclosure is required for interests in unconsolidated structured entities in the first year of application.

Outstanding commitments to private equity vehicles are £65 million.

There are no other contractual arrangements that could require a Group entity to provide financial support to these structured entities, the Group has not provided any support in the period and there is no current intention to provide support. The carrying amounts represent the Group's maximum exposure to loss from its interests in unconsolidated structured entities other than commitments to private equity vehicles.

The Group does not sponsor any unconsolidated structured entities.

Notes to the consolidated accounts

19. Fair values of assets and liabilities

In accordance with the requirements of IFRS 13: *Fair value measurement* assets and liabilities which are measured at fair value have been classified into three categories as set out below. Financial assets at fair value include shares and other variable yield securities, government securities, corporate bonds (including ABS and loans at fair value), derivative financial instruments and deposits with credit institutions. Financial liabilities at fair value include unit-linked investment contract liabilities, amounts due to reinsurers, net asset value attributable to unit-holders (non-controlling interest in the OEICs that are consolidated) and derivative financial instruments.

Level 1 – quoted prices (unadjusted) in active markets for identical assets. An active market is one in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis. Examples include listed equities and bonds in active markets and quoted unit trusts/OEICs.

Level 2 – inputs other than quoted prices included within level 1 that are observable for the asset, either directly (i.e. as prices) or indirectly (i.e. derived from prices). This category generally includes assets that are priced based on models using market observable inputs. Examples include certain corporate bonds, certificates of deposit and derivatives.

Level 3 – inputs for the assets that are not based on observable market data. Assets with single price feeds and/or limited trading activity are included in this category. Examples include unlisted equities, private equity investments and property.

The majority of the Group's assets held at fair value are valued based on quoted market information or market observable data. Approximately 6% (12% excluding unit-linked assets) of the Group's assets are based on valuation techniques where significant observable market data is not available (2013: 7% (11% excluding unit-linked assets)) or the price is not observable from current market transactions. However, the fair value measurement objective of these assets remains the same, that is, an exit price from the perspective of the Group.

The fair values of financial and non-financial assets are generally provided by external parties. During the year, the Group has performed independent reviews of pricing models to ensure that appropriate methodologies have been applied. The approach taken for each class of specific unlisted investment is as follows:

Corporate bond valuations are generally obtained from brokers and pricing services. Bond prices provided by pricing services are based on the best estimate of market price determined by market makers based on a variety of factors and are considered to be observable prices. In determining fair value, market makers will take into account transactions they have observed in identical or similar assets as well as movements in market indices and any other factors that they regard as relevant. In some cases, consensus prices have been based on fewer, and potentially more historic, transactions. Corporate bonds with single price feeds or limited trading activity are included in the level 3 category.

Exchange-traded derivatives are valued using active market prices. The values of over the counter derivative financial instruments are estimated by applying valuation techniques, using pricing models or discounted cash flow methods. Where pricing models are used, inputs – including future dividends, swap rates and volatilities – based on market data at the reporting date are used to estimate derivative values. Where discounted cash flow techniques are used, estimated future cash flows and discount rates are based on current market swap rates at the valuation date. Derivative financial instruments and amounts due to reinsurers are managed on the basis of net exposure, after taking into account related collateral, with fair value determined on the basis of the price of the net position.

Investment properties and properties occupied by the Group are measured at fair value at the reporting date. Fair values are measured by external independent valuers, using methods set out in the RICS Red Book. The valuations used are based on valuation techniques using multiples of future rental incomes. The rental multiples are based on multiples observed in recent similar transactions in the market. Key assumptions include occupancy and rental income.

Methods considered when determining fair values of unlisted shares and other variable yield securities include discounted cash flow techniques and net asset valuation. Regular checks are performed of tolerance levels for changes such as percentage movements in prices, excess movements and inter vendor price comparisons, where tolerance levels are pre-defined for security types.

The valuation of the holdings in private equity limited partnerships and companies is based on the most recent underlying valuations available at the reporting date as adjusted for contributions, distributions and known diminutions in value of individual underlying investments in the period since valuations were performed. The valuation technique is not supported by observable market values. Valuations of private equity holdings are prepared in accordance with International Private Equity and Venture Capital Board ("IPEV") guidelines.

The fair value of the investments in property limited partnerships is taken as the Group's appropriate share of the net asset value of the partnerships. The net asset value is based on the latest external market valuation of the underlying property investments, which is updated at least every six months. The valuation would be adjusted in the event of a significant market movement in the period between the last market valuation and the reporting date.

Notes to the consolidated accounts

19. Fair values of assets and liabilities continued

Loans are valued using a general discounted cash flow methodology, with the discount rates derived from the relevant risk-free curve and a credit spread curve. The valuation process is carried out by the investment manager and reviewed by management. All spreads are reviewed at least twice a year and will be recalibrated accordingly if they appear to be outliers relative to factors such as available market proxies and spreads of underlying securities.

Participation in investment pools mainly relates to property investments. Property is independently valued in accordance with the methods set out in the RICS Red Book at each year end.

The classifications of financial liabilities take into account the types of inputs used to determine the fair value measurements.

The Group has financial liabilities which contain DPF of £9,335 million (2013: £8,991 million) that form part of its with-profits funds. Products giving rise to these liabilities are mainly investment or pension contracts with a unitised with-profits element. The Group is unable to measure the fair value of these financial liabilities reliably due to the lack of a robust basis to measure the supplemental discretionary returns arising on with-profits contracts and because there is not an active market for such instruments. These liabilities have therefore been excluded from the fair value hierarchy analysis below. Investment contract non-unit reserves, relating primarily to deferral of front-end fees in the form of unfunded units, have also been excluded from the fair value hierarchy analysis.

An analysis of recurring non-financial assets, financial assets and liabilities held at fair value in accordance with the fair value hierarchy is set out below. The table shows both the total recurring non-financial assets, financial assets and liabilities and the total excluding unit-linked assets and liabilities, as shareholders have no direct exposure to profits or losses on unit-linked assets (other than through investment management and annual management fees).

a) Recurring fair value measurements

	Including unit-linked				Excluding unit-linked			
As at 31 December 2014	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**	**Total £m**	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**	**Total £m**
Non-financial assets held at fair value								
Investment properties	–	–	2,690	2,690	–	–	1,316	1,316
Owner-occupied property	–	–	35	35	–	–	35	35
Financial assets held at fair value								
Shares and other variable yield securities	47,355	6,471	1,317	55,143	5,275	43	874	6,192
Debt securities and other fixed income securities:								
– Government securities	17,802	10	–	17,812	10,568	4	–	10,572
– Corporate bonds and loans at fair value (including asset-backed securities)	13,931	3,312	1,972	19,215	11,938	2,813	1,951	16,702
Derivative financial instruments	42	546	–	588	32	543	–	575
Deposits with credit institutions	9	–	–	9	–	–	–	–
Total assets held at fair value	**79,139**	**10,339**	**6,014**	**95,492**	**27,813**	**3,403**	**4,176**	**35,392**
Financial liabilities held at fair value								
Unit-linked investment contracts	–	53,233	–	53,233	–	–	–	–
Net asset value attributable to unit-holders	589	–	–	589	4	–	–	4
Derivative financial instruments	55	323	–	378	27	319	–	346
Total liabilities held at fair value	**644**	**53,556**	**–**	**54,200**	**31**	**319**	**–**	**350**

There are no non-recurring fair value measurements at 31 December 2014.

Notes to the consolidated accounts

19. Fair values of assets and liabilities continued

	Including unit-linked				Excluding unit-linked			
As at 31 December 2013	Level 1 £m	Level 2 £m	Level 3 £m	Total £m	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Non-financial assets held at fair value								
Investment properties	–	–	2,561	2,561	–	–	1,259	1,259
Owner-occupied property	–	–	40	40	–	–	40	40
Financial assets held at fair value								
Shares and other variable yield securities	64,679	1,943	3,463	70,085	5,725	81	1,134	6,940
Debt securities and other fixed income securities:								
– Government securities	15,716	395	–	16,111	8,885	45	–	8,930
– Corporate bonds and loans at fair value (including asset-backed securities)	15,549	4,974	1,855	22,378	12,375	3,200	1,337	16,912
Derivative financial instruments	34	231	–	265	10	189	–	199
Deposits with credit institutions	217	–	–	217	–	–	–	–
Total assets held at fair value	96,195	7,543	7,919	111,657	26,995	3,515	3,770	34,280
Financial liabilities held at fair value								
Unit-linked investment contracts	–	72,682	–	72,682	–	–	–	–
Amounts due to reinsurers	–	1,580	–	1,580	–	1,580	–	1,580
Net asset value attributable to unit-holders	621	–	–	621	28	–	–	28
Derivative financial instruments	37	393	–	430	30	375	–	405
Total liabilities held at fair value	658	74,655	–	75,313	58	1,955	–	2,013

There are no non-recurring fair value measurements at 31 December 2013.

The Group's policy is to recognise transfers into and transfers out of levels 1, 2 and 3 as of the date the statement of financial position is prepared.

For the Friends Life Holdings plc £162 million subordinated debt due 2021, Friends Life Holdings plc £500 million subordinated debt due 2022 and the Friends Life Holdings plc US$575 million reset perpetual subordinated debt, the fair value measurements (as disclosed in note 31) are categorised as level 1.

b) Transfers between level 1 and level 2

As at 31 December 2014, £9,637 million (2013: £2,175 million) of corporate bonds, shares and other variable yield securities were transferred from level 1 to level 2 and £765 million (2013: £6,102 million) of corporate bonds, shares and other variable yield securities were transferred from level 2 to level 1. The transfers from level 1 to level 2 as at 31 December 2013 and 31 December 2014 include movements arising from refinements to the methodology under which shares and other variable yield securities are classified. Other movements between level 1 and level 2 reflect changes in market activity and in the availability of current quoted prices.

Notes to the consolidated accounts

19. Fair values of assets and liabilities continued

c) Level 3 assets

The following table shows a reconciliation of level 3 assets which are recorded at fair value.

	Investment property £m	Owner-occupied properties £m	Shares and other variable yield securities £m	Corporate bonds and loans at fair value (including ABS) £m	Total assets held at fair value £m
At 1 January 2014	**2,561**	**40**	**3,463**	**1,855**	**7,919**
Total gains/(losses) in consolidated income statement(i)	**290**	**–**	**(338)**	**121**	**73**
Purchases	**53**	**–**	**325**	**609**	**987**
Sales	**(214)**	**(5)**	**(428)**	**(397)**	**(1,044)**
Issues	**–**	**–**	**–**	**191**	**191**
Settlements	**–**	**–**	**–**	**(15)**	**(15)**
Net transfer (to)/from level 1 and level 2(ii)	**–**	**–**	**(202)**	**97**	**(105)**
Foreign exchange adjustments	**–**	**–**	**(57)**	**(18)**	**(75)**
Transferred to operations classified as held for sale(iii)	**–**	**–**	**(1,446)**	**(471)**	**(1,917)**
At 31 December 2014	**2,690**	**35**	**1,317**	**1,972**	**6,014**
Total unrealised gains/(losses) for the year included in profit or loss for assets held at 31 December 2014	**304**	**–**	**(89)**	**125**	**340**

	Investment property £m	Owner-occupied properties £m	Shares and other variable yield securities £m	Government securities £m	Corporate bonds and loans at fair value (including ABS) £m	Total assets held at fair value £m
At 1 January 2013	2,735	40	2,812	8	1,148	6,743
Total gains/(losses) in consolidated income statement(i)	46	–	(33)	–	(153)	(140)
Purchases	45	–	226	–	103	374
Sales	(265)	–	(221)	–	(93)	(579)
Issues	–	–	12	–	174	186
Settlements	–	–	–	–	(19)	(19)
Net transfer from/(to) level 1 and level 2(ii)	–	–	632	(8)	681	1,305
Foreign exchange adjustments	–	–	35	–	14	49
At 31 December 2013	2,561	40	3,463	–	1,855	7,919
Total unrealised gains/(losses) for the year included in profit or loss for assets held at 31 December 2013	47	–	26	–	(7)	66

(i) Gains and their reversal on owner-occupied properties are recognised in the consolidated statement of comprehensive income, losses and their reversal are recognised in the income statement within investment return. All other gains and losses on assets held at fair value are recognised in the income statement within investment return.

(ii) Amounts were transferred from level 1 and level 2 because of a lack of observable market data, resulting from a decrease in market activities for the securities. Amounts were transferred to level 1 and level 2 because observable market data became available for the securities.

(iii) Lombard assets were transferred to operations classified as held for sale as at 30 June 2014.

The Group's Securities Pricing Committee provides oversight of the valuation of securities, including the review of valuation methodologies, appropriateness of prices provided by external valuers, and fair value hierarchy disclosures made by the Group.

Notes to the consolidated accounts

19. Fair values of assets and liabilities continued

IFRS 13 requires the disclosure, where available, of quantitative information relating to significant unobservable inputs used to derive the valuation of investments classified within the fair value hierarchy as level 3. The majority of the Group's investments are valued by third parties, resulting in limited availability of unobservable inputs used. Available unobservable inputs are as follows:

- Corporate bonds and loans at fair value include £346 million (2013: £331 million) of private loans; credit rating assumptions, ranging between AA and CC, have been used to derive discounted cash flow values.
- Shares and other variable yield securities include private equity investments, £194 million (2013: £268 million) of which are valued using multiples of earnings before interest, tax, depreciation and amortisation ranging between 5 and 11.5.
- Investment properties have typically been valued based on equivalent rental multiples, ranging between 4 and 30.

d) Level 3 financial assets sensitivity analysis

	2014		2013	
As at 31 December	Carrying amount £m	Effect of reasonably possible alternative assumptions £m	Carrying amount £m	Effect of reasonably possible alternative assumptions £m
Unit-linked investments	464	–	2,847	–
Shares and other variable yield securities	874	175	1,134	227
Corporate bonds and loans at fair value (including asset-backed securities)	1,951	195	1,337	134
Total level 3 financial assets	3,289	370	5,318	361

For unit-linked investments, the policyholders bear the investment risk and any change in asset values is matched by a broadly equivalent change in the liability. Shareholder profits from annual management charges levied on such funds will, however, vary according to the change in asset values leading to some limited investment risk.

For shares and other variable yield securities, where there is no active market the price at year end could reasonably be expected to be higher or lower by approximately 20%.

For corporate bonds, it could reasonably be expected that the fair values could be higher or lower by approximately 10% to reflect changes in the credit ratings of the underlying bonds.

20. Deferred acquisition costs

Insurance and investment contracts with DPF

Acquisition costs comprise all direct and indirect costs arising from writing the contracts, which are incurred during a financial period. Acquisition costs are deferred and amortised over the life of the contracts where their recovery has not been reflected in the valuation of policyholder liabilities but only to the extent that they are recoverable from future margins.

The rate of amortisation of acquisition costs on such contracts is proportional to the future margins expected to emerge in respect of the related policies, over the life of those policies.

Investment contracts without DPF

Acquisition costs comprise all incremental costs that are directly related to the writing of the contract, which are incurred during a financial period, and are amortised on a straight-line basis over the lifetime of the contract if they are recoverable out of future margins.

For the year ended 31 December 2014	Insurance contracts £m	Investment contracts £m	Total £m
At 1 January	117	780	897
Incurred and deferred in the period	19	108	127
Amortisation and impairment	(36)	(83)	(119)
Transferred to operations classified as held for sale	–	(52)	(52)
At 31 December	100	753	853

Notes to the consolidated accounts

20. Deferred acquisition costs continued

For the year ended 31 December 2013	Insurance contracts £m	Investment contracts £m	Total £m
At 1 January	121	717	838
Incurred and deferred in the period	28	143	171
Amortisation and impairment(i)	(32)	(80)	(112)
At 31 December	117	780	897

(i) Includes an impairment charge of £(5) million in respect of the Heritage segment's OLAB operations.

Included in the carrying values above, £740 million (2013: £742 million) is expected to be recovered more than 12 months after the reporting date. Acquisition expenses that do not meet the criteria for deferral are expensed directly as incurred.

21. Reinsurance assets

The benefits to which the Group is entitled under its reinsurance contracts are recognised as reinsurance assets. Amounts recoverable from reinsurers are measured consistently with the amounts associated with the underlying insurance contracts that are being reinsured and in accordance with the terms of each reinsurance contract.

Contracts that do not give rise to a significant transfer of insurance risk to the reinsurer are considered financial reinsurance and are accounted for and disclosed in a manner consistent with financial instruments (see note 31 for further details).

For the year ended 31 December	**2014 £m**	2013 £m
At 1 January	**2,837**	3,153
Premiums(i)	**(1,000)**	595
Claims	**(672)**	(688)
Other movements(ii)	**66**	(223)
At 31 December	**1,231**	2,837

(i) On 24 November 2014 an existing reinsurance treaty was amended such that the investment risk was transferred back to the Group whilst the longevity risk continued to be reinsured. A reinsurance asset of £1.6 billion was derecognised at the amendment date. See note 32 for further details.

(ii) Other movements include changes in economic and non-economic assumptions.

No significant gain or loss arose on reinsurance contracts incepted in the year.

Included in the carrying values above, £971 million (2013: £2,565 million) is expected to be recovered more than 12 months after the reporting date.

22. Deferred tax assets and liabilities

Deferred tax is the tax expected to be payable or recoverable on temporary differences between the carrying amount of assets and liabilities in the financial statements and the corresponding tax basis used in the computation of taxable profit. This is accounted for using the balance sheet liability method and the amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of the assets and liabilities. The tax rates used are the rates that have been enacted or substantively enacted by the balance sheet date.

Deferred tax liabilities are recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable future profits will be available against which deductible temporary differences, being the carry forward of excess tax expenses and tax losses, can be utilised.

Deferred taxation is not recognised on the initial recognition of goodwill or an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss.

Notes to the consolidated accounts

22. Deferred tax assets and liabilities continued

a) Recognised deferred tax assets and liabilities

Deferred tax assets and liabilities are attributable to the following:

	2014			2013		
As at 31 December	Assets £m	Liabilities £m	Net £m	Assets £m	Liabilities £m	Net £m
Property and equipment	23	–	23	12	–	12
AVIF	–	(544)	(544)	–	(693)	(693)
Other intangible assets	–	(17)	(17)	–	(35)	(35)
Unrealised gains on investments	–	(520)	(520)	–	(581)	(581)
Employee benefits	30	–	30	38	–	38
Deferred acquisition costs	–	(11)	(11)	–	(14)	(14)
Tax value of recognised tax losses	151	–	151	389	–	389
Short-term temporary differences	–	(73)	(73)	–	(96)	(96)
Deferred tax assets/(liabilities)	204	(1,165)	(961)	439	(1,419)	(980)
Offset of deferred tax assets	(204)	204	–	(439)	439	–
Net deferred tax liabilities	–	(961)	(961)	–	(980)	(980)

At 31 December 2014, all of the deferred tax assets above (2013: £439 million) can be offset against deferred tax liabilities and are presented net in the consolidated statement of financial position.

b) Movement in deferred tax assets and liabilities

For the year ended 31 December 2014	At 1 January 2014 £m	Recognised in income[(i)] £m	Recognised in other comprehensive income £m	Foreign exchange £m	Transferred to operations classified as held for sale £m	At 31 December 2014 £m
Property and equipment	12	11	–	–	–	23
AVIF	(693)	57	–	3	89	(544)
Other intangible assets	(35)	9	–	–	9	(17)
Unrealised gains on investments	(581)	61	–	–	–	(520)
Employee benefits	38	(8)	–	–	–	30
Deferred acquisition costs	(14)	4	–	–	(1)	(11)
Tax value of recognised tax losses	389	(225)	–	–	(13)	151
Short-term temporary differences	(96)	17	10	–	(4)	(73)
Net deferred tax (liabilities)/assets	(980)	(74)	10	3	80	(961)

(i) This amount includes £12 million relating to Lombard that is included within loss after tax on discontinued operations.

Notes to the consolidated accounts

22. Deferred tax assets and liabilities continued

For the year ended 31 December 2013	At 1 January 2013 £m	Recognised in income £m	Recognised in other comprehensive income £m	Foreign exchange £m	At 31 December 2013 £m
Property and equipment	31	(20)	–	1	12
AVIF	(849)	159	–	(3)	(693)
Other intangible assets	(60)	26	–	(1)	(35)
Unrealised gains on investments	(279)	(302)	–	–	(581)
Employee benefits	5	(3)	36	–	38
Deferred acquisition costs	(42)	28	–	–	(14)
Tax value of recognised tax losses	339	50	–	–	389
Short-term temporary differences	(38)	(58)	–	–	(96)
Net deferred tax (liabilities)/assets	(893)	(120)	36	(3)	(980)

c) Unrecognised deferred tax assets and liabilities

As at 31 December 2014 the Group has £40 million (2013: £34 million) of unrecognised deferred tax assets in respect of tax losses to carry forward against future taxable profits or capital gains. Of the £40 million unrecognised deferred tax assets, £19 million (2013: £26 million) relate to trading losses, £12 million (2013: £nil) relate to non-trade loan relationship losses and the remaining £9 million (2013: £8 million) relate to capital losses. None of these losses have expiry dates.

No deferred tax assets have been recognised on these losses as there is currently no convincing evidence that future profits or capital gains will be available against which these losses can be utilised.

23. Insurance and other receivables

Insurance and other receivables are recognised when due and measured on initial recognition at the fair value of the amount receivable plus incremental costs. Subsequent to initial recognition, these receivables are measured at amortised cost using the effective interest rate method.

As at 31 December	**2014 £m**	2013 £m
Receivables arising out of direct insurance operations:		
– policyholders	**92**	91
– agents, brokers and intermediaries	**24**	36
Investment income receivables	**109**	132
Investments sold for subsequent settlement	**53**	103
Prepayments and accrued income	**468**	527
Other receivables	**134**	211
Total insurance and other receivables	**880**	1,100

Of the carrying value above, £20 million (2013: £39 million) is expected to be recovered more than 12 months after the reporting date. The carrying value of each item approximates to fair value.

Notes to the consolidated accounts

24. Cash and cash equivalents

Cash and cash equivalents include cash in hand, deposits held at call with banks and other short-term highly liquid investments with original maturities of three months or fewer. Where bank overdrafts with a right of set off are repayable on demand and form an integral part of cash management, such overdrafts are also included as a component of cash and cash equivalents.

As at 31 December	2014 £m	2013 £m
Bank and cash balances	**3,915**	5,007
Short-term deposits	**3,588**	4,523
Total cash and cash equivalents	**7,503**	9,530

The Group holds the following balances of cash and cash equivalents that are not available for use by shareholders:

As at 31 December	2014 £m	2013 £m
OEICs	**52**	85
Long-term funds	**5,850**	7,426
Total cash and cash equivalents not available for use by shareholders	**5,902**	7,511

25. Terms and conditions of insurance and investment contracts

The main types of insurance and investment contracts that the Group currently has in-force are life assurance and pensions. These contracts may include guarantees and options.

a) Life assurance

Protection business (other than whole life products): these insurance contracts consist mainly of regular premium term assurance, critical illness and income protection products which pay out a fixed amount (the sum assured) on ill health or death. The premium rate is usually guaranteed for the lifetime of the contract. For most policies this payout will be a single amount, whereas income protection products provide a regular income upon incapacity either for the length of illness or to the end of the contract if earlier, depending on the specific policyholder terms. Most contracts have no surrender value.

Endowments and whole life products: these insurance contracts both provide benefits upon death or, in the case of endowments, at a preset maturity date if earlier. These policies usually have a surrender value. The amount payable on death is subject to a guaranteed minimum amount. The maturity value usually depends on the investment performance of the underlying assets. For with-profits business, it is underpinned by a minimum guarantee, which may be increased by the addition of bonuses.

Single premium bonds: these are unit-linked or unitised with-profits investment contracts that have no maturity date. On death, the amount paid is 100%-105% of the value of the units. On surrender the value of units is paid, sometimes in the first few years less a surrender penalty. For with-profits contracts a final bonus may be payable on death or surrender, or if markets are depressed a market value reduction may be applied to surrender values.

b) Pensions

Individual and group pensions: these contracts generally provide a cash sum at retirement. If death occurs before retirement, they generally return the value of the fund accumulated or in some cases premiums paid are returned. Contracts with guaranteed cash and annuity options (see below) are defined as insurance contracts but in the absence of these guarantees products are normally defined as investment contracts.

Annuities in payment: these insurance contracts are typically single premium products which provide for a regular payment to the policyholder whilst they and/or their spouse are still alive. Payments are generally either fixed or increased each year at a specified rate or in line with the rate of inflation. Most contracts guarantee an income for a minimum period usually of five years, irrespective of death.

Notes to the consolidated accounts

25. Terms and conditions of insurance and investment contracts continued

c) Guarantees and options

The main guarantees and options included within the Group's insurance contracts are set out below. The majority of these arise within Friends Life FP With Profits Fund ("FP WPF"), Friends Life FPLAL With Profits Fund ("FPLAL WPF"), Friends Life FLC New With Profits Fund ("FLC New WPF"), Friends Life FLC Old With Profits Fund ("FLC Old WPF"), Friends Life FLAS With Profits Fund ("FLAS WPF"), Friends Life WL With Profits Fund ("WL WPF") and OLAB:

- guaranteed cash and annuity options: most conventional deferred annuity contracts have benefit options expressed in terms of cash and annuity payments with a guaranteed conversion rate, allowing the policyholder the option of taking the more valuable of the two at retirement;
- guarantees in respect of bonus additions: bonuses added to with-profits policies increase the guaranteed minimum benefit that policyholders are entitled to at maturity. These are set at a level that takes account of expected market fluctuations, such that the cost of the guarantee is generally met by the investment performance of the assets backing the policyholder liability. However in circumstances where there has been a significant fall in investment markets, the guaranteed maturity benefits may exceed asset shares and these guarantees become valuable to the policyholder. Also, for unitised with-profits policies, it is guaranteed that the value of units will not fall provided the policy is held until maturity or another guaranteed date, and for some older product classes, the value of units rises at a minimum guaranteed rate;
- guaranteed surrender bases: certain older products have a guaranteed basis for calculating surrender values. In all these cases the basis includes an element of final bonus which can be reduced or taken away. The effect of the guaranteed surrender basis is to extend the guarantee in respect of bonus additions so that they apply over an extended period and not just at the maturity date;
- guaranteed minimum pensions: certain policies secured by transfer values from pension schemes provide a guarantee that the pension at retirement will not be less than the GMP accrued as a result of contracting out of the State Earnings Related Pension Scheme or State Second Pension; and
- guaranteed return of premiums: certain pension contracts including OLAB contracts provide a guarantee for the return of premiums at maturity date. For some contracts the guarantee continues to apply when policies are paid-up.

26. Insurance contracts

Contracts under which the Group accepts significant insurance risk from another party (the policyholder), by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder, are classified as insurance contracts. Under IFRS 4: *Insurance contracts* insurance risk is risk other than financial risk. Financial risk is the risk of a possible future change in one or more of: a specified interest rate, security price, commodity price, foreign exchange rate, index of price or rates, a credit rating or credit index or other variable. Insurance contracts may also transfer some financial risk.

Once a policyholder contract has been classified as an insurance contract, it remains an insurance contract for the remainder of its lifetime, even if the insurance risk reduces significantly during this period. As a general guideline, the Group defines as significant insurance risk the possibility of having to pay benefits on the occurrence of an insured event that are more than 5% greater than the benefits payable if the insured event did not occur.

For operations conducted in the UK, insurance contract liabilities are calculated based on the relevant PRA rules contained in the Prudential Sourcebook for Insurers. For overseas operations, insurance contract liabilities are calculated on recognised actuarial principles, based on local regulatory requirements.

For conventional with-profits policies, the liabilities to policyholders include both declared and constructive obligations for future bonuses not yet declared (excluding the shareholders' share of future bonuses) and include the cost of options and guarantees measured on a market consistent basis. The basis of calculation does not recognise deferred acquisition costs, but allows for future profits of non-profit and unit-linked business written in the with-profits fund to be recognised.

The calculation of liabilities to policyholders for non-profit contracts includes explicit allowance for future expenses and allows for lapses where appropriate.

The value of unit-linked insurance contract liabilities includes provision for tax losses in the unit-linked funds whose benefit will ultimately accrue to policyholders.

Notes to the consolidated accounts

26. Insurance contracts continued

The Group applies shadow accounting in relation to certain insurance contract liabilities, which are supported by owner-occupied properties and overseas subsidiaries, on which unrealised gains and losses are recognised in the statement of other comprehensive income. Adjustments are made to the insurance contract provisions to reflect the movements that would have arisen if the unrealised gains and losses had been recognised in the income statement. The corresponding change in the value of these insurance contract liabilities is recognised in the consolidated statement of comprehensive income.

The Group carries out an annual liability adequacy test on its insurance contract liabilities less related deferred acquisition costs and other related intangible assets to ensure that the carrying amount of its liabilities is sufficient in light of estimated future cash flows. Where a shortfall is identified, an additional provision is made.

a) Changes in insurance contracts liabilities

The following table shows the movements in insurance contracts liabilities in the year:

For the year ended 31 December	2014 £m	2013 £m
At 1 January	**34,590**	37,232
Increase in liability from premiums	**1,517**	1,607
Release of liability due to recorded claims	**(3,710)**	(4,191)
Unwinding of discount	**409**	488
Change in assumptions:		
– Economic	**1,653**	(398)
– Non-economic	**(147)**	(66)
Other movements including net investment return	**1,438**	(82)
At 31 December	**35,750**	34,590

Included in the carrying amount above is £30,603 million (2013: £29,931 million) which is expected to be settled more than 12 months after the reporting date.

A liability adequacy test was carried out at portfolio level and resulted in no additional provision in 2014 (2013: £nil).

It should be noted that changes in the financial assets backing the liabilities are typically largely offset by corresponding changes in the economic assumptions. In addition, assumption changes on with-profits contracts will result in changes in the unallocated surplus, and not in retained earnings.

b) Method used for reserving for both insurance contracts and investment contracts with DPF

The liability for insurance contracts and investment contracts with DPF is calculated on the basis of recognised actuarial methods, having due regard to actuarial principles and best practice, including compliance with the PRA's rules contained in the Prudential Sourcebook for Insurers.

The principal method of actuarial valuation of liabilities arising under long-term insurance contracts is the gross premium method which involves the discounting of projected income (e.g. premiums and annual management charges) and charges (e.g. claims and expenses). It includes explicit assumptions for valuation interest rates, mortality and morbidity, persistency and future expenses. The assumptions used can vary by contract type and reflect current and expected future experience. This note includes details of mortality tables, valuation interest rates and lapse rate assumptions by class of business.

For unit-linked insurance contracts and some unitised with-profits business, the liabilities are valued by adding a non-unit reserve to the bid value of units. The non-unit reserve is based on non-unit cash flows, assuming future premiums cease, unless it is more onerous to assume that they continue. In circumstances where the resultant future income is greater than charges (i.e. negative liabilities), credit can only be taken in circumstances where penalties exist to recover this income on surrender of the policy.

For the UK non-linked business, where the discounted value of future income is greater than the discounted value of future charges at a policy level (i.e. negative liabilities), credit can be taken to the extent that it offsets policies with positive liabilities within the same broad product group. For overseas business, negative liabilities are limited to zero at a policy level.

Notes to the consolidated accounts

26. Insurance contracts continued

The valuation of with-profits business uses the realistic basis in accordance with FRS 27: *Life assurance*. The realistic valuation includes an assessment of the cost of any future options and guarantees, anticipated future and regular bonuses and future profits on non-participating business written in the with-profits fund. The valuation excludes amounts attributable to shareholders in respect of future bonuses. In calculating the realistic liability, account is taken of the future management actions consistent with those set out in the Principles and Practices of Financial Management ("PPFM").

Calculations are generally made on an individual policy basis; however in addition there are some global provisions which are calculated using statistical or mathematical methods. The results are expected to be approximately the same as if the individual insurance/investment contract liability was calculated for each contract.

c) Options and guarantees

Options and guarantees are features of life assurance and pensions contracts that confer potentially valuable benefits to policyholders. They are not unique to with-profits funds and can arise in non-participating funds. They can expose an insurance company to two types of risk: insurance (such as mortality/morbidity) and financial (such as market prices/interest rates). The value of an option or guarantee comprises two elements: the intrinsic value and the time value. The intrinsic value is the amount that would be payable if the option or guarantee was exercised immediately. The time value is the additional value that reflects the possibility of the intrinsic value increasing in the future, before the expiry of the option or guarantee. Under PRA rules all options and guarantees must be valued and included in policyholder liabilities.

For funds within the PRA's realistic capital methodology, options and guarantees are valued on a market consistent basis that takes into account both the time value and the intrinsic value of the options and guarantees.

All material options and guarantees are valued stochastically and included in the liabilities. There are two main types of guarantees and options within the with-profits funds: maturity guarantees and guaranteed annuity options, and in addition, a return of premium guarantee for OLAB. Maturity guarantees are in respect of conventional and unitised with-profits business and represent the sum assured and reversionary bonuses declared to date. For certain with-profits pension policies there are options guaranteeing the rates at which annuities can be purchased. OLAB return of premium guarantees relate to a guarantee to repay all premiums paid to maturity.

The cost of the maturity guarantees, guaranteed annuity options and return of premium guarantees have been calculated as:

		31 December 2014 £m	31 December 2013 £m
Maturity guarantees	FP WPF	**239**	192
	FLC New WPF	**160**	250
	FLC Old WPF	**38**	62
	FLAS WPF	**187**	209
	WL WPF	**97**	81
Guaranteed annuity options	FP WPF	**645**	495
	FLC New WPF	**197**	127
	FLC Old WPF	**73**	46
	FLAS WPF	**107**	84
	WL WPF	**7**	5
Return of premium guarantee	OLAB	**110**	60

Notes to the consolidated accounts

26. Insurance contracts continued

d) Year end assumptions

i) Economic assumptions

Details regarding the economic assumptions used in the stochastic model for the valuation of with-profits policyholder liabilities are set out below.

The cost of with-profits guarantees is most sensitive to the assumed volatility of future returns on asset shares, the level of future interest rates and the rates of discontinuance on these policies. The guarantee cost in respect of guaranteed annuity options is most sensitive to the level of future interest rates, future mortality rates, assumed rates of discontinuance and early retirements, and the assumptions relating to the exercise of the tax free cash option on these policies. The cost of OLAB return of premium guarantees is most sensitive to the assumed volatility of future investment returns on unit funds, the level of future interest rates and the rates of discontinuance on these policies. Further details on these assumptions are provided below.

The cost of the with-profits guarantees and OLAB return of premium guarantee is assessed using a market consistent stochastic model as the economic scenario generator (produced by Moody's Analytics) and is calculated using 2,000 simulations.

The with-profits guarantees model is calibrated using the swap risk-free curve assuming interest rates of between 0.6% and 2.2% per annum (2013: 0.4% and 3.8% per annum) and implied volatilities in the market as shown in the following disclosures. The OLAB return of premium guarantee model is calibrated using the Euro swap curve assuming interest rates of between 0.2% and 1.6% per annum (2013: 0.2% and 3.5% per annum) and implied volatilities as shown in the following disclosures.

Swaption implied volatilities – FP WPF, FPLAL WPF, FLC New WPF, FLC Old WPF, FLAS WPF and WL WPF

	31 December 2014 swap term			
Option term	**10 years**	**15 years**	**20 years**	**25 years**
UK Sterling				
10 years	**27%**	**26%**	**25%**	**24%**
15 years	**27%**	**27%**	**26%**	**25%**
20 years	**26%**	**25%**	**24%**	**23%**
25 years	**27%**	**26%**	**24%**	**22%**

	31 December 2013 swap term			
Option term	10 years	15 years	20 years	25 years
UK Sterling				
10 years	18%	17%	16%	15%
15 years	19%	18%	17%	16%
20 years	17%	16%	15%	14%
25 years	16%	15%	14%	13%

Swaption implied volatilities - OLAB

	31 December 2014 swap term			
Option term	**10 years**	**15 years**	**20 years**	**25 years**
Euro				
10 years	**35%**	**34%**	**32%**	**31%**
15 years	**35%**	**34%**	**32%**	**30%**
20 years	**32%**	**30%**	**28%**	**26%**
25 years	**28%**	**26%**	**24%**	**23%**

Notes to the consolidated accounts

26. Insurance contracts continued

	31 December 2013 swap term			
Option term	10 years	15 years	20 years	25 years
Euro				
10 years	23%	22%	21%	20%
15 years	25%	23%	22%	20%
20 years	22%	20%	19%	18%
25 years	21%	19%	18%	16%

For equity capital return and property total return, implied volatilities are shown in the table below:

FP WPF, FPLAL WPF, FLC New WPF, FLC Old WPF, FLAS WPF and WL WPF

	31 December 2014		31 December 2013	
Option term	**Equities**	**Property**	Equities	Property
5 years	**21%**	**13%**	19%	15%
10 years	**22%**	**13%**	22%	15%
15 years	**23%**	**13%**	24%	15%

OLAB

	31 December 2014	31 December 2013
Option term	**Equities**	Equities
5 years	**21%**	20%
10 years	**21%**	21%
15 years	**21%**	21%

The cost of with-profits guarantees also depends on management actions that would be taken under various scenarios. Regular bonus rates are set each year such that, guaranteed maturity benefits are targeted as a predefined proportion of asset share, leaving the remaining portion of the asset share to be paid as a final bonus. This management action is in line with the Company's PPFM.

For FLAS WPF, FLC Old WPF and FLC New WPF, the regular bonus rates are derived from the gross redemption yields on gilts with deductions for guaranteed interest rates, tax, expenses, shareholder transfers and a contingency margin. The remaining portion of the asset share is paid as a final bonus. This management action is in line with the Company's PPFM.

The guarantee cost in respect of guaranteed annuity options is assessed using a market consistent stochastic model and values both the current level of the guaranteed annuity rate benefit (allowing for future improvements in annuitant mortality) and the time value due to uncertainty in future interest rates. The guarantee cost in each scenario is the value of the excess annuity benefit provided by the options, relative to an annuity purchased in the open market. In estimating the future open market annuity rate, the model allows for stochastic variation in interest rates and for future mortality improvements. The stochastic interest rate assumption reflects that implied by current market interest rate derivative prices. Future annuitant mortality within the FLL with-profits balance sheet has been derived from the premium basis at which annuities can be purchased from FLPL, which allows for future mortality improvements.

The guarantee cost in respect of premium guarantees is assessed using a market consistent stochastic model and values both the current level of the guarantee and the time value due to uncertainty in future unit growth. The guarantee cost in each scenario is the value of the excess benefit provided by the guarantee relative to the projected unit fund at maturity, including future contractual premiums. In estimating the projected fund at maturity, the model allows for stochastic variation in equity and cash values.

Notes to the consolidated accounts

26. Insurance contracts continued

ii) Non-economic assumptions

The provision for insurance contracts and investment contracts with DPF liabilities is sensitive to the principal assumptions in respect of mortality, morbidity and maintenance expenses, persistency and guaranteed annuity option take-up rates, although the relative sensitivity will vary depending on the insurance or investment contract.

Long-term estimates of future mortality and morbidity assumptions are based on standard tables wherever possible but adjusted to reflect the Group's own experience. Expense assumptions are based on recent experience for FLL and FLPL. Within FLL and FLPL, there are provisions for future expenses to cover the expected level of maintenance cost recharges payable to FLSL and FLMS under the management services agreements in place, fees payable to investment managers and further amounts in respect of other expenses.

Experience investigations for mortality, morbidity, persistency, guaranteed annuity option take-up rates and maintenance expenses are performed at least annually for major product classes. Where industry analysis indicates that changes in expected future mortality, morbidity or other assumptions mean that claim costs are likely to rise in the future, then this is taken into account in the liability calculation.

For some classes of protection business, the benefit from a prudent view of expected future mortality improvements is taken on the realistic balance sheet. Improving mortality has been assumed when valuing annuities. Also, deteriorating morbidity has been assumed when valuing some critical illness business. Assumptions, for policies other than with-profits, are generally intended to be a prudent estimate of future experience.

The guaranteed annuity options and OLAB return of premium cost also depend upon other factors such as policy discontinuance and for guaranteed annuity options, the take up rate for the options. The factors are based on recent experience, adjusted to reflect industry benchmarks and to anticipate trends in policyholder behaviour. A summary of the key assumptions is as follows:

Policy discontinuances: lapse, early retirement and paid-up rates vary by policy type and period and have been based on recent experience.

Policy lapses and paid-up rates are generally in the ranges shown below:

FP WPF

	2014 % pa	2013 % pa
Pensions – lapses	**0.5 to 7**	1 to 9
Life – lapses	**4.5 to 14**	4.5 to 18
Mortgage endowments – lapses	**2.5 to 3**	3 to 4
With-profits bonds – lapses	**6.5**	9
Pensions – paid-up	**4 to 17**	4 to 17
Life – paid-up	**0.5 to 2**	0.5 to 2

FLC New WPF

	2014 % pa	2013 % pa
Pensions – lapses	**4 to 10**	4 to 10
Life – lapses	**4 to 8**	4 to 8
Mortgage endowments – lapses	**1 to 6.5**	1 to 6.5
With-profits bonds – lapses	**5.5 to 8.5**	6.25 to 8.5
Pensions – paid-up	**4 to 12**	4 to 12
Life – paid-up	**0.5 to 2**	0.5 to 2

Notes to the consolidated accounts

26. Insurance contracts continued

FLC Old WPF

	2014 % pa	2013 % pa
Pensions – lapses	**4 to 10**	4 to 10
Life – lapses	**4 to 8**	4 to 8
Mortgage endowments – lapses	**1 to 6.5**	1 to 6.5
With-profits bonds – lapses	**5.5 to 8.5**	6.25 to 8.5
Pensions – paid-up	**4 to 12**	4 to 12
Life – paid-up	**0.5 to 2**	0.5 to 2

FLAS WPF

	2014 % pa	2013 % pa
Pensions – lapses	**5.5 to 11**	6.5 to 11
Life – lapses	**4.5 to 12**	4.5 to 12
Mortgage endowments – lapses	**1 to 6.5**	1 to 6.5
With-profits bonds – lapses	**5.5 to 8.5**	6.25 to 8.25
Pensions – paid-up	**4.5 to 12**	4.5 to 12.5
Life – paid-up	**1 to 2**	1 to 2

WL WPF

	2014 % pa	2013 % pa
Pensions – lapses	**3 to 8**	3 to 8
Life – lapses	**4 to 9**	3 to 8
Mortgage endowments – lapses	**2 to 8**	2 to 8
With-profits bonds – lapses	**5**	5 to 9

FPLAL WPF

	2014 % pa	2013 % pa
Whole of Life – lapses	**2.5 to 3.5**	2.5 to 3.5
Whole of Life – paid-up	**5**	5

OLAB

	2014 % pa	2013 % pa
Pensions – lapses	**7.5**	2 to 12
Pensions – paid-up	**2.5**	2.5 to 12

Early retirement rates vary by age band and policy type and are set based on recent experience.

Tax free cash option: where a guaranteed annuity option is more valuable than the cash equivalent it is assumed that 5% to 27% (2013: 5% to 27%) of the benefit of the option is taken tax-free depending on the type of business. This is based on recent experience.

There are also guarantees and options in respect of some of the other life assurance business within the Group, but these are not considered to be material to the Group's future cash flows. In addition, they have largely been matched with suitable assets and there is no material exposure to market or interest rate changes. Provisions have been established using deterministic scenarios based on prudent assumptions.

Notes to the consolidated accounts

26. Insurance contracts continued

e) Valuation interest rates

As explained above, with-profits business within FLL is valued in accordance with the PRA's realistic reporting regime. Valuation interest rates for other than conventional with-profits business are shown in the table below.

	Company	Class of Business	2014 %	2013 %
Life	FLL	Endowment and Whole Life in non-profit funds	**1.70**	2.50
		Protection	**1.70**	2.50
		Endowment and Whole Life in with-profits funds	**1.80**	2.60
	ex-FLC	Over 50 Plan in non-profit funds	**1.35**	1.95
		Over 50 Plan in with-profits funds	**1.65**	2.35
		Additional life reserves	**1.35**	1.95
		Other conventional life in non-profit funds	**1.35**	1.95
		Other conventional life in with-profits funds	**1.95**	1.95
		Life annuities from FLAS	**1.90**	2.85
		Unit-linked life	**1.35**	1.95
	ex-FLAS	Conventional life	**2.25**	3.00
		Unit-linked life	**2.25**	3.00
	ex-FLWL	With-profits fund immediate annuities	**1.45**	2.15
		Life (other)	**2.20**	2.45
		Non-profit fund life	**1.65**	2.00
	FPIL	International Protector	**2.15**	3.20
Income Protection	FLL	Income Protection	**1.60**	2.60
	ex-FLC	Permanent Health Insurance	**1.70**	2.40
Pensions	FLL	Annuities in payment	**2.08 to 2.72**	3.76
		Protection	**2.10**	3.10
		Individual and Group pensions in non-profit funds	**2.10**	3.20
		Individual and Group pensions in with-profits funds	**2.30**	3.30
	ex-FLC	Unit-linked pensions	**1.70**	2.40
		Conventional pensions in non-profit funds	**1.70**	2.40
		Conventional pensions in with-profits funds	**2.60**	3.40
		WPAD stage 1 ring-fenced NP Fund	**2.75**	3.65
		WPAD stage 2 ring-fenced NP Fund	**2.70**	n/a
		Additional pensions reserves	**1.70**	2.40
	ex-FLAS	Conventional pensions	**2.65**	3.80
		Unit-linked pensions	**2.80**	3.80
	FAL	Ex-FLC annuities reinsured December 2007	**2.45**	3.45
		Ex-FLAS annuities reinsured July 2009	**2.45**	3.55
		Ex-FLC index-linked annuities reinsured December 2007	**(0.55)**	0.15
		Ex-FLAS index-linked annuities reinsured July 2009	**(0.55)**	0.10
	ex-FLWL	With-profits fund pensions (immediate annuities)	**1.80**	2.70
		Non-profit fund pensions (immediate annuities)	**2.60**	3.65
		Non-profit fund pensions (other)	**2.10**	2.50
		With-profits fund with-profits business deferred	**1.30**	2.60
		With-profits fund with-profits business other	**2.75**	3.10

Notes to the consolidated accounts

26. Insurance contracts continued

Within FLL certain products can have positive or negative reserves. The interest rate used for these products depends on which is more onerous.

	31 December 2014		31 December 2013	
	Positive reserves %	Negative reserves %	Positive reserves %	Negative reserves %
FLL	**1.20**	**3.20**	2.00	4.40
ex-FLC non-critical illness	**0.85**	**1.85**	1.45	2.45
ex-FLC critical illness	**1.20**	**2.20**	1.90	2.90

Notes to the consolidated accounts

26. Insurance contracts continued

f) Mortality, morbidity and lapse rates

Insurance contract liabilities allow for mortality and morbidity risk by making assumptions about the proportion of policyholders who die or become sick. Allowance for future mortality has been made using the following percentages of the standard published tables below.

		31 December 2014	31 December 2013
Term assurances – FLL	Smoker male	**82.5% TMS00(5)**	82.5% TMS00(5)
	Smoker female	**71.5% TFS00(5)**	71.5% TFS00(5)
	Non-smoker male	**82.5% TMN00(5)**	82.5% TMN00(5)
	Non-smoker female	**71.5% TFN00(5)**	71.5% TFN00(5)
Term assurances – ex-FLC/ex-FLAS	Smoker male	**82.5% TMS00(5)**	82.5% TMS00(5)
	Smoker female	**71.5% TFS00(5)**	71.5% TFS00(5)
	Non-smoker male	**82.5% TMN00(5)**	82.5% TMN00(5)
	Non-smoker female	**71.5% TFN00(5)**	71.5% TFN00(5)
Term assurance – ex-FLWL	Smoker male	**114% TM92ult[(i)]**	114% TM92ult[(i)]
	Smoker female	**114% TF92ult[(i)]**	114% TF92ult[(i)]
	Non-smoker male	**66% TM92ult[(i)]**	66% TM92ult[(i)]
	Non-smoker female	**60% TF92ult[(i)]**	60% TF92ult[(i)]
Term assurance – FPIL	Smoker male	**180% HKA01**	180% HKA01
	Smoker female	**210% HKA01**	210% HKA01
	Non-smoker male	**97.5% HKA01**	97.5% HKA01
	Non-smoker female	**97.5% HKA01**	97.5% HKA01
Critical illness	FLL	**CIBT02[(ii)]**	CIBT02[(ii)]
Critical illness	ex-FLC/ex-FLAS	**CIBT02[(iii)]**	CIBT02[(iii)]
Other life assurances	FLL	**120% AM/FC00ult**	120% AM/FC00ult
Other life assurances	ex-FLC/ex-FLAS male	**140% AMC00**	140% AMC00
	ex-FLC/ex-FLAS female	**125% AFC00**	125% AFC00
Unitised policies	Life – FLL	**130% AM/FC00ult**	130% AM/FC00ult
	Other – FLL	**110% AM/FC00ult**	110% AM/FC00ult
Unitised policies	Life/Other – ex-FLC/ex-FLAS male	**105% AMC00ult**	102.5% AMC00ult
	Life/Other – ex-FLC/ex-FLAS female	**110% AFC00ult**	100% AFC00ult
Pensions	FLL/FLPL male	**65% AMC00ult**	65% AMC00ult
	FLL/FLPL female	**55% AMFC00ult**	55% AMFC00ult
	ex-FLC/ex-FLAS male	**90.91% A67/70ult–1**	90.91% A67/70ult–1
	ex-FLC/ex-FLAS female	**90.91% AF80ult–1**	90.91% AF80ult–1
Individual income protection	FLL	**60% AM/F80ult[(iv)]**	60% AM/F80ult[(iv)]
	ex-FLC/ex-FLAS	**100% AM/AF92[(iv)]**	100% AM/AF92[(iv)]
Annuities in payment	FLL/FLPL individual annuities	**PCMA/PCFA00[(v)]**	PCMA/PCFA00[(v)]
	FLL/FLPL group annuities	**PCMA/PCFA00[(v)]**	PCMA/PCFA00[(v)]
	ex-FLC/FAL pension annuities male	**94.3% PCMA00[(vi)]**	96.6% PCMA00[(vi)]
	ex-FLC/FAL pension annuities female	**98.9% PCFA00[(vi)]**	98.9% PCFA00[(vi)]
	ex-FLAS pension annuities male	**94.3% PCMA00[(vi)]**	89.7% PCMA00[(vi)]
	ex-FLAS pension annuities female	**89.7% PCFA00[(vi)]**	92% PCFA00[(vi)]
Immediate annuities – ex-FLWL	Male	**101.2% PCMA00[(vi)]**	98.9% PCMA00[(vi)]
	Female	**101.2% PCFA00[(vi)]**	98.9% PCFA00[(vi)]

Notes to the consolidated accounts

26. Insurance contracts continued

(i) Aids loading at 1/3 of the R6A standard requirement applied to reserving basis.

(ii) The percentages of the table used differ by sex and smoker status. CIBT02 has been adjusted to allow for a select period as follows: Year 1: 80% of CIBT02; Year 2: 95% of CIBT02; Year 3+: 100% of CIBT02. Future deterioration in morbidity is allowed for by assuming claim rates increase by 0.50% (2013: 1.25%) per annum and 0.75% (2013:1.5%) per annum for males and females respectively.

(iii) The percentages of the table used differ by sex, smoker status and sales group. Future deterioration in morbidity is allowed for by assuming claim rates increase by:

a) 0.50% (2013: 0.75%) per annum and 0.75% (2013: 1.50%) per annum for males and females respectively for standalone critical illness

b) 0.50% (2013: 0.50%) per annum and 0.75% (2013: 1.00%) per annum for males and females respectively for accelerated critical illness

(iv) Individual income protection sickness and recovery rates are based on percentages of CMIR 12 (male and female) published tables. Rates differentiate by smoker status, deferred period and occupational class.

(v) Age related percentages of the mortality tables are used.

(vi) Future improvements in mortality are based on the CMI's core model CMI-2013 with long-term rates of 2.0% male and 1.75% female (2013: CMI-2011 with a long-term rate of 2% for both males and females).

For protection business, lapse rates are based on recent experience with a prudent margin.

In determining liabilities for with-profits business, it is assumed that a proportion of policies is discontinued (surrendered, lapsed or converted paid-up) in each future year. The relevant rates vary by product and duration.

g) Apportionment of surplus between shareholders and with-profits policyholders

Shareholders are entitled to 100% of surplus emerging from companies within the Group, with the exception of surplus emerging in the with-profits funds.

The Group has six with-profits funds of which only FP WPF is open to new business and five (FLC New WPF, FLC Old WPF, WL WPF, FPLAL WPF and FLAS WPF) are closed to new business.

Shareholders are entitled to one-ninth of the cost of bonuses added to policies, except for:

- within the FP WPF, surplus arising on pre-demutualisation non-profit and unitised business (excluding the investment element) arises within the with-profits fund but assets of the with-profits fund equal to 60% of the surplus arising are transferred to shareholders;
- within the FP WPF, post-demutualisation policyholders are only entitled to surplus from the return on their investments; other sources of surplus are wholly-owned by shareholders including policies written by FPLAL and FLPL, where the investment element is reinsured to the FP WPF;
- within the FPLAL WPF, policyholders are entitled to all the surplus of that fund. In addition, FLL has a closed unitised with-profits fund. Shareholders are entitled to all profits from the unitised with-profits fund other than investment profits, which are wholly-owned by with-profits policyholders. The investment element of the contract is wholly reinsured to the FP WPF;
- certain unitised with-profits policies in FLL which are written in the non-profit fund and reassured to the WL WPF; and
- certain policies in FLC New WPF and FLC Old WPF with guaranteed bonus rates, where the shareholders do not receive one-ninth of guaranteed bonuses.

The effect of the fund structure is that investment risk, in respect of assets backing with-profits policies is largely borne by policyholders; shareholders bear 10% of the investment risk from conventional with-profits policies, other than within the FPLAL WPF.

Expense risk is borne by shareholders, other than within the FPLAL WPF. Increases to expenses that can be charged to the WL WPF are capped in line with RPI.

Notes to the consolidated accounts

27. Investment contracts

Policyholder contracts not considered insurance contracts under IFRS 4 are classified as investment contracts. Contracts classified as investment contracts are either unit-linked or contracts with DPF with no significant insurance risk. The latter are mainly unitised with-profits contracts.

An investment contract is a financial liability designated on initial recognition at fair value through profit or loss, when one of the following criteria is satisfied:

- it eliminates or significantly reduces an accounting mismatch with corresponding assets which are managed on a fair value basis.
- it contains or may contain an embedded derivative.

A unit-linked contract is recognised at fair value through profit or loss and is calculated as the number of units allocated to policyholders in each of the unit-linked funds multiplied by the bid price of the units which reflects the fair value of the assets in the fund at the balance sheet date. In addition, the fair value of the investment contract liability includes provision for tax losses in the unit-linked funds whose benefit will ultimately accrue to the policyholders and provision for renewal commissions where intermediaries are not required to perform any service once the policy is incepted. Non-unit reserves, relating primarily to deferral of front end fees in the form of unfunded units, are also included as an investment contract liability and recognised as income on a straight-line basis over the period in which services are rendered.

Investment contracts with DPF held within the with-profits funds (which are mainly unitised with-profits contracts) are measured on a basis that is consistent with a measurement basis for insurance contracts held within these funds.

Movement in investment contracts liabilities are shown in the table below.

For the year ended 31 December	2014 £m	2013 £m
At 1 January	**83,502**	78,184
Premiums	**4,550**	5,956
Claims	**(6,513)**	(8,472)
Investment return, annual management charges and other expenses	**2,920**	7,356
Foreign exchange adjustments	**(756)**	478
Transferred to operations classified as held for sale	**(19,616)**	–
At 31 December	**64,087**	83,502
Analysed as follows:		
Unit-linked contracts	**53,233**	72,682
Policies with DPF	**9,335**	8,991
Other non-unit reserves	**1,519**	1,829
Total investment contract liabilities	**64,087**	83,502

None of the movement in liabilities is attributable to changes in the credit risk of the liabilities. Investment return of £3,102 million (2013: £6,900 million) is included within the income statement arising from movements in investment contract liabilities.

Included in the carrying amount above, £53,311 million (2013: £72,814 million) is expected to be settled more than 12 months after the reporting date.

Notes to the consolidated accounts

28. Unallocated surplus

The unallocated surplus in the with-profits funds is presented as a liability and comprises all amounts available for allocation, either to policyholders or to shareholders, the allocation of which has not been determined at the balance sheet date.

Insurance and investment contract liabilities within with-profits funds are measured on a realistic basis and therefore include amounts attributable in respect of future bonuses. Such amounts are estimated in accordance with the published PPFM and represent a constructive obligation. The realistic liabilities include an estimate of the fair value of policyholder options and guarantees. The unallocated surplus within the with-profits funds represents the excess of assets of the fund relative to the realistic liabilities and other current liabilities not included within the realistic liability measurement. The unallocated surplus can be considered to represent the working capital of the funds and includes a part which represents the value of future transfers to shareholders from the with-profits funds.

	2014 £m	2013 £m
At 31 December	**692**	627

29. Capital

a) Overview

The Group manages its capital resources on both regulatory and economic capital bases, focusing primarily on capital efficiency and the ease with which cash and capital resources can be transferred between entities.

The capital management objectives are:

- to maintain capital resources for life operations at the greater of the capital resources requirement ("CRR") as required by local solvency rules and CRR as required by the local capital management policy;
- to hold capital resources for Friends Life Group that meet a minimum of 150% (2013: 150%) of the Group CRR (excluding the with-profits insurance capital component ("WPICC"));
- to maintain financial strength within the Group and regulated entities sufficient to support new business growth targets, and to satisfy the requirements of the policyholders, regulators and stakeholders including rating agencies;
- to retain financial flexibility by maintaining strong liquidity to cover expected and unexpected events, which includes access to an undrawn facility with a consortium of banks;
- to manage the with-profits business of the Group in accordance with agreed risk appetites and all statutory requirements; and
- to ensure that transfers from long-term business funds and dividends from entities that support the cash generation requirements of the Group are balanced with the need to maintain appropriate capital within the Group and regulated entities.

The operations of the Group are subject to regulatory requirements within the countries where it operates. Such regulations specify that a minimum amount of required capital must be maintained at all times throughout the financial year.

Under PRA rules, the UK life operations are also required to perform a private individual capital assessment ("ICA") of the economic capital required to mitigate the risk of insolvency to a minimum of a 99.5% confidence level over a one year period. The PRA review the ICA and may impose additional capital requirements by way of individual capital guidance ("ICG").

In addition to the regulatory requirements for individual life operations, the Group must comply with the requirements of the Insurance Groups Directive and as such monitors the insurance groups capital adequacy ("IGCA") requirements at FLGL level.

The formal procedures for identifying and assessing risks that could affect the capital position of the Group are described in the risk management policies set out in note 30.

b) Capital statement

The Group capital statement is set out below. It is based on estimated local regulatory positions and incorporates the following:

- a statement showing local basis capital resources and the related capital requirement. For UK life operations, the capital statement shows capital resources and regulatory capital resource requirements as specified by PRA rules. For overseas life operations, capital resources and requirements are calculated according to local regulatory requirements; and
- a reconciliation from the local basis regulatory surpluses to the Group's estimated and unaudited IGCA surplus, calculated in accordance with the valuation rules of the Insurance Groups Directive; and an analysis of policyholder liabilities on an IFRS basis.

Notes to the consolidated accounts

29. Capital continued

As at 31 December 2014	Total UK with-profits funds £m	UK shareholder and non-profit funds £m	Overseas life operations £m	Total life operations £m	Other operations and consolidation adjustments £m	Total £m
Shareholders' equity						
Outside long-term fund	–	438	36	474	2,229	2,703
Inside long-term fund	–	1,656	16	1,672	–	1,672
	–	2,094	52	2,146	2,229	4,375
Other qualifying capital						
Innovative tier one capital (STICS)	–	511	–	511	(23)	488
Subordinated debt	–	869	–	869	162	1,031
Unallocated surplus	692	–	–	692	–	692
	692	3,474	52	4,218	2,368	6,586
Regulatory adjustments						
Assets	(23)	(1,292)	(2)	(1,317)	(2,523)	(3,840)
Liabilities	4,879	(26)	1	4,854	594	5,448
Available capital resources	5,548	2,156	51	7,755	439	8,194
Capital requirement						
UK realistic basis	5,054	–	–	5,054	–	5,054
Other regulatory bases	–	904	18	922	24	946
	5,054	904	18	5,976	24	6,000
Local basis capital resources over capital requirement						2,194
IGCA valuation adjustments						
Restricted assets(i) and shareholders' capital support of the with-profits funds						(498)
Assets in excess of market risk and counterparty limits						230
Other						(7)
FLGL IFRS net assets(ii)						421
Estimated FLGL IGCA surplus						2,340
Analysis of policyholder liabilities						
With-profits	17,552	–	–	17,552	–	17,552
Unit-linked	246	54,510	6,961	61,717	–	61,717
Non-participating and other non-unit reserves	4,458	15,010	1,100	20,568	–	20,568
Total policyholder liabilities	22,256	69,520	8,061	99,837	–	99,837

(i) Long-term fund surplus capital over and above capital requirements is excluded from capital resources on an IGCA basis.

(ii) FLGL is deemed to be the ultimate EEA parent undertaking of the Group and as such the IGCA requirements are monitored at the FLGL level.

Notes to the consolidated accounts

29. Capital continued

UK with-profits funds

As at 31 December 2014	FP WPF £m	FPLAL WPF £m	FLC New WPF £m	FLC Old WPF £m	FLAS WPF £m	WL WPF £m	Total £m
Other qualifying capital							
Unallocated surplus	224	3	187	63	206	9	692
Regulatory adjustments							
Assets	(24)	–	–	–	–	1	(23)
Liabilities	1,313	34	1,557	467	1,421	87	4,879
Available capital resources	1,513	37	1,744	530	1,627	97	5,548

Capital requirement							
UK realistic basis	1,305	37	1,640	489	1,482	101	5,054
Local basis capital resources over capital resources requirement							494

Analysis of policyholder liabilities							
With-profits	7,227	177	4,669	1,289	3,607	583	17,552
Unit-linked	50	–	21	3	172	–	246
Non-participating and other non-unit reserves	2,283	73	843	146	1,000	113	4,458
Total	9,560	250	5,533	1,438	4,779	696	22,256

The excess of capital requirements over available capital resources of WL WPF is covered by available capital resources of UK shareholder and non-profit funds.

Notes to the consolidated accounts

29. Capital continued

As at 31 December 2013	Total UK with-profits funds £m	UK shareholder and non-profit funds £m	Overseas life operations £m	Total life operations £m	Other operations and consolidation adjustments £m	Total £m
Shareholders' equity						
Outside long-term fund	–	74	133	207	3,197	3,404
Inside long-term fund	–	1,627	34	1,661	–	1,661
	–	1,701	167	1,868	3,197	5,065
Other qualifying capital						
Preference shares	–	300	–	300	(300)	–
Innovative tier one capital (STICS)	–	511	–	511	(23)	488
Subordinated debt	–	847	–	847	162	1,009
Unallocated surplus	627	–	–	627	–	627
	627	3,359	167	4,153	3,036	7,189
Regulatory adjustments						
Assets	6	(1,295)	(49)	(1,338)	(3,016)	(4,354)
Liabilities	4,913	59	47	5,019	657	5,676
Available capital resources	5,546	2,123	165	7,834	677	8,511
Capital requirement						
UK realistic basis	4,959	–	–	4,959	–	4,959
Other regulatory bases	–	765	73	838	24	862
	4,959	765	73	5,797	24	5,821
Local basis capital resources over capital requirement						2,690
IGCA valuation adjustments						
Restricted assets(i) and shareholders' capital support of the with-profits funds						(616)
Assets in excess of market risk and counterparty limits						(2)
FLGL IFRS net assets(ii)						164
Estimated FLGL IGCA surplus						2,236
Analysis of policyholder liabilities						
With-profits	17,614	–	131	17,745	–	17,745
Unit-linked	251	53,621	27,272	81,144	–	81,144
Non-participating and other non-unit reserves	5,198	12,809	1,196	19,203	–	19,203
Total policyholder liabilities	23,063	66,430	28,599	118,092	–	118,092

(i) Long-term fund surplus capital over and above capital requirements is excluded from capital resources on an IGCA basis.
(ii) FLGL is deemed to be the ultimate EEA parent undertaking of the Group and as such the IGCA requirements are monitored at the FLGL level.

Notes to the consolidated accounts

29. Capital continued

UK with-profits funds

As at 31 December 2013	FP WPF £m	FPLAL WPF £m	FLC New WPF £m	FLC Old WPF £m	FLAS WPF £m	WL WPF £m	Total £m
Other qualifying capital							
Unallocated surplus	155	3	200	62	193	14	627
Regulatory adjustments							
Assets	6	–	–	–	–	–	6
Liabilities	1,487	41	1,506	446	1,353	80	4,913
Available capital resources	1,648	44	1,706	508	1,546	94	5,546
Capital requirement							
UK realistic basis	1,366	44	1,584	467	1,398	100	4,959
Local basis capital resources over capital requirement							587
Analysis of policyholder liabilities							
With-profits	7,277	137	4,797	1,282	3,591	530	17,614
Unit-linked	29	–	–	–	45	177	251
Non-participating and other non-unit reserves	2,235	104	806	139	1,831	83	5,198
Total	9,541	241	5,603	1,421	5,467	790	23,063

The excess of capital requirements over available resources of WL WPF is covered by available capital resources of UK shareholder and non-profit funds.

Restrictions on availability of capital

The available capital in a regulated entity is generally subject to restrictions as to its availability to meet capital requirements elsewhere in the Group. The principal restrictions are:

UK with-profits funds

- FP WPF: shareholders are entitled to one-ninth of the amount distributed to conventional with-profits policyholders in the form of bonuses. In addition, shareholders are entitled to 60% of the surplus arising in respect of the pre-demutualisation non-profit and unitised business written in the fund (excluding the investment element); the remaining 40% belongs to with-profits policyholders. Also, post-demutualisation policyholders are only entitled to surplus from the return on their investments; other sources of surplus are wholly-owned by shareholders.
- FPLAL WPF: the surplus in the closed with-profits fund may only be distributed to policyholders.
- FLC New WPF, FLC Old WPF and FLAS WPF: shareholders are entitled to one-ninth of the amount distributed to policyholders in the form of bonuses, with the following exception: certain policies in FLC WPFs with guaranteed bonus rates, where the shareholders do not receive one-ninth of guaranteed bonuses.
- WL WPF: shareholders are entitled to one-ninth of the amount distributed to policyholders in the form of bonuses, with the following exception: where elements of the non-profit fund policies are invested in the WL WPF the shareholder receives the management charges in the non-profit fund.

Non-participating business

For non-participating business, surplus can generally be distributed to shareholders subject to meeting regulatory requirements and those of the 2013 scheme in relation to support arrangements for the with-profits funds in FLL as set out in the disclosures on intra-group capital arrangements in section d).

Notes to the consolidated accounts

29. Capital continued

c) Movement in available capital

At 31 December 2014, total available capital resources in the life operations have decreased during the year by £79 million to £7,755 million (2013: £740 million increase to £7,834 million), as shown below.

For the year ended 31 December 2014	UK Total with-profits funds £m	UK shareholders' and non-profit funds £m	Overseas life operations £m	Total life operations £m
At 1 January 2014	**5,546**	**2,123**	**165**	**7,834**
New business strain	–	(65)	(28)	(93)
Expected existing business contribution	115	504	52	671
Experience variances and development costs	68	(52)	–	16
Operating assumption changes	118	121	(18)	221
Other operating items	14	166	4	184
Economic variance and other non-operating items	(313)	(179)	(28)	(520)
Total earnings from continuing operations	2	495	(18)	479
Total earnings from discontinued operations	–	–	–	–
Other capital and dividend flows	–	(462)	(94)	(556)
Foreign exchange variances	–	–	(2)	(2)
At 31 December 2014	**5,548**	**2,156**	**51**	**7,755**

Analysis of with-profits funds

For the year ended 31 December 2014	FP WPF £m	FPLAL WPF £m	FLC New WPF £m	FLC Old WPF £m	FLAS WPF £m	WL WPF £m	Total £m
At 1 January 2014	**1,648**	**44**	**1,706**	**508**	**1,546**	**94**	**5,546**
Expected existing business contribution	12	–	47	14	41	1	115
Experience variances and development costs	3	–	8	2	39	16	68
Operating assumption changes	56	3	7	1	48	3	118
Other operating items	1	–	1	2	10	–	14
Economic variance and other non-operating items	(207)	(10)	(25)	3	(57)	(17)	(313)
At 31 December 2014	**1,513**	**37**	**1,744**	**530**	**1,627**	**97**	**5,548**

Notes to the consolidated accounts

29. Capital continued

For the year ended 31 December 2013	UK Total with-profits funds £m	Restated UK shareholders' and non-profit funds £m	Restated Overseas life operations £m	Restated Total life operations £m
At 1 January 2013	4,823	2,079	192	7,094
Opening adjustment: divested business	–	–	(50)	(50)
New business strain	(17)	(70)	(34)	(121)
Expected existing business contribution	224	462	70	756
Experience variances and development costs	(266)	(37)	(1)	(304)
Operating assumption changes	59	57	5	121
Other operating items	3	107	(8)	102
Economic variance and other non-operating items	713	(6)	(3)	704
Total earnings from continuing operations	716	513	29	1,258
Total earnings from discontinued operations	–	–	10	10
Other capital and dividend flows	7	(469)	(18)	(480)
Foreign exchange variances	–	–	2	2
At 31 December 2013	5,546	2,123	165	7,834

Analysis of with-profits funds

For the year ended 31 December 2013	FP WPF £m	FPLAL WPF £m	FLC New WPF £m	FLC Old WPF £m	FLAS WPF £m	WL WPF £m	Total £m
At 1 January 2013	1,710	33	1,382	451	1,157	90	4,823
New business strain	–	–	(2)	–	(15)	–	(17)
Expected existing business contribution	(2)	–	(18)	30	148	66	224
Experience variances and development costs	7	–	(217)	(118)	43	19	(266)
Operating assumption changes	(2)	1	53	7	1	(1)	59
Other operating items	(23)	–	(52)	(7)	85	–	3
Economic variance and other non-operating items	(42)	10	560	145	120	(80)	713
Other capital and dividend flows	–	–	–	–	7	–	7
At 31 December 2013	1,648	44	1,706	508	1,546	94	5,546

d) Intra-group capital arrangements

FLL has guaranteed the £210 million (2013: £210 million) STICS issued in 2003 and the £268 million (2013: £268 million) STICS issued in 2005. The Company's £162 million subordinated debt is also guaranteed by FLL.

On 21 April 2011, the Company issued a £500 million external Lower Tier 2 ("LT2") debt instrument with a coupon of 8.25% and a maturity of 2022. The £500 million external LT2 debt is guaranteed on a subordinated basis by FLL.

On 8 November 2012, the Company issued a US$575 million Upper Tier 2 ("UT2") reset perpetual subordinated debt instrument with a coupon of 7.875%, which is irrevocably guaranteed on a subordinated basis by FLL. A derivative instrument was entered into on 8 November 2012 to manage the risks associated with fluctuations in exchange rates on the issue of this debt.

Following the Part VII in 2013, all with-profits support arrangements were incorporated into one FLL scheme. The FLL shareholder and non-profit fund are required to retain £1.1 billion of capital support assets. Of this, £0.7 billion needs to be held in the form of tangible assets which could be transferred to the various FLL with-profits funds on a temporary basis if necessary. As at 31 December 2014 £30 million (2013: £59 million) of these support assets have been temporarily transferred to the FP WPF in the form of a contingent loan.

Notes to the consolidated accounts

29. Capital continued

In the case of a temporary transfer to the with-profits funds, assets and related investment income would remain attributable to the shareholders as they would be returned when they are no longer required to support the capital requirements of the with-profits funds, under the tests set out in the 2013 scheme. In the case of the FLC WPFs if all or part of the assets transferred were unlikely to be returned in the foreseeable future (taking into consideration the duration of the in-force with-profits policies), then the relevant part of the transfer would be designated permanent resulting in an income statement charge to the shareholders. Under the rules of the 2013 scheme, a test must be performed once in every 12 month period and may result in a transfer being made to the with-profits funds. As at 31 December 2014, the transfer to the FLC WPFs was £nil (2013: £nil). In the case of the WL WPF, should any transfer of the £13 million (2013: £15 million) support arrangement be made, it would be on a permanent basis and would result in an income statement charge to the shareholders.

e) Policyholder liabilities

The assumptions which have the greatest effect on policyholder liabilities (including options and guarantees) and the process used to determine those assumptions are summarised in note 26. The terms and conditions of options and guarantees relating to life assurance contracts are disclosed in note 25.

The sensitivity of policyholder liabilities to changes in market conditions and to key assumptions and other variables are disclosed in note 30.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks

Overview

Risks to which the Group is exposed

The Group, in the course of doing business, is exposed to the following categories of risk:

- financial risks: these are risks relating to the financial management of the business, the economy and other external events which result in the Group being unable to meet its financial obligations, and include market, credit and liquidity risks. Although under IFRS 4 insurance risk is risk other than financial risk, for risk management purposes, insurance risk is considered together with financial risk;
- strategic risks: these are risks related to the Group's business strategy and decision-making, and include risks associated with mergers and acquisitions activity and the composition of the Group's capital structure;
- operational risks: these are risks of losses arising from inadequate or failed internal processes, personnel or systems, or from external events. Operational risks include regulatory, financial crime, people, legal, outsourcing, information technology and business protection risks; and
- Group risks: these are risks of losses or reputational damage due to the activities of a Group member, including any business unit or subsidiary.

This note presents information about the Group's exposure to financial risks and the Group's preferences, policies and processes for measuring and managing these risks. The Group's risk preferences are approved by the Board and form part of the Group's Enterprise Risk Management framework. The Group policies outline the core principles to which the Group must adhere. The Group policy framework consists of nine Group policies, with a number of supporting control standards and detailed processes and procedures. The risks noted above form part of the Group Enterprise Risk Management Policy. Further quantitative disclosures are included throughout these consolidated financial statements.

a) Quantitative risk exposure

The Group applies sensitivity and scenario tests to economic and experience assumptions to understand the volatility of earnings, the volatility of its capital requirements, and to manage its capital more efficiently. The sensitivity and scenario results are produced to inform the Group's decision-making and planning processes. These results are also used as a part of the framework for identifying and quantifying the risks to which each of its business units, and the Group as a whole, are exposed.

The Group's quantitative exposure to a range of financial risks can be illustrated in the MCEV sensitivity analysis, where the impacts of reasonably possible changes in risk variables are disclosed. The basis of preparation and limitations of the MCEV methodology are provided in the MCEV supplementary information within the FLGL Report and Accounts.

Limitations of sensitivity analysis

The sensitivities assume that only the key assumption is changed while the other assumptions remain unchanged. The sensitivities do not take account of any correlation between the assumptions and other factors that may occur in reality. The sensitivities shown are non-linear, and larger or smaller impacts should not be interpolated or extrapolated from these results. Other limitations in the sensitivities shown include the use of hypothetical market movements to demonstrate potential risks that only represent the Group's view of possible near-term market changes that cannot be predicted with any certainty, and the assumption that all interest rates move in an identical fashion.

Life and pensions

The following tables show the sensitivity of the embedded value for covered business and the contribution from new business to changes in assumptions at 31 December 2014 and 2013, split by UK, Heritage (including the Corporate business where relevant) and International.

The sensitivities shown reflect movement in MCEV covered business only.

In calculating each sensitivity it is assumed that other future experience assumptions remain unchanged, except where changes in economic conditions directly affect them. Any changes in the assumptions underlying the statutory reserving calculations have no material impact on the MCEV sensitivities shown. For Heritage and UK businesses statutory assumptions have not been changed in applying the MCEV sensitivities, but for FPI the statutory assumptions have been changed to fit with regulatory requirements.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

2014 Sensitivities	Change in MCEV (net of tax) UK £m	Heritage £m	Int'l[iv] £m	Total £m	Change in VNB (gross of tax) UK £m	Heritage £m	Int'l[iv] £m	Total £m
Base MCEV and VNB	1,780	2,172	516	4,468	141	(21)	12	132
Market and credit risk								
100bps increase in reference rates	(45)	3	3	39	(12)	–	(1)	(13)
100bps decrease in reference rates	51	(21)	(5)	(25)	13	–	1	14
Removal of illiquidity premium for immediate annuities	(174)	(563)	–	(737)	(42)	–	–	(42)
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield	(52)	(156)	(26)	(234)	n/a	n/a	n/a	n/a
25% increase in equity and property volatility at the valuation date	–	(31)	–	(31)	n/a	n/a	n/a	n/a
25% increase in swaption implied volatility at the valuation date	–	(1)	–	(1)	n/a	n/a	n/a	n/a
100bps increase in corporate bond spreads[i]	(90)	(209)	–	(299)	(19)	–	–	(19)
100bps decrease in corporate bond spreads[i]	116	270	–	386	24	–	–	24
10% adverse movement in Sterling/overseas exchange rate[ii]	(7)	(31)	(20)	(58)	n/a	n/a	n/a	n/a
10% fall in value in unit-linked funds	(67)	(233)	(31)	(331)	n/a	n/a	n/a	n/a
100bps increase in expense inflation	(33)	(91)	(10)	(134)	(8)	–	–	(8)
100bps decrease in expense inflation	30	76	9	115	7	–	–	7
Insurance and other risk								
Reduction to EU minimum capital or equivalent[iii]	8	43	–	51	2	–	–	2
10% decrease in maintenance expenses	38	71	23	132	5	–	2	7
10% proportionate decrease in lapse rates	44	55	8	107	15	–	1	16
10% proportionate decrease in paid-up rates	10	1	2	13	5	–	–	5
5% decrease in mortality and morbidity – life assurance								
– Before reinsurance	38	52	6	96	10	–	–	10
– After reinsurance	17	24	2	43	1	–	–	1
5% decrease in mortality/morbidity – annuity business								
– Before reinsurance	(20)	(172)	–	(192)	(3)	–	–	(3)
– After reinsurance	(20)	(59)	–	(79)	(5)	–	–	(5)
Effect of end of period assumptions on VNB	n/a	n/a	n/a	n/a	7	–	–	7

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

2013 Sensitivities	Change in MCEV (net of tax)				Change in VNB (gross of tax)			
	UK £m	Restated Heritage[(iv)] £m	Restated Int'l[(iv)] £m	Total £m	UK £m	Restated Heritage[(iv)] £m	Restated Int'l[(iv)] £m	Total £m
Base MCEV and VNB	1,418	2,530	1,106	5,054	184	(26)	46	204
Market and credit risk								
100bps increase in reference rates	(21)	45	(1)	23	(3)	–	–	(3)
100bps decrease in reference rates	20	(35)	(3)	(18)	1	–	2	3
Removal of illiquidity premium for immediate annuities	(118)	(399)	–	(517)	(44)	–	–	(44)
10% decrease in equity/property capital values at the valuation date, without a corresponding fall/rise in dividend/rental yield	(48)	(149)	(62)	(259)	n/a	n/a	n/a	n/a
25% increase in equity and property volatility at the valuation date	–	(30)	–	(30)	n/a	n/a	n/a	n/a
25% increase in swaption implied volatility at the valuation date	–	(4)	–	(4)	n/a	n/a	n/a	n/a
100bps increase in corporate bond spreads[(i)]	(72)	(177)	(9)	(258)	(18)	–	–	(18)
100bps decrease in corporate bond spreads[(i)]	77	150	9	236	19	–	–	19
10% adverse movement in Sterling/overseas exchange rate[(ii)]	(7)	(32)	(71)	(110)	n/a	n/a	n/a	n/a
10% fall in value in unit-linked funds	(62)	(212)	(94)	(368)	n/a	n/a	n/a	n/a
100bps increase in expense inflation	(30)	(94)	(18)	(142)	(7)	–	–	(7)
100bps decrease in expense inflation	26	81	14	121	5	–	–	5
Insurance and other risk								
Reduction to EU minimum capital or equivalent[(iii)]	9	42	–	51	2	–	–	2
10% decrease in maintenance expenses	30	69	35	134	8	–	4	12
10% proportionate decrease in lapse rates	36	57	46	139	14	–	5	19
10% proportionate decrease in paid-up rates	9	2	3	14	5	–	1	6
5% decrease in mortality and morbidity – life assurance								
– Before reinsurance	27	50	9	86	8	–	–	8
– After reinsurance	12	19	5	36	3	–	–	3
5% decrease in mortality/morbidity annuity business								
– Before reinsurance	(17)	(129)	–	(146)	(3)	–	–	(3)
– After reinsurance	(17)	(51)	–	(68)	(5)	–	–	(5)
Effect of end of period assumptions on VNB	n/a	n/a	n/a	n/a	(11)	–	(3)	(14)

(i) The corporate bond spread sensitivities of an increase/(decrease) of 100bps assume an increase/(decrease) in the illiquidity premium for immediate annuities of 40bps (2013: 40bps) for in-force business and 40bps (2013: 40bps) for the value of new business.

(ii) Currency risk is expressed in terms of total overseas exposure; the Group's principal currency exposures other than Sterling are the Euro and US Dollar.

(iii) Required capital is set at the greater of regulatory capital and requirements arising from internal capital management policies. In aggregate, the required capital is higher than the regulatory requirement by £835 million (2013: £812 million). This sensitivity shows the impact on embedded value and value of new business of using the lower regulatory capital requirement.

(iv) The 2013 comparatives for International include the Lombard business. OLAB was transferred to the Heritage segment in 2014 and comparatives have been restated.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

b) Market risk

Overview

Market risk is defined within the Group as: "The risk that movement in market factors impacts adversely on the value of, or income from, shareholder or policyholder funds". Market risk can be categorised into the following risk drivers which correspond to the sub-modules through which they are modelled within Friends Life's economic capital model. These are equity and property risk, interest rate risk, volatility risk and foreign exchange risk.

The FLGL Board sets preferences for market risk for each of the different asset classes taking account of the risk appetite set by the Board. Consideration is given to the objectives of the asset pools to which they relate and the nature of the liabilities backed by those assets.

Shareholders' earnings are directly affected by market movements. For shareholder funds, the exposure will impact both the assets and associated liabilities. The Group manages market risk attached to assets backing specific policyholder liabilities and to assets held to deliver income and gains for the shareholder. The principal objective for shareholder assets is to manage them so that they meet the capital requirements of the Group, and support its future strategic objectives.

Shareholders' earnings are further exposed to market risk to the extent that the income from policyholder funds is based on the value of financial assets held within those unit-linked or with-profits funds. Within the unit-linked funds and with-profits funds, the Group manages market risk so as to provide a return in line with the expectations of policyholders.

Market risk arises on guarantees and options offered on some of the Group's products. As described within the section on policyholder liabilities (see notes 25 and 26), the Group is exposed to guarantees on bonus additions that become more valuable as investment values fall and where the cost of hedging increases. In addition, the Group is exposed to guaranteed cash and annuity options on certain pension policies that become more valuable as interest rates fall and where the cost of hedging increases.

Management of market risk

The following summarises the key actions undertaken by the Group to manage market risk:

The FLGL Board has adopted a Group Enterprise Risk Management Policy, underpinned by the Market Risk Control Standard. The Market Risk Control Standard sets out how market risk should be managed within the Group. The Market Risk Control Standard is reviewed as part of the Group's annual review of documentation.

The Market Risk Control Standard is further embedded in the business through the operation of investment limits. These specify the permitted asset classes for investment, the limits for exposures to asset classes including gilts and corporate bond exposures, cash exposures, derivative exposures, equity and other exposures, and also limits in relation to interest rate risk, inflation risk, foreign exchange risk, implied equity and interest rate volatility. The relevant limits are also reflected in investment guideline documents which are maintained for each fund.

To support the setting of investment limits, the Asset and Liability Management ("ALM") function is responsible for carrying out strategic asset allocation studies on each block of business within a three year life cycle. This review considers risk appetite, capital requirements and other metrics.

The Investment Oversight Committee, which is a committee of the FLGL Board, oversees investment policy and strategy, which the Group controls primarily through the use of investment fund mandates. Day-to-day implementation of investment policy and strategy is managed predominantly by:

- Schroders Investment Management Limited ("Schroders") in respect of some with-profits funds within FLL, non-profit portfolios within FLPL as well as a proportion of the unit-linked business sold by FLL and FLPL;
- AXA Investment Managers ("AXA IM") in respect of the FLC WPFs, FLAS WPF and WL WPF, non-profit, and shareholder portfolios within FLL and FLPL, as well as a proportion of the unit-linked business sold by FLL and FLPL, and the management of the Group's cash fund; and
- FLI in respect of some with-profits funds within FLL, non-profit, and shareholder portfolios within FLL and FLPL, as well as the Group's collateral management.

Mandates are set for each fund within each of the insurance legal entities within the Group taking account of the relevant factors outlined above. Unit-linked funds are managed in line with their underlying objectives as set out in fund guidelines. The mandates seek to limit exposure to market risk by using some or all of the following mechanisms:

- restrictions on the asset classes held;
- restrictions on the maximum exposure to any one issuer; and
- defined sector, country or regional limits.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

Use of derivatives to manage market risk

FLI, Schroders and AXA IM managed funds may hold derivatives to facilitate efficient portfolio management where their use is provided for in the relevant fund mandates. The types of derivatives held vary between investment mandates but may include both interest rate and equity derivatives. Currency forwards and other derivatives may also be held to manage currency risk, but only if permitted by individual fund mandates. The Group may seek to reduce investment risk by holding derivatives (without disproportionately increasing other types of risk).

Unit-linked funds may use derivatives for the purposes of efficient portfolio management and risk reduction in accordance with fund guidelines and marketing literature relevant to the funds.

In addition to the mandates, the Group undertakes a programme of asset/liability management. For example, in order to manage the impact of interest rate changes on profit, corporate bonds and gilts are held to match the duration, profile and cash flows of annuity and income protection policies.

In order to manage the exposure arising from guarantees and options, the Group has purchased a number of derivatives, including interest rate swaps, equity put options, currency forwards, inflation swaps, interest rate swaptions and equity futures to manage exposures to movements in equity prices or interest rates. Hedge accounting has not been applied to these derivatives, as movements in the fair value of these instruments will be offset by the movement in the valuation of the liability. As noted, the majority of these guarantees arise within the Group's with-profits funds and so any net fair value movement will be reflected in the unallocated surplus rather than within shareholders' funds. In addition, derivatives are used to manage guarantees in respect of non-profit business.

Additional information

The following provides additional information on the exposure to equity and property risk, foreign exchange risk, interest rate risk and volatility risk:

i) Equity and property risk

Equity and property risk are accepted in accordance with agreed risk preferences in order to achieve the desired level of return from policyholder assets.

Asset allocation within the with-profits funds is actively managed with the proportion of property and equity backing asset shares monitored against target equity backing ratios ("EBRs"). The target EBRs are 45% for the FP WPF pre-demutualisation business, 55% for the FP WPF post-demutualisation business, 60% for the FLC WPFs and 50% for the FLAS and WL WPFs (the WL WPF target corresponds to the equity participation portion of the fund only). These target levels are unchanged from 31 December 2013. These ratios reflect the perceived risk preferences of the with-profits funds and are in line with the Group's commitment to fair treatment of all its customers and the published PPFM.

The proportion of equity and property backing asset shares in the FLAS, FP and FPLAL WPFs are managed on a basis which targets a stable proportion over time. This is also true in WL WPF for policies with equity participation, although as policies get close to maturity their allocation is moved towards short-term fixed interest investments, and thus the overall equity and property proportion is likely to fall over time. For the FLC WPFs, asset allocation varies for different policies depending on how close they are to maturity, and thus the overall equity and property proportion within the fund is expected to gradually reduce over time.

For with-profits and unit-linked policies, the policyholders bear the majority of the investment risk and any change in asset values is matched by a broadly equivalent change in the realistic liability. For with-profits business, in very adverse circumstances shareholders may be obliged to provide additional support to these funds. In addition, unit-linked business charges that are expressed as a percentage of fund values, are impacted by movements in asset values and therefore falling values still have an adverse effect on shareholder earnings.

In some cases, the Group has issued policies containing return of premium guarantees and in adverse investment conditions these guarantees may become in the money, leading to shareholders bearing the investment risk associated with the policy.

In their decision-making on equity investments, Schroders and AXA IM assess the extent of equity risk required or allowed by the fund as set out in the fund objectives and relative to defined performance benchmarks. The management of equity investments by non Schroders and AXA IM fund managers is performed in accordance with the objectives of the fund as set out in policy contracts and marketing literature.

Throughout 2014 there has been no material exposure to equity risk within any of the shareholders' funds.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

ii) Foreign exchange risk

The Group is exposed to foreign exchange risk through its investment in foreign operations, fee income derived from financial instruments denominated in currencies other than its measurement currency (pounds Sterling), revenues receivable and payables due in foreign currency. Consequently, the Group is exposed to the risk that the exchange rate of its measurement currency relative to other currencies may change in a manner that has an adverse effect on the value of the Group's financial assets and liabilities. Derivative instruments are used to manage potential foreign exchange volatility in relation to foreign currency loans and borrowings; all other exchange rate risk is accepted as being within the Group's agreed risk preferences given the relative materiality of the exposure.

The net exposure to foreign exchange risk through investment in overseas equities is currently small, and exposure through debt securities is limited due to the restrictions through limits placed by investment mandates. For unit-linked contracts and with-profits policies (to the extent that currency risk on overseas equities held by the with-profits funds are only partially hedged), currency risk is borne by the policyholder. As noted above, the shareholder is subject to currency risk only to the extent that income from policyholder funds is based on the value of the financial assets held in those funds. The liability for non-linked insurance contracts in currencies other than Sterling is immaterial.

The Group is also exposed to foreign exchange risk through its issuance of US$575 million reset perpetual subordinated notes, guaranteed by its principal subsidiary, FLL. The USD cash flows for the coupons and principal up until the first reset date in 2018 have been hedged.

The disposal of the Lombard business has reduced the Group's exposure to translation risk. Prior to the disposal, Lombard was the only significant subsidiary undertaking with a reporting currency other than Sterling. The Lombard disposal proceeds included a deferred payment in the form of a vendor loan note, denominated in Euros, with a fair value of £56 million (€70 million). The vendor loan has an eight year term.

iii) Interest rate risk

The Group is exposed to fair value interest rate risk where changes to interest rates result in changes to fair values rather than cash flows, for example fixed interest rate loans and assets. Conversely, floating rate loans expose the Group to cash flow interest rate risk. The Group makes use of derivatives to manage interest rate risk. In the case of swaps, the Group holds both:

- receiver interest rate swaps (where fixed payments are received in return for floating payments being paid) – increases to interest rates increase cash flows payable and reduce fair value; and
- payer interest rate swaps (where floating payments are received in return for fixed payments being paid) – reductions to interest rates reduce cash flows receivable and reduce fair value.

However both types of swaps are held in order to reduce the net asset/liability rate risk which would otherwise arise.

Bond-related performance benchmarks within fund mandates are generally set so that asset profiles broadly match liability profiles and hence the interest rate risk is minimised. However in FAL and in FLL, the FP, FPLAL, FLC, FLAS and WL WPFs assets have been invested intentionally in bonds with a shorter duration than the companies' liabilities. Interest rate swaps have then been put in place to reduce the reinvestment risk which would otherwise arise.

Day-to-day investment decisions around the management of interest rate risk and its impact on the value of the Group's investments are largely undertaken on behalf of the Group by the relevant investment manager, within the boundaries set by fund mandates. In its decision-making on gilt and corporate bond investments, the investment manager will assess the extent of interest rate risk allowed by the fund as set out in the fund objectives and relative to the defined performance benchmarks.

The ALM function is responsible for monitoring and managing net asset/liability interest rate risk across all of the businesses. From time to time the ALM function may propose changes to the fund mandates to reflect changes in interest rate risk preferences.

The Group may also be exposed to interest rate risk on its strategic investments, and on any debt issuance. As part of any proposal for strategic investment or debt capital raising, the interest rate risk to which the Group is exposed will be given careful consideration as one of the factors impacting on the final recommendation. Ultimate approval for any strategic investments or debt raising rests with the FLGL Board.

iv) Volatility risk

The Group is exposed to the risk of loss or of adverse change in its financial position arising from changes in the market implied volatility used to value its realistic liabilities.

Swaptions and equity put options are held to mitigate interest rate volatility and implied equity volatility risk impacting the value of guarantees offered by most of the Group's insurance businesses.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

c) Credit risk

Credit risk includes the following seven elements:

- investment credit risk – financial loss arising from a change in the value of an investment due to a rating downgrade, default, or widening of credit spread. Changes in credit spreads are also affected by the liquidity of the stock and market expectations in respect of whether any option embedded within it will be exercised, but since the liquidity and effects related to embedded options are usually closely related to credit risk, these risks are managed as credit risk;
- derivative counterparty risk – financial loss arising from a derivative counterparty's default, or the deterioration of the derivative counterparty's financial position;
- reinsurance counterparty risk – financial loss arising from a reinsurer's default, or the deterioration of the reinsurer's financial position;
- deposit risk – financial loss arising from a deposit institution's default, or the deterioration of the deposit institution's financial position;
- loan risk – financial loss arising from a debtor's inability to repay all, or part, of its loan obligations or the deterioration of the debtor's financial position;
- country risk – financial loss arising from economic agents in a sovereign foreign country, including its government, being unable or unwilling to fulfil their international obligations due to a shortage of foreign exchange or another common reason such as currency inconvertibility; and
- settlement risk – financial loss arising from the failure or substantial delay of an expected settlement in a transfer system to take place, due to a party other than the Group defaulting/not delivering on its settlement obligations.

i) Investment credit risk

The Group's Life and Pensions business will take on investment credit risk when it is commensurate to do so in support of its financial objectives.

The Group is exposed to investment credit risk on its investment portfolio (in line with the Group's risk preferences), primarily from investments in corporate bonds and ABS. Creditworthiness assessment for new and existing investments is largely undertaken on behalf of the Group by Schroders, AXA IM and FLI. In their decision-making, Schroders, AXA IM or FLI (as appropriate) will assess the extent of investment credit risk allowed by each fund as set out in the fund mandates and relative to defined performance benchmarks.

The majority of the Group's corporate bond portfolio has a high credit rating (see subsequent tables in this note).

The Group has continued to diversify and expand its assets backing the growing annuity portfolios. During 2014, following the appointment of Metlife and Pramerica, the Group invested an additional circa £60 million in infrastructure loans and circa £70 million in commercial real estate loans.

During 2014, the exposure of the Group's shareholder funds to credit risk has been increased through a £206 million investment in a syndicated loans fund.

ii) Derivative counterparty risk

Derivatives purchased over the counter have the potential to expose the Group to substantial credit risk but this risk is significantly reduced through collateral arrangements with counterparties. When transacting over the counter, the Group endeavours only to transact derivatives with highly rated counterparties.

iii) Reinsurance counterparty risk

The Group is exposed to reinsurance counterparty risk in three different ways:

- as a result of debts arising from claims made but not yet paid by the reinsurer;
- from reinsurance premium payments made to the reinsurer in advance; and
- as a result of reserves held by the reinsurer which would have to be met by the Group in the event of default.

In addition, there is potential for the Group's credit risk exposure to increase significantly under adverse insurance risk events, e.g. if one of the insurance companies within the Group received a large number of claims for which it needed to recover amounts from its reinsurers. In order to mitigate reinsurance counterparty risk, the Group gives consideration to the credit quality of a reinsurer before incepting a reinsurance treaty. To facilitate this process, a list of acceptable reinsurers is maintained.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

iv) Deposit risk

The Group is exposed to credit risk on the balances deposited with banks in the form of cash, certificates of deposit and money market instruments. Money market instruments issued by parties other than banks such as commercial paper are also covered under this heading. The primary risk is borrower quality; this is mitigated by limiting holdings in any one issuer.

v) Loan risk

Companies in the Group are exposed to loan risk in several different areas, the most material of which are:

- loans to Independent Financial Advisers ("IFAs") as part of strategic investments;
- other strategic loans;
- loans to appointed representatives;
- loans to brokers;
- agency debt (including debt arising as a result of clawback of commission);
- policyholder debt;
- rental income due; and
- vendor loan note which formed part of the Lombard sale proceeds (refer to note 3(c)).

In general, these quantitative credit exposures are relatively low but, in some cases, they can bear relatively high likelihoods of default.

vi) Country risk

The Group is exposed to country risk in a number of key areas, the most significant of which is bonds issued by foreign governments and corporates in non-domestic currency. The mandates that govern all Schroders, AXA IM and FLI managed funds restrict the purchase of foreign government bonds and corporate bonds to only those that exceed a minimum level of creditworthiness.

The management of country risk on the creditworthiness of the investments is largely undertaken on behalf of the Group by Schroders, AXA IM and FLI. Counterparties are assessed on an individual basis, including the counterparty's sensitivity to a sovereign debt crisis in its country of domicile.

vii) Settlement risk

Settlement risk is a form of credit risk that arises at the settlement of a transaction, as a result of a counterparty failing to perform its obligations. The Group is exposed to settlement risk in the following key areas:

- bank transfers, including foreign exchange transactions;
- the purchase or sale of investments;
- the purchase or sale of property;
- the purchase, sale or expiry of exchange-traded derivatives or the transfer of periodic payments under these contracts; and
- the settlement of derivative contracts.

Objectives in managing credit risk

To mitigate credit risk:

- investment mandates for many funds will have a prescribed minimum credit rating of bonds that may be held and will generally prohibit investment in bonds of below specified minimum ratings, subject to some discretion where assets are downgraded. Investing in a diverse portfolio reduces the impact from individual companies defaulting;
- counterparty limits are set for investments, cash deposits, foreign exchange trade exposure and stock lending;
- all over the counter derivative transactions are covered by collateral, with minor exceptions;
- the Group regularly reviews the financial security of its reinsurers; and
- in some cases, derivatives are held to protect against the risk of credit default or internal hedge solutions have been implemented.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

The exposure to individual counterparties is limited to specific percentages of total non-linked assets in the long-term fund, based on regulatory categorisation of counterparties.

Concentrations of credit risk might exist where the Group has significant exposure to a group of counterparties with similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic and other conditions.

An indication of the Group's exposure to credit risk is the quality of the investments and counterparties with which it transacts. The Group is most exposed to credit risk on debt and other fixed-income securities, derivative financial instruments, deposits with credit institutions, reinsurance arrangements and cash equivalents. Debt and other fixed-income securities mainly comprise government bonds and corporate bonds. The Group monitors the quality of its corporate bonds and sovereign debt.

The following table gives an indication of the level of creditworthiness of those categories of assets which are neither past due nor impaired and are most exposed to credit risk using principally ratings prescribed by Standard & Poor's and Moody's. Assets held within unit-linked funds have been excluded from the table below as the credit risk on these assets is borne by the policyholders rather than the shareholders. The carrying amount of assets included in the consolidated statement of financial position represents the maximum credit exposure.

As at 31 December 2014	**AAA £m**	**AA £m**	**A £m**	**BBB £m**	**BB £m**	**B £m**	**Not rated £m**	**Total £m**
Corporate bonds and loans at fair value	**204**	**2,158**	**5,598**	**3,776**	**307**	**159**	**147**	**12,349**
Asset-backed securities	**1,350**	**828**	**1,568**	**564**	**29**	**10**	**4**	**4,353**
Derivative financial instruments	**–**	**–**	**419**	**114**	**–**	**–**	**42**	**575**
Reinsurance assets	**–**	**1,149**	**82**	**–**	**–**	**–**	**–**	**1,231**
Cash and cash equivalents	**3,511**	**397**	**567**	**268**	**–**	**–**	**17**	**4,760**
Insurance and other receivables	**32**	**129**	**120**	**66**	**5**	**–**	**337**	**689**
Total	**5,097**	**4,661**	**8,354**	**4,788**	**341**	**169**	**547**	**23,957**
%	**21%**	**20%**	**35%**	**20%**	**1%**	**1%**	**2%**	**100%**

As at 31 December 2013	AAA £m	AA £m	A £m	BBB £m	BB £m	B £m	Not rated £m	Total £m
Corporate bonds and loans at fair value	210	3,626	5,139	3,404	297	53	59	12,788
Asset-backed securities	1,395	825	1,326	498	47	29	4	4,124
Derivative financial instruments	–	30	149	–	–	–	20	199
Reinsurance assets	–	2,736	101	–	–	–	–	2,837
Cash and cash equivalents	3,300	555	754	21	–	–	117	4,747
Insurance and other receivables	30	118	120	106	6	1	80	461
Total	4,935	7,890	7,589	4,029	350	83	280	25,156
%	20%	31%	30%	16%	1%	1%	1%	100%

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

The Group holds collateral in respect of over the counter derivatives. Such collateral held by the Group consists of gilts, non-Sterling government bonds and cash. Collateral is valued at bid price.

For the majority of over the counter derivative transactions undertaken by the Group, collateral is received from the counterparty if the sum of all contracts held with the counterparty is in the money (i.e. it is being valued as an asset). The Group has a legal right to this collateral if the counterparty does not meet its obligations, but has no economic benefit from holding the assets and the counterparty may substitute at any time the collateral delivered for another asset of the same value and quality. It is repayable if the contract terminates or the contract's fair value falls. Contractual agreements between the Group and each counterparty exist to protect the interests of each party, taking into consideration minimum threshold, asset class of collateral pledged and the frequency of valuation. The carrying value of collateral is fair value. No collateral has been sold or repledged (2013: £nil).

The reinsurance assets of £1,580 million shown as at 31 December 2013 related to a reinsurance agreement that was amended in 2014 as set out in note 32. In 2013 the asset was secured by a collateral arrangement with HSBC offering protection should any counterparty supporting the reinsurance agreement default. An investment management agreement was in place to govern the suitability of collateral assets.

The following table provides information on derivative financial instruments and reinsurance assets that are subject to master netting agreements and illustrates the potential effect of netting offset arrangements after taking into account these agreements.

		Related amounts not set off in the consolidated statement of financial position(i)			
As at 31 December 2014	**Gross amounts recognised £m**	**Financial instruments £m**	**Collateral received £m**	**Collateral pledged £m**	**Net exposure £m**
Financial assets(ii)	**471**	**(176)**	**(245)**	**n/a**	**50**
Financial liabilities(ii)	**(144)**	**18**	**n/a**	**91**	**(35)**

		Related amounts not set off in the consolidated statement of financial position(i)			
As at 31 December 2013	Gross amounts recognised £m	Financial instruments £m	Collateral received £m	Collateral pledged £m	Net exposure £m
Financial assets(ii)	61	(18)	(32)	n/a	11
Reinsurance assets	1,580	–	(1,580)	n/a	–
Total	1,641	(18)	(1,612)	n/a	11
Financial liabilities(ii)	(355)	131	n/a	213	(11)

(i) Financial assets and financial liabilities that do not meet the offsetting criteria under IAS 32: *Financial instruments* and are reported gross in the consolidated statement of financial position.

(ii) Total derivative financial instruments disclosed in note 18 of £588 million (2013: £265 million) consist of the gross amounts of recognised financial assets of £471 million (2013: £61 million) and the total financial instruments offsetting financial liabilities of £18 million (2013: £131 million) in the tables above, plus other derivative financial instruments that are not subject to master netting agreements of £99 million (2013: £73 million). Total derivative financial instruments of £378 million disclosed in note 35 (2013: £430 million) consist of the gross amounts of recognised financial liabilities of £144 million (2013: £355 million) and the total financial instruments offsetting financial assets of £176 million (2013: £18 million) in the tables above, plus other derivative financial instruments that are not subject to master netting agreements of £58 million (2013: £57 million).

30. Risk management objectives and policies for mitigating risks continued

The following table shows the amounts of insurance receivables and loans that were impaired and the amounts of insurance receivables and loans that were not impaired but either past due or not past due at the end of the year. No other financial assets were either past due or impaired at the end of the year. However, some issuers of subordinated bonds in which the Group has holdings have suspended or announced that they intend to suspend the payment of coupons. Assets held in unit-linked funds have been excluded from the table.

	2014		2013	
As at 31 December	**Insurance receivables**	**Loans**	Insurance receivables	Loans
Financial assets that are neither past due nor impaired	**92.28%**	**40.71%**	87.02%	100%
Financial assets that are past due:				
0 – 3 months past due	**3.58%**	**–**	5.38%	–
3 – 6 months past due	**0.79%**	**–**	1.98%	–
6 – 12 months past due	**0.52%**	**–**	1.11%	–
Impaired financial assets for which provision is made	**2.83%**	**59.29%**	4.51%	–
Total before provision for impairment (£m)	**708**	**2**	483	8

d) Liquidity risk

Liquidity risk is the risk that, any of the Group's undertakings are unable to realise investments and other assets in order to settle their financial obligations when they fall due or can secure them only at excessive cost.

The Group faces two key stakeholders of liquidity risk:

- shareholder liquidity risk (liquidity within funds managed for the benefit of shareholders, including shareholders' interests in long-term funds); and
- policyholder liquidity risk (liquidity within funds managed for the benefit of policyholders).
- The Group will meet shareholder liquidity needs arising in a number of key areas. For example:
- the ability to support the liquidity requirements arising from new business;
- the capacity to maintain dividend payments/loan repayments and interest;
- the ability to deal with the liquidity implications of strategic initiatives, such as merger and acquisition activity;
- the capacity to provide financial support across the Group; and
- the ability to fund its day-to-day cash flow requirements.

The overall objective of shareholder liquidity risk management is to ensure that there is sufficient liquidity over short (up to one year) and medium time horizons to meet the cash flow needs of the business.

For policyholder funds, liquidity needs arise from a number of potential areas, including:

- a short term mismatch between cash flows arising from assets, premium receipts and cash flow requirements of liabilities;
- having to realise assets to meet liabilities during stressed market conditions;
- investments in illiquid assets such as property and private placement debt;
- higher than expected levels of lapses/surrenders caused by economic shock, adverse reputational issues or other events; and
- higher than expected payments of claims on insurance contracts.

The overall objective of policyholder liquidity risk management is to ensure that sufficient liquid funds are available to meet cash flow requirements under all but the most extreme scenarios.

Liquidity risk is managed in the following way:

- forecasts are prepared regularly to predict required liquidity levels over both the short and medium term;
- credit risk of cash deposits is managed by applying counterparty limits and imposing restrictions over the credit ratings of third parties with whom cash is deposited;

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

- assets of a suitable maturity and marketability are held to meet policyholder liabilities as they fall due;
- the implementation of temporary restrictions on the withdrawal of funds such as extension of the notice periods for switches and restrictions on withdrawals from property funds; and
- a £250 million credit facility with a syndicate of banks (Barclays Bank plc, Royal Bank of Canada, HSBC Bank plc and The Royal Bank of Scotland plc, with Barclays Bank plc as agent) exists to enable cash to be raised in a relatively short time-span. If a third party who does not presently have control of the Group acquires such control, the Group must notify the agent immediately and in this circumstance, the lenders are not obliged to fund utilisation and may notify the agent to cancel their commitments under the facility. This would have the effect of rendering all of their loans repayable within ten business days from the date of notice. As at 31 December 2014 the facility remains undrawn.

The following table details the undiscounted contractual net cash flows in respect of financial and insurance liabilities. Where contracts have a surrender value (i.e. the policy is theoretically payable on demand), the current surrender value is disclosed within the "within one year or payable on demand" column.

	Contractual undiscounted cash flows			
For the year ended 31 December 2014	**Carrying value £m**	**Within 1 year or payable on demand £m**	**1–5 years £m**	**More than 5 years £m**
Non-derivative financial liabilities				
Insurance contracts	**35,750**	**19,193**	**3,535**	**15,922**
Investment contracts	**64,087**	**64,087**	**–**	**–**
Loans and borrowings:[i]				
–Principal	**1,051**	**13**	**4**	**1,031**
–Interest	**–**	**89**	**351**	**132**
Net asset value attributable to unit-holders	**589**	**589**	**–**	**–**
Insurance payables and other payables	**629**	**589**	**40**	**–**
Derivative financial liabilities				
Interest rate swaps	**234**	**2**	**9**	**223**
Inflation rate swaps	**54**	**1**	**4**	**49**
Futures backing equities	**29**	**29**	**–**	**–**
Credit default swaps	**6**	**–**	**6**	**–**
Cross-currency swaps	**20**	**3**	**16**	**1**
Futures – fixed interest	**26**	**26**	**–**	**–**
Forward currency contracts	**9**	**9**	**–**	**–**

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

		Contractual undiscounted cash flows		
For the year ended 31 December 2013	Carrying value £m	Within 1 year or payable on demand £m	1–5 years £m	More than 5 years £m
Non-derivative financial liabilities				
Insurance contracts	34,590	20,321	3,252	15,880
Investment contracts	83,502	83,502	–	–
Loans and borrowings:(i)				
–Principal	1,050	28	7	1,009
–Interest	–	89	379	192
Due to reinsurers	1,580	115	444	1,653
Net asset value attributable to unit-holders	621	621	–	–
Insurance payables and other payables	817	715	100	–
Derivative financial liabilities				
Interest rate swaps	337	1	28	308
Futures backing equities	56	56	–	–
Credit default swaps	7	–	7	–
Cross-currency swaps	28	7	21	–
Futures – fixed interest	1	1	–	–
Forward currency contracts	1	1	–	–

(i) There is an option for the Friends Life Holdings plc US$575 million UT2 reset perpetual subordinated debt to be repaid in November 2018 but there is no obligation to repay.

Amounts expected to be settled from the unallocated surplus are excluded from the analysis above as there is no contractual obligation to settle the liability. Of the carrying amount in the consolidated statement of financial position in respect of the unallocated surplus, £634 million (2013: £584 million) is expected to be settled more than 12 months after the reporting date.

e) Insurance risk

Insurance risk includes the following areas:

- mortality risk – risk of loss arising due to policyholder death experience being different from expectations; or for annuities, risk of annuitants living longer than expected (called annuity longevity risk);
- morbidity risk – risk of loss arising due to policyholder health experience being different from expectations;
- persistency risk – risk of loss arising from lapse experience being different from expectations;
- expense risk – risk of loss due to expense experience being different from expectations; and
- option risk – risk of loss arising from experience of take up of options and guarantees being different from expectations.

The Group's Life and Pensions business actively pursues mortality risk, longevity risk and morbidity risk in those areas where it believes it has a competitive advantage in managing these risks to generate shareholder value (without compromising the interests of policyholders and the need to treat customers fairly). Persistency risk and expense risk are taken on when it is deemed financially beneficial for the organisation to do so, or where the taking of these risks is in support of the Group's strategic objectives.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

Underpinning the Group's management of insurance risk is:

- adherence to an approved underwriting policy that takes into account the level of risk that the Group is prepared to accept;
- controls around the development of products and their pricing;
- regular analysis of actual mortality, morbidity and lapse experience which feeds into the development of products and policies. If the analysis changes expectations of future liability cash flows, periodic adjustments are made to asset cash flows to maintain the asset/liability match; and
- monitoring concentration of risk using a variety of risk monitoring tools, involving scenario testing and sensitivity analysis of the Group's capital and profitability metrics, including MCEV, IGCA and Group economic capital. MCEV sensitivity analysis is provided in section (a) of this note.

Risks in excess of agreed underwriting limits may be reinsured. The Group's reinsurance strategy outlines the instances when reinsurance arrangements should be entered into or amended. With any reinsurance arrangement, the Group's objective is to undertake this in the most cost-effective manner and work with reinsurers whose creditworthiness is deemed appropriate.

Substantially all insurance contracts, and the majority of the combined insurance and investment contract portfolio, are written in the UK and so results are sensitive to changes in the UK insurance market and tax regime. Otherwise the Group sells a diverse range of products to a diverse group of people.

i) Mortality and morbidity risk

Life assurance

Most insurance policies other than annuities and deferred annuity policies include life assurance. When pricing policies, an assumption is made as to the likelihood of death during the policy term and this assumption is reviewed as part of the annual valuation of policies. To the extent that actual mortality experience is worse than that anticipated in pricing (and subsequently in the insurance liability valuation) a loss will be made. The risk is greater for those policies such as term assurance where the maturity or surrender benefit is small in relation to the death benefit. Other policies which have a savings element, such as endowment assurance, have significant liabilities relating to the maturity benefit, particularly as the policy approaches maturity. Contractual terms for unit-linked and unitised with-profits products include provision for increases in mortality charges.

Critical illness

The Group writes a number of critical illness policies that pay out in the event of a policyholder's ill health. As for life assurance, the amount payable on ill health can be significantly higher than the amount payable if the policy is surrendered.

Income protection

The two main risks related to income protection are an increase in the frequency of claims (the inception rate) and an increase in the average length of the claim (a reduction in recovery rate). Most income protection policies are regular premium with the premium and cover fixed at inception. Some Group policies allow premiums to be reviewed but the premium rates are usually guaranteed for two years.

Annuities

If annuitants live longer than expected on average, then profits will reduce. In most cases there is an initial guarantee period in which, in the event of death, annuity payments continue to be made to dependants or the policyholder's estate and many policies are written so that when the first life dies the benefit continues, often at a reduced level. These features tend to reduce the volatility of results to random fluctuations in experience but not the impact of a general increase in longevity.

Deferred annuities are subject to a similar risk from the impact of longevity, the only difference being that the risk of adverse impact is greater given that the annuity is payable further into the future.

Longevity and investment risk in respect of annuities was reduced through a reinsurance agreement put in place in April 2007. The agreement covered 100% of FLPL's in-force post-demutualisation annuity books as at 31 December 2006. On 24 November 2014 the reinsurance agreement was amended such that investment risk transferred back to the Group whilst the longevity risk continued to be reinsured. The agreement covers annuity contracts valued at £1,679 million at 31 December 2014 (2013: £1,580 million).

Longevity risk within FAL and the FLL NPF has been reduced by reinsurance of the annuity business with external parties. The agreement reinsures 95% of the longevity risk in respect of £2,905 million of annuity liabilities in FAL and a further £1,779 million of annuity liabilities in the FLL NPF.

Notes to the consolidated accounts

30. Risk management objectives and policies for mitigating risks continued

In September 2014 the Group's longevity exposure was increased by a further reallocation of £760 million of annuities from the with-profits funds to the shareholder funds within the Heritage Division (initial reallocation of £2 billion was performed in 2013). This transfer mitigated some of the longevity risk within the with-profits funds, transferring it to the shareholder funds which are actively seeking these risks. A third transfer of £665 million of annuity liabilities has taken place during January 2015.

ii) Persistency and option risk

Persistency experience varies over time as well as from one type of contract to another. Factors that will cause lapse rates to vary over time include changes in investment performance of the assets underlying the contract where appropriate, regulatory changes that make alternative products more attractive (or incentivise advisers to be more or less active in recommending policyholders to switch provider), customer perceptions of the insurance industry in general and the Group in particular, and the general economic environment.

The valuation of the Group's guarantees and options is described in note 26. As stated in that note, the cost of guaranteed annuity options is dependent on decisions made by policyholders such as policy discontinuance and tax-free cash take-up. These assumptions are set by reference to recent experience.

iii) Expense risk

Although under IFRS 4 expense risk is not a component of insurance risk, it is an important policy cash flow risk in the context of insurance and investment contracts.

The whole of the impact of changes in expense levels is borne by shareholders with the following exceptions:

- the charges made to the FP WPFs for managing policies are due next for review in 2018 to reflect market rates at that time. Pre- demutualisation with-profits policyholders will bear the impact of any resulting changes to charges;
- FPLAL WPF closed fund with-profits policyholders bear the full expense risk for the fund; and
- FLC WPFs, FLAS WPF and WL WPF have a fee agreement with FLSL under which increased expenses may be passed on to the funds provided independent review of the proposed expenses shows they are in line with market rates.

Contractual terms for unit-linked and unitised with-profits products include provision for increases in charges. Certain expenses such as fees and commissions are fixed at the time a contract is written.

The Group follows a heavily outsourced operating model which assists in the management of expense risk by ensuring the cost base allows for variable costs built into contractual assumptions. While such deals seek to deliver cost savings and greater certainty in relation to expenses, risks nevertheless remain that expense savings will not emerge as expected.

31. Loans and borrowings

The Group classifies its loans and borrowings as financial liabilities carried at amortised cost. Borrowings are recognised initially at fair value, which is generally the cash consideration received, net of transaction costs incurred, and subsequently stated at amortised cost. The amortised cost of a financial liability is the amount at which the financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest rate method of any difference between that initial amount and the maturity amount.

Any difference between the proceeds, net of transaction costs, and the redemption value is recognised in the income statement over the period of the borrowings, using the effective interest rate method. Interest accrued on loans and borrowings is recognised under insurance payables, other payables and deferred income and not included in the carrying value of interest-bearing loans and borrowings.

Notes to the consolidated accounts

31. Loans and borrowings continued

The Group's loans and borrowings are as follows:

		2014		2013	
	Coupon %	Carrying Amount £m	Fair Value £m	Carrying Amount £m	Fair Value £m
Subordinated liabilities:					
Friends Life Holdings plc £162 million LT2 subordinated debt due 2021	12.00	**176**	**228**	178	210
Friends Life Holdings plc £500 million LT2 subordinated debt due 2022	8.25	**497**	**613**	497	550
Friends Life Holdings plc US$575 million UT2 reset perpetual subordinated debt	7.875	**361**	**417**	339	378
Financial reinsurance:					
UK financial reinsurance treaties	Various	**5**	**5**	–	–
Heritage financial reinsurance treaties	Various	**9**	**9**	17	17
FPI financial reinsurance treaties	Various	**–**	**–**	11	11
Lombard financial reinsurance treaties	Various	**–**	**–**	3	3
Other:					
Amounts owed to credit institutions (overdrafts)		**3**	**3**	5	5
Total loans and borrowings		**1,051**	**1,275**	1,050	1,174

Subordinated liabilities

The Company's LT2 subordinated debt 2021 is irrevocably guaranteed on a subordinated basis by FLL. This debt is carried at amortised cost based on the fair value at the date of acquisition of Friends Provident by the Company.

The Company's LT2 subordinated debt 2022 is irrevocably guaranteed on a subordinated basis by FLL. This debt is carried at amortised cost being £500 million principal less capitalised issue costs of £3 million (2013: £3 million).

The Company's UT2 reset perpetual subordinated debt instrument, is irrevocably guaranteed on a subordinated basis by FLL. This debt is carried at amortised cost being the US$575 million principal translated at the effective exchange rate less capitalised issue costs of £8 million. The debt does not have a fixed repayment date but has an initial call date in November 2018 and is callable on every subsequent interest payment date from the initial call date. With effect from the initial call date, and for so long as the debt is outstanding, the interest coupon will be reset every six years at a rate equal to the six year US dollar mid swap rate plus a margin of 6.828%. The Company holds a derivative instrument to manage the risks associated with fluctuations in exchange rates on the issue of this debt.

Financial reinsurance

On 30 June 2014, FLPL entered into a financial reinsurance treaty with Munich Reinsurance Company UK Limited ("Munich Re") to finance new protection business written in the first half of 2014 in the UK division. The total amount owed to Munich Re under this financial reinsurance agreement as at 31 December 2014 was £5 million (31 December 2013: £nil).

FLL has three financial reinsurance contracts with Munich Re to finance German unit-linked pensions business (now reported within the Heritage division) written in the years ended 31 December 2010, 2011 and 2012. The total amount owed to Munich Re under these financial reinsurance arrangements as at 31 December 2014 was £9 million (31 December 2013: £17 million).

During 2013, FPI entered into a financial reinsurance agreement with Munich Re to finance new Rest of World Premier regular premium savings business written between 1 January 2013 and 31 December 2013 in certain territories. The total amount owed to Munich Re under this financial reinsurance agreement as at 31 December 2014 was £nil (31 December 2013: £11 million).

Other

Amounts owed to credit institutions (overdrafts) include £3 million (31 December 2013: £5 million) relating to credit balances held within OEICs that have been consolidated as the Group is deemed to have control. Such overdrafts are fully repayable out of the assets of the OEICs.

Notes to the consolidated accounts

31. Loans and borrowings continued

The Group benefits from a £250 million multi-currency revolving credit facility with Barclays Bank plc, Royal Bank of Canada, HSBC Bank plc and The Royal Bank of Scotland plc, with Barclays Bank plc as agent. If a third party who does not presently have control of the Group acquires such control, the Group must notify the agent immediately and in this circumstance, the lenders are not obliged to fund utilisation and may notify the agent to cancel their commitments under the facility. This would have the effect of rendering all of their loans repayable within ten business days from the date of notice. As at 31 December 2014, the facility remains undrawn.

Total interest-bearing loans and borrowings are repayable as follows:

As at 31 December	2014 £m	2013 £m
Within one year or on demand	**15**	31
Between one and two years	**3**	9
Between two and three years	**3**	2
Between three and four years	**4**	2
Between four and five years	**3**	2
In more than five years	**1,023**	1,004
Total loans and borrowings	**1,051**	1,050

Annual repayments include £2 million per annum amortisation of fair value adjustments and issue costs.

Total interest expense for financial liabilities not measured at fair value through profit or loss, which arises solely from interest-bearing loans and borrowings, is £95 million (2013: £94 million).

32. Amounts due to reinsurers

The amounts due to reinsurers represent future reassurance premiums payable and are accounted for as a financial liability at fair value through profit or loss, thereby avoiding a mismatch with the assets backing the liability.

During 2007 FLPL entered into a reinsurance agreement which took effect from 1 January 2007 and reinsured the longevity and investment risk, but not expense risk, of 100% of FLPL's in-force post-demutualisation annuity books as at 31 December 2006. Business written after 31 December 2006 was not reinsured under the treaty. Reassurance premium payments were funded from the fixed return on an investment in a collateralised HSBC amortising note, purchased with a transfer of the assets previously backing the annuity policies.

On 24 November 2014 the reinsurance agreement was amended such that investment risk transferred back to the Group whilst longevity risk continued to be reinsured. This amendment resulted in the derecognition of the HSBC amortising loan note previously held and the receipt of a £1,650 million portfolio of directly held assets (UK government securities and cash) generating a realised investment gain of £28 million. The amount due to reinsurers under the agreement of £1,622 million was also derecognised with a corresponding credit recognised in premiums ceded to reinsurers. This credit was offset by a reduction in insurance contract liabilities net of reinsurance assets previously recognised in respect of this agreement of £1,659 million. During 2015, it is the Group's intention to trade the assets received into higher yielding assets thereby reducing the IFRS valuation of annuity liabilities backed by the assets.

Notes to the consolidated accounts

33. Net asset value attributable to unit-holders

OEICs and unit trusts where the Group has a controlling interest and the units are not owned by the Group are treated as a liability, as there is a contractual obligation to deliver cash, and are presented as "net asset value attributable to unit-holders".

The movements in the value of third party interests in OEICS and unit trusts that are consolidated by the Group are as follows:

For the year ended 31 December	2014 £m	2013 £m
At 1 January	**621**	754
Share of total return in the year	**60**	89
Share of distributions in the year	**(14)**	(7)
Amount paid on issue of shares	**273**	194
Disposals	**(92)**	(156)
Amount received on cancellation of shares	**(259)**	(253)
At 31 December	**589**	621

The carrying value of the net asset value attributable to unit-holders approximates fair value.

34. Provisions

A provision is recognised when the Group has a present legal or constructive obligation, as a result of a past event, which is likely to result in an outflow of resources and where a reliable estimate of the amount of the obligation can be made. If the effect is material, the provision is determined by discounting the expected future cash flows. The Group recognises a provision for onerous contracts when the expected benefits to be derived from the contracts are less than the related unavoidable costs.

For the year ended 31 December 2014	At 1 January £m	Charged in the period £m	Released in the period £m	Utilised in the period £m	Transferred to operations classified as held for sale £m	At 31 December £m
Customer redress	**117**	**35**	**(5)**	**(30)**	**–**	**117**
Separation and integration	**2**	**–**	**–**	**(1)**	**–**	**1**
Outsourcing	**19**	**–**	**–**	**(17)**	**–**	**2**
ROL separation costs	**3**	**–**	**(1)**	**(1)**	**–**	**1**
Sesame lapses	**16**	**15**	**–**	**(18)**	**–**	**13**
Vacant property	**13**	**4**	**–**	**(9)**	**–**	**8**
Other	**57**	**23**	**(21)**	**(17)**	**(8)**	**34**
Total provisions	**227**	**77**	**(27)**	**(93)**	**(8)**	**176**

For the year ended 31 December 2013	At 1 January £m	Charged in the period £m	Released in the period £m	Utilised in the period £m	At 31 December £m
Customer redress	114	63	(50)	(10)	117
Separation and integration	35	–	–	(33)	2
Outsourcing	32	–	–	(13)	19
ROL separation costs	14	1	–	(12)	3
Sesame lapses	19	25	–	(28)	16
Vacant property	11	4	–	(2)	13
Other	53	41	(21)	(16)	57
Total provisions	278	134	(71)	(114)	227

Notes to the consolidated accounts

34. Provisions continued

Included in the carrying amount above, £28 million (2013: £43 million) is expected to be settled more than 12 months after the reporting date. Where provisions are held for the longer term, discounting is applied at a rate of 3% per annum. A net £nil (2013: £nil) is included within the charge for the year in respect of the unwind of discount and £nil (2013: £nil) relating to a change in the discount rate applied.

a) Customer redress

Provision for customer redress and associated costs includes:

- provisions relating to aspects of the administration of defined benefit pension schemes, totalling £47 million (2013: £49 million);
- provision for expected costs of customer redress in relation to the SBG business, totalling £23 million (2013: £35 million). This includes a provision in relation to a review of past pension transfer business of £12 million (2013: £16 million), and a provision of £11 million (2013: £19 million) in relation to complaints and other past business reviews. Whilst SBG is liable for redress costs, it is estimated that £10 million (2013: £17 million) will be recoverable from third parties. The provisions are best estimates, based on available information. The Group's review of the SBG business is continuing and there is considerable uncertainty with regards to potential additional adverse impacts; and
- other redress provisions, totalling £47 million (2013: £33 million).

In addition to accounting provisions, an actuarial reserve of £2 million (2013: £2 million) is held in insurance contract liabilities in respect of estimated further customer redress payments.

Timing and amounts are uncertain, but the provisions are expected to be largely utilised within two years.

b) Separation and integration

As part of the respective purchase agreements, costs were incurred to separate the businesses purchased from AXA UK plc, Bupa Investments Limited and its parent, Bupa Finance plc, and to integrate the businesses within the Group. The remaining provision is expected to be utilised during 2015.

c) Outsourcing

The outsourcing provision relates to committed costs of the Diligenta outsourcing agreement. The provision is expected to be utilised during 2015.

d) Resolution Operations LLP ("ROL") separation costs

Provision was made in 2012 in relation to the costs of transferring an operating agreement, under which the Company outsourced most of its operating functions, from ROL to the Group, including associated restructuring costs. The remaining provision is expected to be utilised during 2015.

e) Sesame lapses

This provision has been incurred in the ordinary course of business and is short term in nature, with full utilisation and reassessment on an annual basis.

f) Vacant property

This provision has been incurred in the ordinary course of business and is expected largely to be utilised within six years.

g) Other

Other includes £13 million relating to the Sesame strategic review, which is expected to be utilised during 2015, together with a number of minor provisions incurred in the ordinary course of business.

Notes to the consolidated accounts

35. Insurance payables, other payables and deferred income

Insurance and other payables are recognised when due and are measured on initial recognition at the fair value of the consideration payable. Subsequent to initial recognition, derivative contract liabilities are carried at fair value and other payables are measured at amortised cost using the effective interest rate method.

Front-end fees charged at the inception of certain investment contracts are recognised as income over the expected term of the contract on a straight-line basis with the unrecognised amount at the end of the year presented as a liability.

As at 31 December	2014 £m	2013 £m
Creditors arising out of direct insurance operations	**50**	104
Creditors arising out of reinsurance operations	**76**	72
Accruals and deferred income	**220**	201
Investments purchased for subsequent settlement	**82**	149
Deferred front-end fees	**61**	64
Derivative contracts	**378**	430
Other payables	**226**	291
Total insurance payables, other payables and deferred income	**1,093**	1,311

Included in the carrying amount above, £304 million (2013: £309 million) is expected to be settled more than 12 months after the reporting date.

All insurance payables, other payables and deferred income balances are carried at cost, which approximates to fair value, with the exception of derivative contract liabilities which are carried at fair value.

36. Share capital

The authorised share capital of the Company is represented by 515 million ordinary shares with par value of £1 each.

	2014 £m	2013 £m
Allotted, called up and fully paid:		
515 million ordinary shares of £1	**515**	515

The holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share at meetings of the Company.

There are no restrictions on the transfer of ordinary shares in the Company other than those imposed by laws and regulations.

Notes to the consolidated accounts

37. Other reserves

Other reserves included in equity attributable to equity holders of the Company are as follows:

For the year ended 31 December 2014	Merger reserve £m	Contributed capital £m	Retained earnings £m	Foreign currency translation reserve £m	Total £m
1 January 2014	**102**	**312**	**4,163**	**(27)**	**4,550**
Loss for the period	–	–	(148)	–	(148)
Remeasurements of the defined benefit scheme (net of tax)	–	–	26	–	26
Tax relief on STICS interest	–	–	20	–	20
Foreign exchange adjustments (net of tax) and other items	–	–	–	(19)	(19)
Recycling of cumulative foreign exchange adjustments on disposal of foreign operations	–	–	–	46	46
Share-based payments	–	–	8	–	8
Dividends paid	–	–	(610)	–	(610)
Funding of EBT	–	–	(13)	–	(13)
At 31 December 2014	**102**	**312**	**3,446**	**–**	**3,860**

For the year ended 31 December 2013	Merger reserve £m	Contributed capital £m	Retained earnings £m	Foreign currency translation reserve £m	Total £m
1 January 2013	102	312	4,351	(36)	4,729
Profit for the period	–	–	225	–	225
Remeasurements of the defined benefit scheme (net of tax)	–	–	(77)	–	(77)
Tax relief on STICS interest	–	–	7	–	7
Foreign exchange adjustments (net of tax) and other items	–	–	–	9	9
Share-based payments	–	–	5	–	5
Release of share entitlement provision	–	–	2	–	2
Dividends paid	–	–	(350)	–	(350)
At 31 December 2013	102	312	4,163	(27)	4,550

38. Step-up Tier one Insurance Capital Securities ("STICS")

A financial instrument is treated as equity if:

- there is no contractual obligation to deliver cash or other financial assets or to exchange financial assets or liabilities on terms that may be unfavourable; and
- the instrument is not a derivative and contains no contractual obligations to deliver a variable number of shares or is a derivative that will be settled only by the Group exchanging a fixed amount of cash or other assets for a fixed number of the Group's own equity instruments.

	2014			2013		
	2003 STICS £m	**2005 STICS £m**	**Total £m**	2003 STICS £m	2005 STICS £m	Total £m
At 1 January	**135**	**183**	**318**	135	183	318
Interest payable in the period	**14**	**17**	**31**	14	17	31
Interest paid in the period	**(14)**	**(17)**	**(31)**	(14)	(17)	(31)
At 31 December	**135**	**183**	**318**	135	183	318

The Company's external STICS have been recognised at fair value at the acquisition date of Friends Provident. These securities are described as the 2003 STICS and the 2005 STICS, respectively, reflecting the year in which they were originally issued by Friends Provident.

Under IFRS, the STICS are accounted for as equity as there is no requirement to settle the obligation in cash or another financial asset. Consistent with this equity classification, interest on these instruments is not treated as an expense but as an appropriation of profit. However, given the operating nature of the interest payments on these securities, the Group has deducted the interest on the securities in computing the IFRS based operating profit for the Group. No ordinary dividend can be paid if the STICS interest is not paid.

A summary of the principal terms of the STICS is set out in the following paragraphs.

2003 STICS

£210 million remain in issue. If they pay out, they bear interest from 21 November 2003 to 21 November 2019 at a rate of 6.875% with interest payable in equal instalments in arrears on 21 May and 21 November of each year. The remaining STICS have no maturity date but will be redeemable in whole or part at the option of the Company on 21 November 2019, thereafter on every fifth anniversary of this date. The STICS are perpetual securities and are not redeemable at the option of the holders at any time. The principal obligor of the STICS is the Company, but they are irrevocably guaranteed on a subordinated basis by FLL. For each coupon period beginning after 20 November 2019, the STICS will bear interest that is reset every five years.

2005 STICS

£268 million remain in issue. If they pay out, they bear interest from 30 June 2005 to 30 June 2015 at a rate of 6.292% with interest payable in arrears on 30 June of each year (except in 2015 when the interest payment date is 1 July). The remaining STICS have no maturity date but will be redeemable in whole or part at the option of the Company on 1 July 2015, thereafter on every fifth anniversary of this date. The STICS are perpetual securities and are not redeemable at the option of the holders at any time. The principal obligor of the STICS is the Company, but they are irrevocably guaranteed on a subordinated basis by FLL. For each coupon period after 1 July 2015, the STICS will bear interest that is reset every five years.

The profit allocated to STICS holders and interest paid is disclosed in the consolidated statement of changes in equity.

Notes to the consolidated accounts

39. Contingent liabilities and commitments

Contingent liabilities are disclosed if there is a possible future obligation as a result of a past event or if there is a present obligation as a result of a past event but either a payment is not probable or the amount cannot be reliably estimated.

In the normal course of its business, the Group is subject to matters of litigation or dispute and interpretation of tax law. In addition, the sale agreement for the disposal of the Lombard business includes representations, warranties and indemnifications that would be expected in a transaction of this nature. Whilst there can be no assurances, at this time the directors believe, based on the information currently available to them, that it is not probable that the ultimate outcome of any of these matters will have a material adverse effect on the financial condition of the Group.

In February 2013 the Group commenced a strategic review of the businesses of SBG, including Sesame Limited. This strategic review is still ongoing with a number of potential options and outcomes for the Sesame business being considered. Due to potential liabilities from future advice related claims, Sesame is reliant on the continued financial support of the Group to be able to continue to trade. Existing provisions for customer redress are disclosed in note 34. Any costs associated with future complaints are not expected to have a material adverse impact for the Group.

b) Commitments

Operating leases where the Group is lessee

The Group leases a number of properties under operating leases with the most material running to 2026. Lease terms include annual escalation clauses to reflect current market conditions.

The future minimum rentals payable under all non-cancellable leases are as follows:

	2014			2013		
	Land and buildings £m	**Other £m**	**Total £m**	Land and buildings £m	Other £m	Total £m
Within one year	**12**	**–**	**12**	15	1	16
Between one and five years	**43**	**–**	**43**	55	1	56
In more than five years	**71**	**–**	**71**	81	1	82
Total operating lease payables	**126**	**–**	**126**	151	3	154

At 31 December 2013, £17 million of lease commitments related to the Lombard business that was sold in 2014 (£14 million land and buildings; £3 million other).

Other commitments

The Group has investment property commitments of £24 million (2013: £16 million) relating to ongoing construction, renovation costs and costs of acquiring existing properties.

40. Related parties

In the ordinary course of business, the Group and its subsidiary undertakings carry out transactions with related parties, as defined by IAS 24: *Related party disclosures*. Material transactions for the year are set out below.

The principal subsidiary undertakings of the Group are shown in note 17.

a) Key management personnel compensation

The key management personnel of FLH are the directors of the Company and the members of the Group Executive Committee. The directors and the Group Executive Committee have responsibility for planning, directing and controlling the activities of the Group.

Notes to the consolidated accounts

40. Related parties continued

In aggregate the compensation of the key management personnel in respect of the year ending 31 December 2014 is as set out below:

	2014 Number	2014 £m	2013 Number	2013 £m
Salary and short-term employee benefits[(i)]	21	10	28	9
Post-employment benefits (excluding defined benefit scheme)	1	–	1	–
Share-based payments	1	1	7	2
Total key management personnel compensation charged to the income statement		**11**		11
Post-employment benefits: defined benefit schemes	–	–	–	–
Total key management personnel compensation		**11**		11

(i) Including Messrs Cowdery and Tiner who stepped down from the board on 8 May 2014.

There were no balances outstanding at the year end with key management (2013: £nil).

Salary and short-term employment benefits include £nil payments for loss of office (2013: £0.9 million).

Details of pension schemes and share schemes operated by the Group, and in which key management personnel participate, are given in notes 9 and 10.

A number of key management personnel, and their close families, have long-term insurance policies with the Group. Such policies are on normal commercial terms which are also available to other members of staff. The Board has considered the financial effect of such insurance policies and concluded that they are not material.

All these transactions were completed on terms that were no better than those available to other members of staff.

b) Other related parties

Details of the Group's pension schemes, whose assets are managed by external investment managers are provided in note 9.

Transactions made between the Group and related parties were made in the normal course of business. Loans from related parties are made on normal arm's length commercial terms.

41. Post balance sheet events

On 19 January 2015, FLGL published a Scheme of Arrangement ("the Scheme") document in relation to the Proposed Acquisition by Aviva plc of the entire ordinary share capital of FLGL. An Aviva Prospectus was issued by Aviva plc on the same day.

The Proposed Acquisition must be approved by FLGL's shareholders, Aviva's shareholders and the Guernsey Court. Subject to approval, the Proposed Acquisition will be completed by way of a Scheme of Arrangement in accordance with Guernsey company law. The Scheme will require shareholder approval at a meeting convened by order of the Guernsey Court ("the Court Meeting") and at an extraordinary general meeting of FLGL ("the General Meeting"). The Court Meeting and General Meeting will be held on 26 March 2015. If the Proposed Acquisition is approved by shareholders and the Court, the Scheme will become effective on 10 April 2015 and at that point the Company will become part of the Aviva Group.

Independent auditor's report to the members of Friends Life Holdings plc

We have audited the parent company financial statements of Friends Life Holdings plc for the year ended 31 December 2014 which comprise the parent company balance sheet and the related notes 1 to 15. 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 ("UK GAAP")).

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditor

As explained more fully in the Statement of directors' responsibilities set out on pages 24 and 25, the directors are responsible for the preparation of the parent company 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 parent company financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the parent company'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 Report and Accounts 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.

Opinion on financial statements

In our opinion the parent company financial statements:

- give a true and fair view of the state of the Company's affairs as at 31 December 2014;
- have been properly prepared in accordance with UK GAAP; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the parent company financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Independent auditor's report to the members of Friends Life Holdings plc

Other matters

We have reported separately on the group financial statements of Friends Life Holdings plc for the year ended 31 December 2014. The opinion in that report is unqualified.

George Reid
Senior statutory auditor
for and on behalf of Ernst & Young LLP
London
4 March 2015

Parent company balance sheet

As at 31 December	Notes	2014 £m	2013 £m
Fixed assets investments			
Shares in Group undertakings	3	**4,846**	4,541
Other investments in Group undertakings	4	**1,356**	1,656
		6,202	6,197
Current assets			
Financial assets	5	**205**	–
Debtors			
Amounts owed by Group undertakings		**33**	35
Prepayments		**1**	1
Other debtors		**66**	53
Cash at bank and in hand		**193**	402
Derivative instruments	7	**10**	–
Total current assets		**508**	491
Creditors: amounts falling due within one year			
Accruals		**(45)**	(45)
Amounts owed to Group undertakings	6	**(40)**	(32)
Loans due to Group companies		**(6)**	–
Total current liabilities		**(91)**	(77)
Net current assets		**417**	414
Total assets less current liabilities		**6,619**	6,611
Creditors: amounts falling due after more than one year			
Derivative instruments	7	**–**	(7)
Loans and borrowings	8	**(1,042)**	(1,024)
Loans due to Group companies		**(260)**	(6)
Net assets		**5,317**	5,574
Capital and reserves			
– Called-up share capital	10	**515**	515
– Profit and loss account	10	**3,900**	4,157
– Other reserves	10	**414**	414
Equity shareholders' funds attributable to shareholders of parent company		**4,829**	5,086
STICS holders	11	**488**	488
Total equity		**5,317**	5,574

The financial statements were approved by the Board of Directors on 4 March 2015.

Tim Tookey
Director

The notes on pages 136 to 140 form an integral part of these financial statements.

Notes to the parent company accounts

1. Accounting policies

1.1 Basis of preparation

The financial statements have been prepared in accordance with applicable accounting standards and under the historical cost convention as modified by the revaluation of investments as set out in note 1.2.3.

The Company presents individual financial statements prepared on a United Kingdom Generally Accepted Accounting Practice ("UK GAAP") basis as permitted by section 396 of the Companies Act 2006 and has adopted the exemption of omitting the profit and loss account as permitted by section 408 of that Act.

All accounting policies have been reviewed for appropriateness in accordance with Financial Reporting Standards ("FRS").

In accordance with FRS 1: *Cashflow statements (revised 1996)*, the Company is exempt from the requirement to prepare a cash flow statement on the grounds that this is provided in its consolidated financial statements.

The Directors have adopted the going concern basis in preparing the Parent Company financial statements (see basis of preparation in note 1 of the Group's consolidated financial statements.

1.2 Significant accounting policies

1.2.1 Investment return

Investment return includes dividends, interest, rents, gains and losses on the realisation of assets and unrealised gains and losses. Such income includes any withholding tax but excludes other tax credits, such as attributable tax credits. Income from fixed interest securities together with interest, rents, and associated expenses are accounted for in the period in which they accrue. Dividends are included in the profit and loss account when they are declared. Realised gains or losses on investments are calculated as the difference between the net sale proceeds and original cost. Unrealised gains and losses on investments represent the difference between the valuation of investments at the balance sheet date and their original cost.

1.2.2 Taxation

Taxation is based on the profits and income for the period as determined in accordance with the relevant tax legislation, together with adjustments to provisions for prior periods. Tax payable is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

Current taxation is recognised in the profit and loss account for the period, except to the extent that it is attributable to a gain or loss recognised outside the profit and loss account, in which case the current tax is recognised in the statement of total recognised gains and losses, or equity, as applicable.

Deferred tax is recognised on timing differences arising between the recognition of gains and losses in the financial statements and their recognition in a tax computation. The tax rates used are the rates that have been enacted or substantively enacted by the balance sheet date.

Full provision is made for deferred tax liabilities. Deferred tax assets are recognised to the extent that they are more likely than not to be regarded as recoverable against suitable taxable profits.

Deferred taxation is recognised in the profit and loss account for the period, except to the extent that it is attributable to a gain or loss recognised outside the profit and loss account, in which case the deferred tax is recognised in the statement of total recognised gains and losses, or equity, as applicable. The deferred tax balances are not discounted.

1.2.3 Fixed asset investments

Shares and equity investments in Group undertakings and loans to Group undertakings are stated at historical cost less any provision for impairment. Any provision for impairment is charged to the profit and loss account.

1.2.4 Financial assets including derivative instruments

Financial assets are designated as fair value through profit or loss ("FVTPL") upon initial recognition, in accordance with FRS 26: *Financial instruments: recognition and measurement,* as they are managed individually or together on a fair value basis. Derivative instruments are classified as held for trading in accordance with FRS 26 and are held at FVTPL. Financial instruments at FVTPL are recognised at face value on initial recognition and are subsequently re-measured at fair value based on quoted prices where such prices are available from a third party in a liquid market. If quoted prices are unavailable, the fair value of the financial instrument is estimated using valuation approaches as outlined in note 5.

1.2.5 Cash at bank

Cash at bank comprises cash on call and is stated at cost.

Notes to the parent company accounts

1. Accounting policies continued

1.2.6 Impairment of assets

At each balance sheet date the Company assesses whether there is objective evidence that a fixed asset investment is impaired. A financial asset is impaired and impairment losses are incurred only if there is objective evidence of impairment. This may be as a result of one or more events that have occurred after the initial recognition of the asset which have an impact on the estimated future cash flows of the financial asset.

1.2.7 Offsetting financial instruments

Financial assets and liabilities are only offset when a legally enforceable right to offset exists and when there is either an intention to settle on a net basis or it is intended to realise the asset and settle the liability simultaneously.

1.2.8 Interest-bearing loans and borrowings

Borrowings are recognised initially at fair value, which is generally the cash consideration received, net of transaction costs incurred, and subsequently stated at amortised cost. Where a fixed maturity date exists any difference between the proceeds, net of transaction costs, and the redemption value is recognised in the profit and loss account over the period of the borrowings, using the effective interest rate method.

2. Auditors remuneration

Auditors remuneration for audit services for 2014 of £21,000 (2013: £21,000) was borne by other companies within the Group. Fees paid to the Company's auditor, Ernst & Young LLP and its associates for services other than the statutory audit of the Company and other Group undertakings are disclosed in note 7b of the Group's consolidated financial statements.

3. Shares in Group undertakings

	2014 Subsidiary undertakings £m	2013 Subsidiary undertakings £m
Cost		
At 1 January	**4,541**	4,519
Additions(i)(ii)(iii)	**305**	27
Credit for the management long term incentive scheme(iv)	**–**	(5)
At 31 December	**4,846**	4,541

(i) The Company purchased additional shares of £300 million in Friends Life FPG Limited ("FPG") on 26 September 2014, funded by the repurchase of preference shares by Friends Life Limited ("FLL") as shown in note 4.
(ii) On 25 September 2014, the Company subscribed for and was issued 4.5 million ordinary shares of £1.00 each in the capital of Friends Life Funds Limited ("FLFL") in connection with FLFL's authorisation under the Alternative Investment Fund Managers Directive.
(iii) The impairment of a debtor in 2013 related to the acquisition of Friends ASLH Limited ("FASLH") was accounted for as an increase in the cost of investment of £27 million.
(iv) When the share-based payment scheme, the FLG LTIP was modified in 2013, the obligation to settle the award transferred from the Company to FLGL. For further details see note 10 of the Group's consolidated financial statements.

Shares in Group undertakings comprise the Company's 100% interest in FPG, FASLH, FLFL, Friends Life Investments Limited ("FLI"), FL Isle of Man No.1 Limited, FL Isle of Man No.2 Limited, FL Isle of Man No.3 Limited, FL Isle of Man No.4 Limited, FL Isle of Man No.5 Limited.

The principal subsidiary undertakings of the Company as at 31 December 2014 are set out in note 17 to the Group's consolidated financial statements.

The Company has provided Friends Life Management Services Limited and Friends Life Services Limited with an undertaking that for at least 12 months from the date of approval of their financial statements, it will continue to make available such funds as are needed by the companies.

In February 2013 the Group commenced a strategic review of the businesses of the Sesame Bankhall Group ("SBG"). This strategic review is still ongoing with a number of potential options and outcomes for the Sesame business being considered and the Company has given a letter of support to SBG to assist them in meeting their liabilities as they fall due.

Notes to the parent company accounts

4. Other investments in Group undertakings

	2014 £m	2013 £m
Equity		
FLL STICS (coupon rate 6.302% p.a.)	**500**	500
Loans to Group undertakings		
FLL preference shares (coupon rate 4.8125% p.a.)[(i)]	**–**	300
FLL LT2 (coupon rate 8.25% p.a.)	**500**	500
FLL UT2 (coupon rate 7.916% p.a.)	**356**	356
Total	**1,356**	1,656

(i) On 26 September 2014, FLL repurchased 300 million preference shares for £1 each from the Company for a cash consideration of £305 million, including £5 million accrued interest.

Other loans to Group undertakings are expected to be repayable after 5 years.

5. Financial Assets

	2014 £m	2013 £m
Other financial assets	**205**	–
Total	**205**	–

In accordance with the requirements of FRS 29: *Financial instruments: disclosures*, financial assets which are measured at fair value have been classified into three categories as set out below. Financial assets at fair value comprise syndicated loan asset investments made in 2014.

Level 1 – quoted prices (unadjusted) in active markets for identical assets.

Level 2 – inputs other than quoted prices included within Level 1 that are observable for the asset, either directly (i.e. as prices) or indirectly (i.e. derived from prices). This category generally includes assets that are priced based on models using market observable inputs.

Level 3 – inputs for the assets that are not based on observable market data.

The fair values of syndicated loan assets are generally provided by brokers and pricing services. During the year, independent reviews of pricing models were performed to ensure that appropriate methodologies have been applied.

Where the number of transactions declines under the current market conditions, valuations become more subjective. Syndicated loan prices provided by pricing services are based on the best estimate of market price determined by market makers based on a variety of factors and are considered to be observable prices. In determining fair value, market makers will take into account transactions they have observed in identical or similar assets as well as movements in market indices and any other factors that they regard as relevant. Assets with single price feeds and/or limited trading activity are included in the level 3 category. The syndicated loans have all been classified within the level 3 category.

The company holds a cross-currency swap derivative instrument (see note 7). The fair value of the cross-currency swap derivative is modelled with reference to observable market inputs and is thus classified within the Level 2 category.

6. Amounts owed to Group undertakings

The amounts due to Group undertakings are repayable on demand. No interest is payable on these amounts.

7. Derivative instruments

The Company uses cross-currency swap derivative contracts to manage the risks associated with fluctuations in the US Dollar/GBP exchange rate, linked to its US Dollar denominated subordinated debt instrument, see note 8. The derivative instruments are measured at FVTPL and as at 31 December 2014 the Company has received collateral of £10 million in respect of the swaps (31 December 2013: £(3) million pledged).

Notes to the parent company accounts

8. Loans and borrowings

	Coupon %	2014 £m	2013 £m
Friends Life Holdings plc US$575 million UT2 reset perpetual subordinated debt	7.875	**361**	339
Friends Life Holdings plc £500 million LT2 subordinated debt due 2022	8.250	**497**	497
Friends Life Holdings plc £162 million LT2 subordinated debt due 2021	12.000	**184**	188
Total loans and borrowings		**1,042**	1,024

On 8 November 2012, the Company issued a US$575 million UT2 reset perpetual subordinated debt instrument with a coupon of 7.875%, which is irrevocably guaranteed on a subordinated basis by FLL. This debt is carried at amortised cost of £361 million being the US$575 million principal translated at the effective exchange rate less capitalised issue costs of £8 million. The debt does not have a fixed repayment date but does carry a callable reset feature for four years time (initial call in November 2018) and on every subsequent interest payment date from the reset date. Derivative instruments were entered into on 8 November 2012 to manage the risks associated with fluctuations in exchange rates on the issue of this debt. The derivative instruments have a six year duration, coupon costs are fixed at £28 million per annum and potential redemption of the US$575 million perpetual subordinated debt instrument is fixed at £356 million. The proceeds of the debt issue were initially used to invest in the £356 million FLL subordinated debt instrument, see note 4.

On 21 April 2011, the Company issued a £500 million LT2 debt instrument with a coupon of 8.25% and maturity of 2022, which is irrevocably guaranteed on a subordinated basis by FLL. This debt is carried at amortised cost being £500 million principal less capitalised issue costs of £3 million. The proceeds of the debt issue were initially used to invest in the £500 million FLL LT2 debt instrument, see note 4.

The £162 million LT2 debt was transferred to the Company from FPG on 15 December 2010 and recognised at a fair value of £198 million on initial recognition. The debt has subsequently been measured at amortised cost and is irrevocably guaranteed on a subordinated basis by FLL.

9. Risk management objectives and policies for mitigating risks

Details of the objectives, policies and processes for mitigating credit risk, market risk and liquidity risk are set out in note 30 to the Group's consolidated financial statements. None of the financial assets are deemed to be past due or impaired.

10. Share capital and reserves

Details of the Company's share capital are set out in note 36 to the Group's consolidated financial statements.

At 31 December 2014	**Share Capital £m**	**Merger reserve(i) £m**	**Contributed capital(ii) £m**	**Profit and loss account £m**	**Total £m**
1 January 2014	**515**	**102**	**312**	**4,157**	**5,086**
Profit for the period	**–**	**–**	**–**	**366**	**366**
Dividends	**–**	**–**	**–**	**(610)**	**(610)**
Funding of Employee Benefit Trust ("EBT")	**–**	**–**	**–**	**(13)**	**(13)**
At 31 December 2014	**515**	**102**	**312**	**3,900**	**4,829**

At 31 December 2013	Share Capital £m	Merger reserve(i) £m	Contributed capital(ii) £m	Profit and loss account £m	Total £m
1 January 2013	515	102	312	4,150	5,079
Profit for the period	–	–	–	357	357
Dividends	–	–	–	(350)	(350)
At 31 December 2013	515	102	312	4,157	5,086

(i) Represents premium arising on issue of shares in the Company in 2009 which has been recognised as a merger reserve.
(ii) Cash contribution from FLGL to finance the elements of consideration paid in cash on acquisition of FPG in 2009.

The distributable reserves of the Company at 31 December 2014 are £3,547 million (2013: £3,803 million).

Notes to the parent company accounts

11. Step-up Tier one Insurance Capital Securities ("STICS")

	2003 STICS £m	2005 STICS £m	Total £m
At 1 January 2014	**212**	**276**	**488**
Interest payable in the period	14	17	31
Interest paid in the period	(14)	(17)	(31)
At 31 December 2014	**212**	**276**	**488**

	2003 STICS £m	2005 STICS £m	Total £m
At 1 January 2013	212	276	488
Interest payable in the period	14	17	31
Interest paid in the period	(14)	(17)	(31)
At 31 December 2013	212	276	488

Further details relating to the STICS are set out in note 38 to the Group's consolidated financial statements.

12. Directors remuneration

The Company has no direct employment costs as these are borne by fellow subsidiary undertakings, Friends Life Management Services Limited and Friends Life Services Limited. The directors and employees who provide services to the Company are employed by and received their remuneration from those subsidiary undertakings.

Details of Directors Emoluments and compensation paid to key management personnel is detailed in notes 8 and 40 in the Group's consolidated financial statements. Full details of directors' emoluments are contained in the Directors' remuneration report in the Report and Accounts of FLGL.

13. Related parties

Details of key management transactions are set out in note 40 to the Group's consolidated financial statements.

14. Ultimate parent company

The Company's immediate parent undertaking is FLG Holdings Limited, formerly Resolution Holdings (Guernsey) Limited, a company registered in Guernsey.

The Company's ultimate parent undertaking is FLGL, formerly Resolution Limited, which is incorporated in Guernsey. Copies of the Group Report and Accounts of FLGL can be obtained from: www.friendslifegroup.com

15. Post balance sheet events

Details of post balance sheet events are set out in note 41 of the Group's consolidated financial statements.

An interim dividend of £250 million was agreed and approved by the Board on 4 March 2015.