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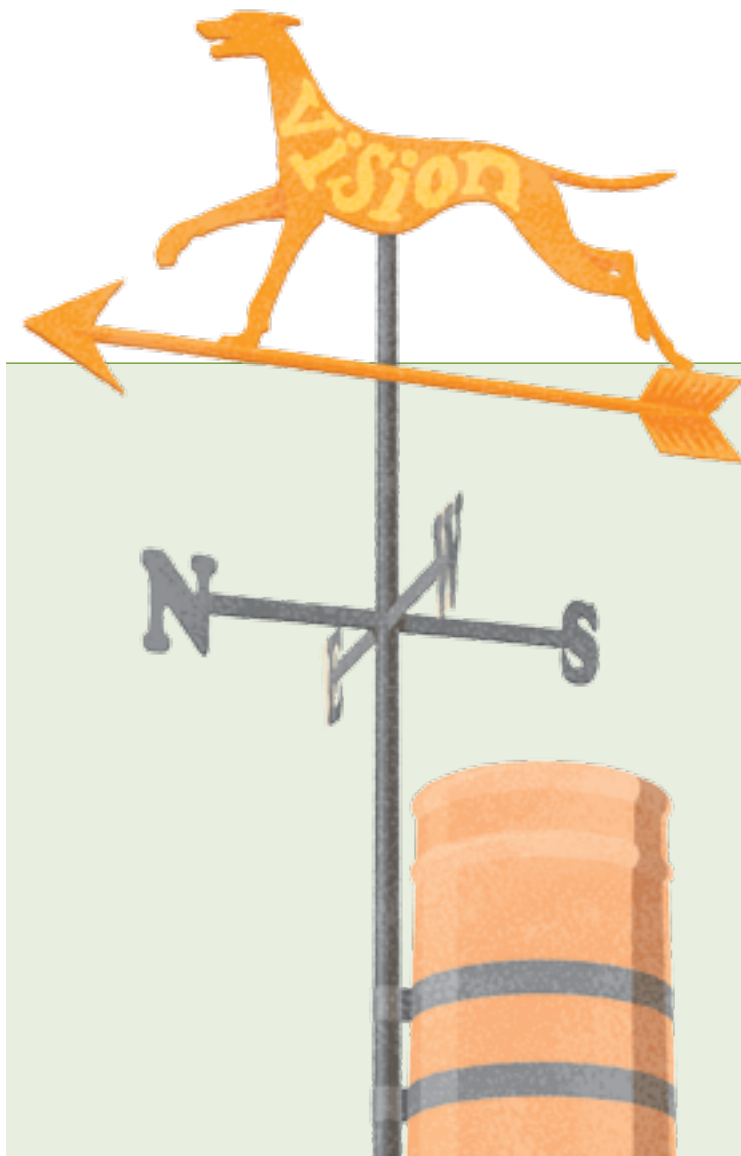
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Established 1868 | Registered and
incorporated Friendly Society no. 369F.

Member of the Association of Financial Mutuals.

Authorised and regulated by the
Financial Services Authority.

Chief Executive Officer: R. Sear
Company Secretary: J. Long



INVESTOR IN PEOPLE

Advisors

Auditors

PricewaterhouseCoopers LLP,
31 Great George Street,
Bristol, BS1 5QD

Bankers

National Westminster, The Mall, Clifton,
Bristol, BS99 5AJ

Custodians

Northern Trust, 50 Bank Street,
Canary Wharf, London, E14 5NT

Internal Auditors

Mazars LLP, Clifton Down House,
Beaufort Buildings, Clifton,
Bristol, BS8 4AN

Investment Managers

Equity and Fixed Income Fund,
Fidelity Investments, 25 Cannon Street,
London, EC4M 5TA

Unit Linked Fund,
Church House Investments, 3 Goldcroft,
Yeovil, Somerset, BA21 4DQ

Solicitors

Beachcroft LLP, 100 Fetter Lane,
London, EC4A 1BN

Lovells, Atlantic House, Holborn Viaduct,
London, EC1A 2FG.

Thring Townsend Lee & Pembertons,
The Paragon, Counterslip,
Bristol, BS1 6BX

Surveyors

Mellersh & Harding, 6 Duke Street,
St James's, London, SW1Y 6BN

With-Profit Actuary

BWCI Limited, Albert House,
South Esplanade, St Peter Port,
Guernsey, GY1 1AW

Chairman's Review



Alan Lewis

I joined the Board as a non-executive director in June 2009 and was elected Chairman in June 2010, following the retirement of Don Burgess after nearly seven years' service in the role.

Don's time at the helm was marked by many important developments, including the introduction of new innovative healthcare insurance products. Without the introduction of these products the Society would have continued to decline and the accompanying restructuring led to the creation of a more vibrant and fresh Society summed up by the adoption of the new National Friendly name and brand identity. We thank Don for his service and wish him well for the future.

My role is to achieve a secure future for the Society and its members and protect the interests of the policy holders. The strong level of sales growth reported in 2009 continued through 2010. However, during the last quarter of the year it became clear that we were experiencing a high level of claims on the healthcare products. Your Board took immediate action to the extent it was able to

alleviate the impact this would have on the Society. However, driven by this significant increase in healthcare claims experience towards the end of 2010, which has continued into the first part of 2011, we have been obliged to increase our 2010 year end reserves for future healthcare claims by a substantial amount, rendering us in breach of our minimum capital requirement.

As a consequence, and working closely with the Financial Services Authority (FSA) whose job it is to ensure that members' interests are safeguarded, we have taken immediate restorative action.

We have reviewed and de-risked our investment strategy for free assets and we have cut costs in order to safeguard reserves. We have also ceased writing new insurance business, including the private medical insurance products Healthcare and Healthguard.

These decisions will ensure that we can continue to provide the same level of service to our members and protect their interests in the long term. This has unfortunately resulted in a number of redundancies and staff departures and we thank all of those people for their hard work and commitment to the Society.

Despite these difficulties National Friendly has a great heritage and numerous positive commercial characteristics which leave it well positioned to compete notwithstanding the tough economic times we live in and competitive markets we operate in. Our relatively small size and short lines of communication allow us to respond quickly and effectively to market changes and demands. We have gained valuable experience

and know-how in the distribution of product and our name and brand are well respected. Our customer service levels are high. We continue to see opportunity in the wider healthcare and welfare markets which are increasingly seen as one of the major challenges facing our society at large.

Our primary objective at the current time however is to continue to take whatever actions are necessary to restore our capital position and we are exploring all opportunities that will enable us to do so as quickly as practicable. We are of course continuing to work closely with the FSA. We will ensure that we will continue to put our members' interests at the heart of what we do in 2011 and working within the constraints of our capital base we will continue to develop your Society as a modern mutual with strong processes, structures and systems and a culture which is able to retain and attract the people resources so necessary to compete.

Looking ahead, the vision must be to build a business which understands its members and customers, protects their interests at all times and has products and services which are relevant to their needs. During 2011 we will face up to our constraints, deal with them in a commercially viable way, and re-develop the business in a sustainable way. As ever, standing still is not an option.

Alan Lewis Chairman
7 June 2011

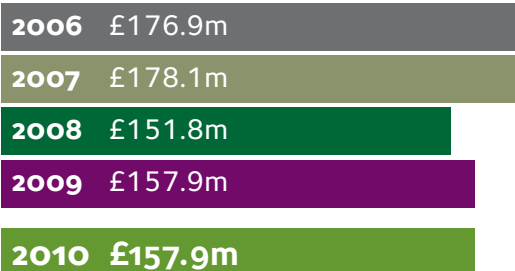
Financial Highlights

Total Assets

Our asset base has stabilised, following the market fall of 2008, assisted by changes in investment strategy.

2010

£157.9m



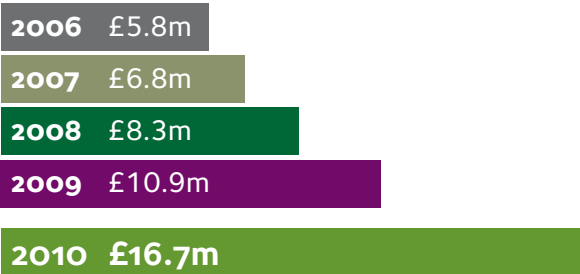
Annual Premiums Earned & Premium Income

Calculated using 10% of Single Premium Business

Continuing premium income growth is attributable to strong performance of our regular Healthcare business.

2010

£16.7m

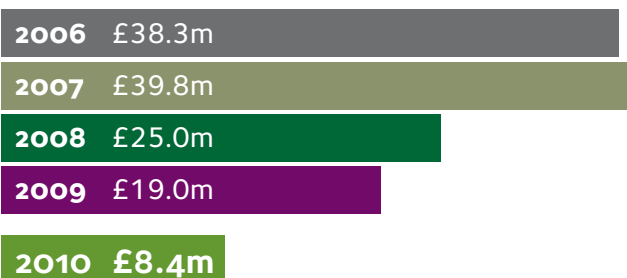


Fund for Future Appropriations

The Fund for Future Appropriations has reduced reflecting both increased levels of new business and a significant deterioration in morbidity experience.

2010

£8.4m



Chief Executive's Report



Richard Sear

Over the last few years we have sold a unique health insurance product to the market. The key risk underlying this product is morbidity. Our morbidity experience in some of the products deteriorated in the last quarter of 2010 and this continued in the early part of 2011. As these policies are treated as life products a significant level of capital is required to be set aside to meet the cost of any claims 10, 20, 30 years into the future. The deterioration in claims experienced, i.e. an increase in the amount of people claiming and the size of the claims, has had an inevitable impact on our reserving position such that we have breached our statutory minimum capital requirement.

We have taken the decision to stop writing all new business while the capital position of the Society is considered. We are working closely with the FSA to finalise our Capital Restoration Plan.

This report covers the main issues of 2010 and developments in the early part of 2011.

Against a backdrop of some of the most testing economic and financial conditions for 60 years coupled with political uncertainty, 2010 was a difficult year for the Society.

We have since undertaken a cost review of the Society, ceasing all strategic expenditure not linked to cost saving projects, and a review of headcount. We also undertook a review of our investment strategy, realising equities matched against our free assets and re-investing in fixed interest assets in order to minimise our exposure to market risk.

In the longer term we will look at new sources of capital to fund our healthcare business or re-insuring the Healthcare book. These decisions will be made with the interests of members at the centre of our decision making and with dialogue from the FSA. Capital restoration is a key issue going forward and the Society has already taken steps to reduce its costs.

We are committed to helping people access the care they need when they are ill or elderly – both through the products and services we provide as well as the initiatives we support in the local community.

This ethos will not change despite our reduced capital position.

With the knowledge that the State will not be able to fully provide for its increasing ageing population and the government promoting the concept of The Big Society, National Friendly's founding principles are more relevant than ever. Mutual societies, like us, were formed by the people for the people, to ensure all members of society were provided for. The government needs to instigate changes that will allow mutuals to flourish and to help plug the gap between an unsustainable welfare state and achieving The Big Society objectives.



“With the knowledge that the State will not be able to fully provide for its increasing ageing population and the government promoting the concept of The Big Society, National Friendly's founding principles are more relevant than ever.”

Our Governing Structures

A new Chairman has been appointed, prompting changes to the way the Board operates and supports the Society.

An effective Board

We have assembled a group of experienced business leaders with shared commitment to lead the change effort. Our Board members have proven to be a strong and coherent force during a year of many changes.

The Board currently comprises 2 Executive Directors and 5 Non-Executive Directors. Each Non-Executive Director brings a different skill set to the Board room and this adds to the strength and performance of the Board in the decision making processes.

Corporate structure

The Society's committee structure is comprehensive; working to keep the Board fully apprised and thus enabling informed decision making. Each sub-committee consists of a minimum of two Non-Executive Directors, ensuring independence in all decision and policy making.

The committee structure is also vital to the safeguarding of member interests ensuring the member is at the heart of all decisions taken.

Strategy in operation

The delivery of the business strategy is underpinned by the Society's internal organisational structure, which is made up of working parties to support the governing committees. The working parties and the strategies they support are crucial to the Society ensuring that risk, capital management, internal control and Treating Customers Fairly (TCF) are embedded principles across the business. The safeguarding of our members' interests is fundamental to the operating purpose of the Society. In 2012 new European regulations, Solvency II, will require further strengthening of our governance structure and whilst the longer term business plan focuses on delivering consolidated growth, the Society has also allowed for some enhancement to risk, capital management, internal control, IT development, management reporting and TCF.

Treating Customers Fairly

The Directors and staff recognise that the Financial Services Authority's initiative of TCF is of fundamental importance in driving up standards in the financial services sector and in line with our long-standing principles we fully support its aims. In 2010 the Society continued to work on embedding TCF into our company

practices, all the way through the sales process. The Society's TCF policy was reviewed in 2010 and the Board signed off a new document in December that sets out how we will ensure that the principles of TCF are fully entrenched in all product design and disclosure, all advertising and promotional activities, in all the advice and recommendations we provide and in the customer service we offer.

Risk Management

Robust capital management has been key in 2010 during a period of increased new business strain. Options to improve the robustness and flexibility of the Society's capital position have been rigorously explored. Concerns regarding the capital strain of our current Healthcare products were investigated and action was taken in relation to both product profitability and claims management. This culminated in the decision in April 2011, following an exceptional period of three years' new business growth, to cease writing new Healthcare business to allow us to reassess and restore our capital position and continue to serve our existing customers. The Board has compiled a Capital Restoration Plan to be discussed with the FSA. Once agreed, the Board will review rigorously progress to the plan on a regular basis, working with the Executive Directors and senior management to effect conclusive outcomes.

2010 has seen us select, develop and implement an in-house actuarial team that allows us to perform regular evaluations in a far more cost effective and timely manner. This has allowed us to model our products far more robustly and has significantly enhanced our reserving and forecasting capabilities, this being key to our preparation for Solvency II, the new European regulation coming into force at the end of 2012. Another key project was the selection and implementation of new risk management software, which has enhanced our risk and capital management framework and processes. The Society's business continuity capability has also been strengthened and successful testing of off-site provision undertaken.

With-Profit

We continue to work with the FSA on determining the respective rights of our different policyholders to participate in the distribution of surplus as part of the With-Profit Review and expect to conclude this work in the second half of 2011.

Financial review

Against a backdrop of continuing economic challenge, National Friendly has continued to deliver new business growth throughout 2010. However due to an increase in claims experience resulting in significant increases in reserving, its capital position has deteriorated, breaching the statutory minimum capital requirement meaning that the Society has had to temporarily stop writing new business to enable the capital position to recover.

Sales and marketing leading new business growth

The Society exceeded £8m in issued new business in 2010. An increase of over 35% on the previous year.

Affinity marketing partnerships have developed in 2010 with the News International partnership in particular being seen as both innovative and market leading, generating sizeable sales volumes and positive exposure for the brand.

425 Direct

In September 2009 we bolstered our call centre capabilities through the acquisition of 425 Direct Ltd, previously the telephony arm of financial advice company, AWD Chase De Vere.

In 2010 the 425 Direct team added impetus to our sales activity; increasing our conversion rates on National Friendly products substantially and providing an additional revenue stream through the Advice and Compare & Buy teams.

As we move into 2011 we have clear vision of how 425 will support our strategic plans through the distribution of third party products and we will continue to leverage the capabilities of the team to drive out maximum value for the Society.

IT infrastructure

The IT and project teams have been restructured in 2010 and have been further strengthened in 2011 with the appointment of a Chief Information Officer to lead this activity.

The Asterix project, which aims to deliver a streamlined policy administration and management information system as well as providing support to help the Society meet Solvency II directives, was launched in April 2010. The key priority is to refine and build upon our existing systems in order to automate as much of our processing activities as practical, thereby creating greater business efficiencies and enabling cost reductions. This will involve constructing detailed business requirements for new and existing policies, and the migration and testing of data from legacy administrative platforms.

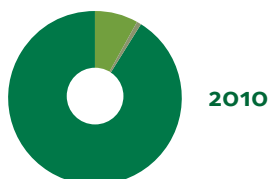
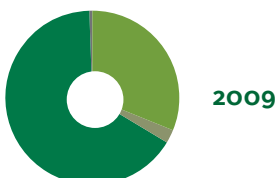
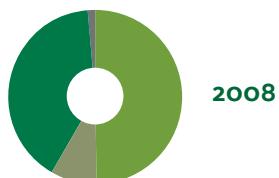
E Strategy

The Salesforce CRM, introduced in August 2009, has been developed further in 2010 helping to automate and streamline key elements of the new acquisition and ongoing intermediary relationship management.

Asset Growth

The Society's asset base contracted by 16% in 2008 due to severe market conditions. We refined our investment strategy in 2009 taking the decision to consolidate our asset base and focus on capital management as well as investment performance. This enabled us to efficiently utilise our resources and by diversifying our surplus funds we have been better able to manage risk. By continuing to monitor our investments and market conditions in 2010, we have been able to stabilise our asset base on the back of the continued recovery of the markets.

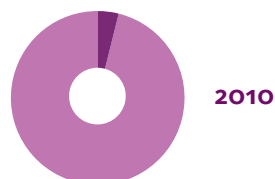
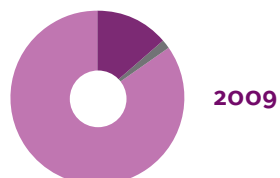
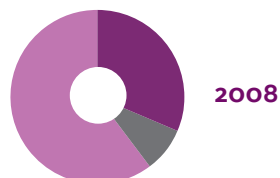
New Business by Policy Numbers



Key

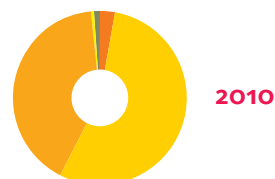
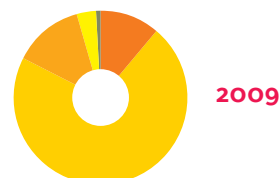
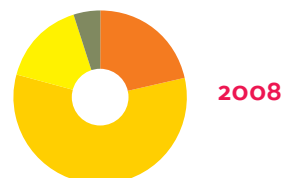
- Regular Premium Assurance
- Single Premium Assurance
- Regular Premium Healthcare
- Pensions & Care

New Business by Annual Premium Equivalent

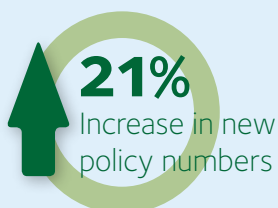


- Regular Premium Assurance
- Single Premium Assurance
- Regular Premium Healthcare

New Business Product Analysis by Annual Premium Equivalent



- Assurance
- Healthcare
- Healthguard
- With-Profits Investment
- Other



Investments

On the back of a poorly performing equity market at the beginning of 2009 and considering the need to adapt our investment strategy to protect our capital position, the Society diversified into Corporate Bonds. We continued to monitor and review our investment strategy in 2010 so as to maximise the matching of assets with liabilities.

Active management of the property portfolio has minimised the effects of the ongoing recession despite further easing of rental yields, throughout the year. The portfolio which is spread geographically with a mix of private and public tenants remains well placed to withstand further economic pressures and maintain value for the future benefit of the members.

Expenditure

Tight management of administration costs meant that the growth in new business and the resultant uplift in claims and administration activities were managed with only modest increases in cost and headcount. However, as part of restoring our capital position all costs have been reviewed, inevitably resulting in headcount reduction.

Administration expenses have risen slightly from 2009 due to the increased amount of new business written in 2010. Income from the existing business has increased to cover the administration cost of the book. Acquisition expense has increased significantly from 2009 as the Society continues to invest in the delivery of new business, although this is now being reviewed with the temporary cessation of writing new policies.

Business process reengineering initiatives were undertaken in 425 Direct and the Customer Services areas, aimed at increasing performance and improving efficiencies.

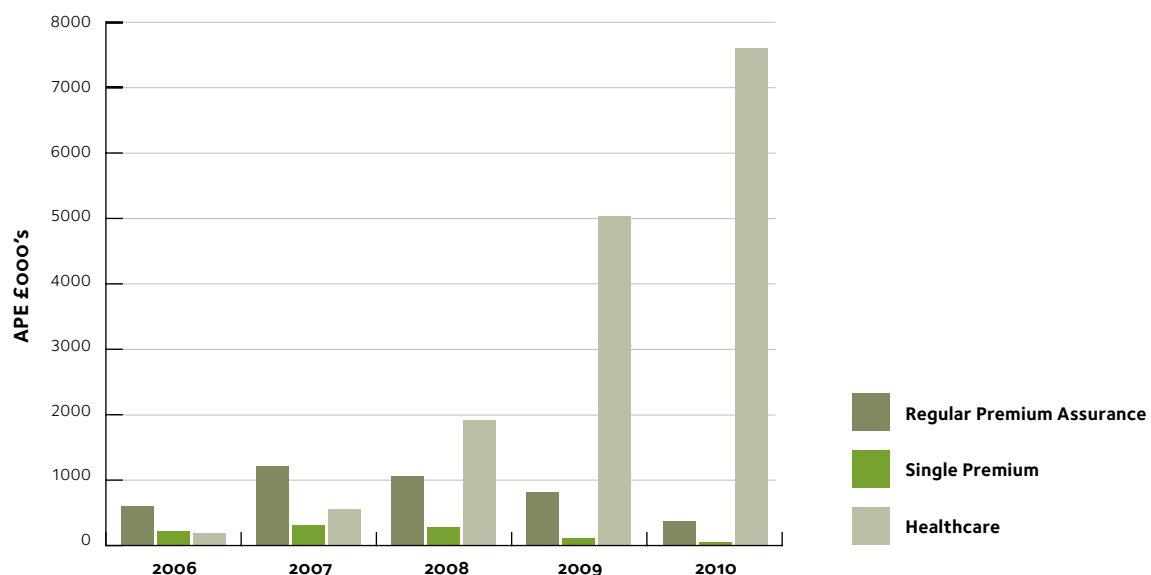
The Actuarial function has now been brought fully in-house resulting in a more responsive service at a significantly reduced cost.

We will continue to monitor our expenditure with capital restoration at the forefront.

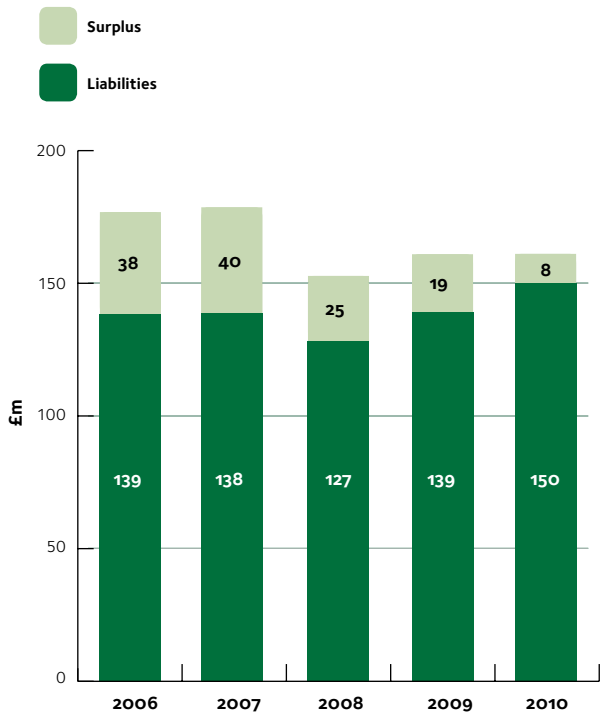
Premium Income

Overall, premium income has increased by 41% due to the significant level of new business written both this year and last. Our premium income is largely attributable to regular premiums with single premium business now only comprising 2% of the total.

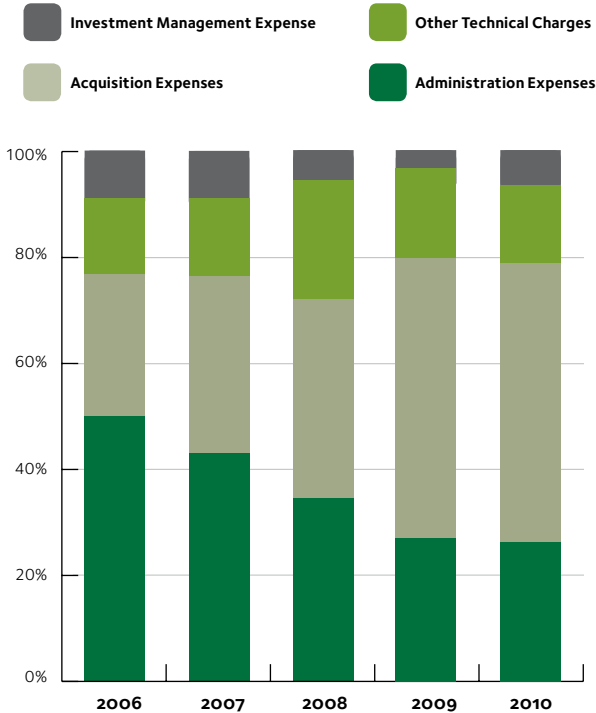
New Business Year on Year Comparison



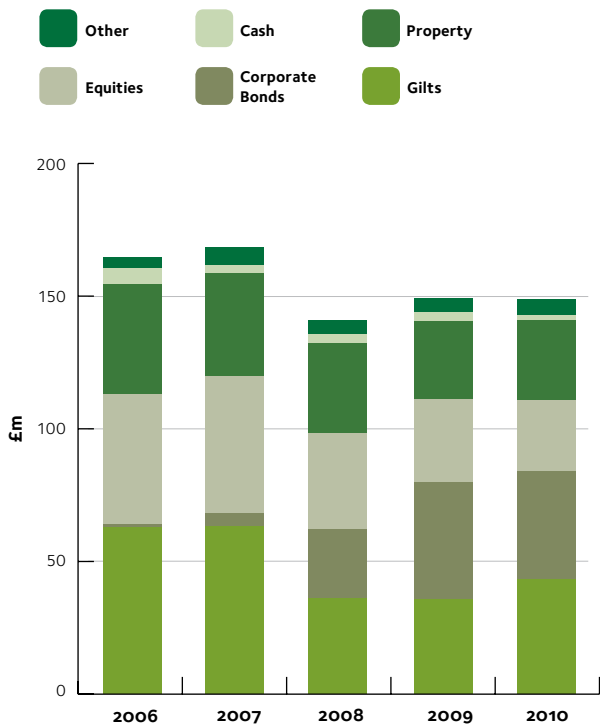
Total liabilities v surplus



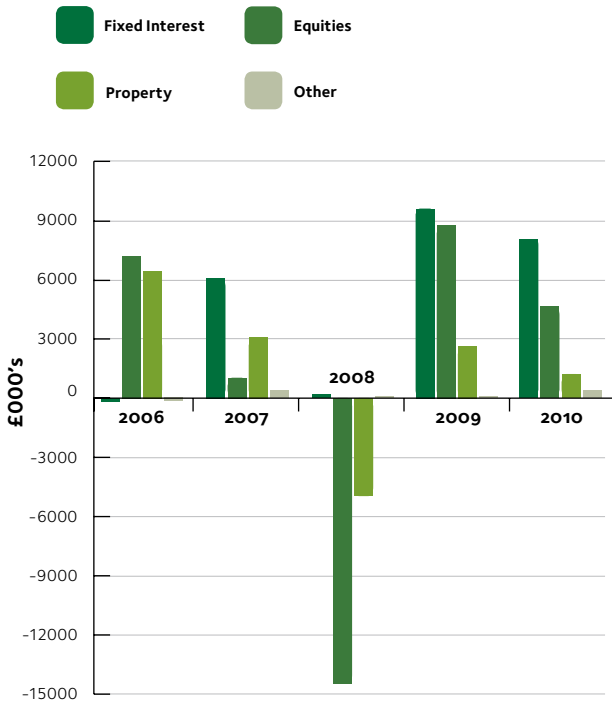
Expense Ratio



Total assets by type



Investment Return



Corporate Social Responsibility

Our approach to Corporate Social Responsibility is a practical one; aimed at areas where we can fundamentally make a difference.

Delivering to our membership relies not only on our service delivery capabilities but delivering our services as good corporate citizens. We believe that Corporate Social Responsibility (CSR) describes our obligations, whilst ensuring economic development, to behave ethically in our business dealings, to improve the quality of life of our workforce and their families, to have a positive influence upon our local community and society at large, and to minimise the Society's impact upon the environment. CSR forms an integral part of delivering our vision; it illustrates our values and how they may be applied in practice, it shows that we care about the environment in which we operate and we will be judged upon both what we say we will do and delivering on it.

In 2010 a committee consisting of members of staff from across the Society, led by the Finance Director, Jonathan Long, was formed with the long term aims of developing two-way community involvement, improving the health and wellbeing of our workforce, ensuring that we operate ethically-sound employment policies and that we achieve high standards in the environmental management of our business.

National Friendly and our community

In order to provide focus and value to our CSR activities we have sought to support a smaller number of initiatives well rather than spread our resources across many.

This year we have continued to support the Prince's Trust after joining its South West Leadership Group in 2009. We sponsored the '2010 Young Achiever Award', part of a series of awards recognising young people's success in the areas of education, skills development, employment, enterprise and community. Eight members of staff also joined the Prince's Trust Dragon Boat Race team in September, helping to raise money and strengthening our relationship with the charity.

2010 also saw the start of National Friendly's commitment to working with Ablaze, a charity formed and supported by members of the Bristol business community to connect local firms with local schools to help improve the life chances of young people. We have joined the Reading Buddies programme and nine volunteers have committed to helping pupils at Gay Elms Primary School practise their reading skills, supporting their learning and helping to raise aspirations. In return our volunteers have gained valuable experiences which help to further develop their own coaching and communications skills.

Charity of the Year

Each year our staff choose a 'Charity of the Year' and in May 2010, following various nominations, it was agreed to support The Lily Foundation, a small charity that raises money for research into Mitochondrial Disease and other metabolic disorders. Focusing on

finding a cure for the disease, it also provides the much needed support for the affected families, including two of our staff members, whose granddaughter suffers from the disease.

We set ourselves a fundraising target of £5,000, which is to be matched by a grant from the Foundation Fund and we have now reached our target, thanks to a fantastic, committed effort of the National Friendly Team.

In 2011 our chosen charity will be St Peter's Hospice, Bristol's only adult hospice caring for people with incurable illnesses. Their commitment is to improve the quality of life of patients while extending care and support to their families and loved ones. They are a fantastic charity and the National Friendly staff's support will really make a difference.

The Foundation Fund

In 2010 we re-launched the Foundation Fund, formed originally in 2008 to provide discretionary grants to deserving causes, put forward by members. Over the period of four years prior to its establishment, £500,000 was transferred from our investment portfolio and at the end of each year a share of the investment income from the capital sum is made available for grants.





1. L-R Neil Thompson (Product Manager), Gemma Cooke (Lily Foundation), Freya Cooke, Debbie Thompson (Claims & Premiums Manager) and Richard Sear (CEO).

2. Reading Buddy Sian Owen (New Business Representative) with Madison (Gay Elms Primary)

3. Aaron Jones (winner of the 2010 Prince's Trust Young Achiever Award) with Jonathan Long (Finance Director).

4. L-R Angela Raper (Interim Head of Marketing), Sam Teale (Prince's Trust), Beth Robertson (Prince's Trust) and Richard Sear (CEO)

5. National Friendly staff taking part in the Bristol Dragon Boat, helping to raise over £900 for The Prince's Trust

6. L-R Foundation Fund Committee: Peter Keightley, Alun Thomas (Head of Operations), Leah Wallace, Jessica Macmillan (PR & Marketing Communications Executive), Alexis Bull (Management Accountant) and Ann Sleath.

The environment

We continually assess how we may improve our environmental impact, and ways in which we can operate on a carbon neutral basis. Over the past 12 months we have undertaken a variety of exercises to become a greener business such as installing recycling waste bins and virtualising our IT equipment to reduce energy usage.

Ethical suppliers

We deal with our customers and suppliers responsibly by:

- Being open and honest about our products and services
- Using local suppliers where practical
- Working with suppliers and distributors who take steps to minimise their environmental impact

Our people

The most successful companies are driven by the power of individuals working in unison through a shared set of common goals and values; companies that recognise that the real cause of their success is always the people and never just the words.



Our people

Our people are key to us achieving our strategic aim of being a 'Modern mutual for the 21st century'. They bring our organisational values to life ensuring that we continue to seek and embrace those changes necessary for us to modernise and remain competitive in a tough commercial environment.

Personal development, training, support and competence

We have continued to invest in employee training and development, enhancing our commitments to existing staff whilst continuing to recruit fresh talent and expertise where required. During the period of capital restoration all development activity will be assessed on its merits; discretionary spend, for the most part, being reduced.

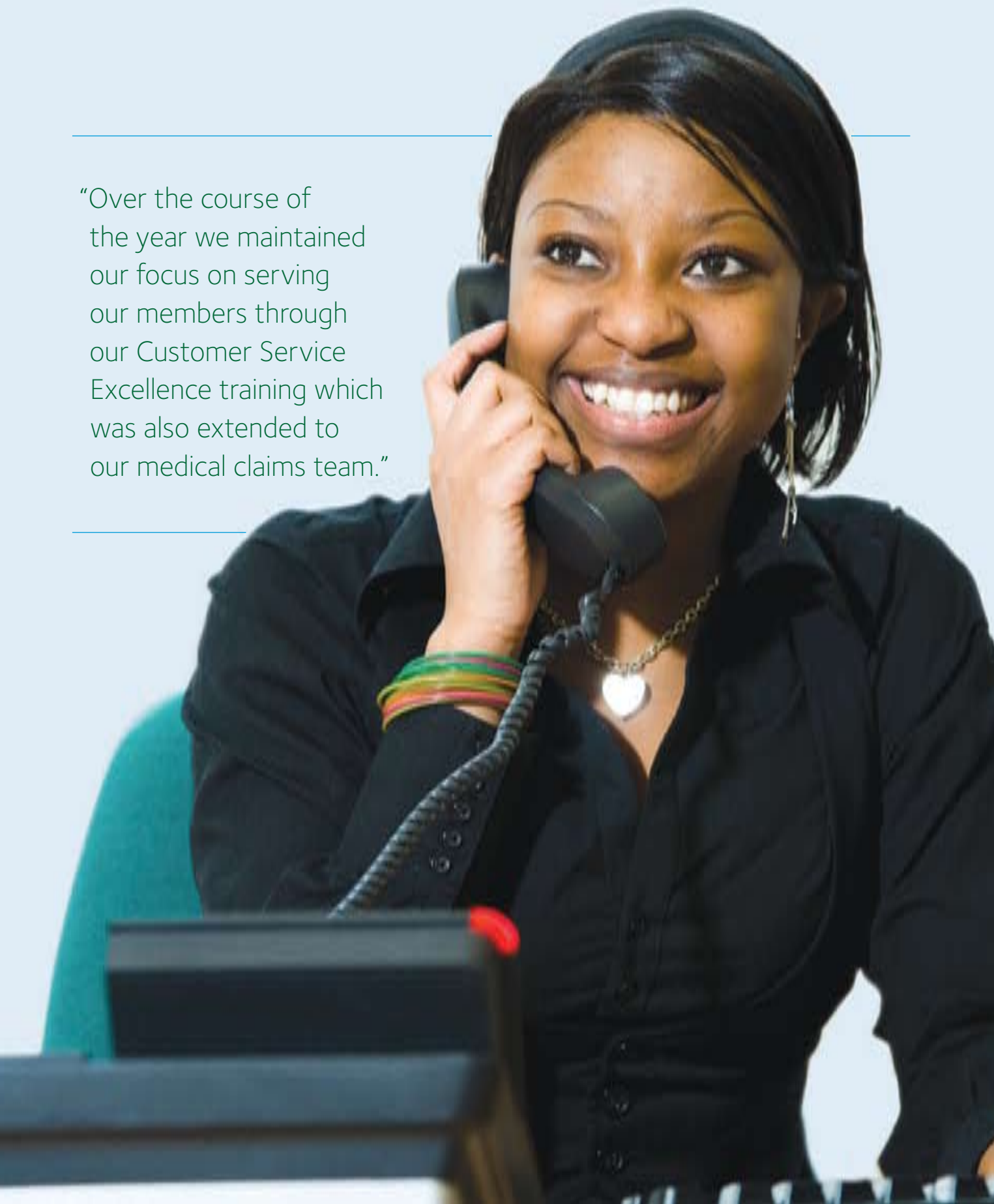
Over the past 18 months the Society has invested in its 'Leading for Exceptional Performance and Empowerment' programs which all staff have participated in. 2010 also saw targeted coaching and development initiatives being undertaken with members of the Executive and Management teams and in specific business areas.

Over the course of the year we maintained our focus on serving our members through our Customer Service Excellence training which was also extended to our medical claims team. Our sales teams have also benefitted from additional sales and technical related training whilst in other areas of the business, either collectively or individually, staff have pursued and attained relevant industry and technical qualifications and accreditations.

An addition to our training activity, 2010 saw the introduction of e-learning training capabilities covering important subjects including data protection, information security and complaints handling. This is an area of training activity we will continue to develop in 2011.

Our continued commitment to support and training, both skills based, technical and developmental, has been validated by positive feedback from a staff survey undertaken in the early part of 2010. The results of this survey confirmed improvements in the effectiveness of communication and performance management within the organisation.

“Over the course of the year we maintained our focus on serving our members through our Customer Service Excellence training which was also extended to our medical claims team.”



Investing in people

A 'Job Evaluation' initiative was undertaken in 2010 aimed at providing a more structured framework for roles and salaries. This has involved reviewing all internal roles and benchmarking them against external equivalents. We now have an updated and improved framework for current and new roles along with agreements in principle to improvements to our reward and recognition mechanisms. These have been approved for implementation in 2011.

Our internal communications were enhanced in 2010 with the launch of a new intranet, a newly formed Employee Forum and the continued development of our weekly staff Communication Circle meetings. In addition, all staff meet bi-monthly with the CEO and senior management to discuss the progress of the Society and other important business matters.

Our members

Engaging with and obtaining the views and opinions of our members has been key to National Friendly's development. Recognising the importance of retaining a strong member engagement programme, the Society introduced two new communication streams in 2009; the Focus Group and the Research Community. In 2010 two Focus Group meetings were held, one in Reading and one in Manchester. Another two are planned for 2011, the first being scheduled to be held in Bristol in May although this has been deferred due to the focus on capital restoration.

As anticipated, both our membership and the number of enquiries we received increased in 2010. Customer Services handled 52,000 telephone calls over the year (+15% on 2009) and almost 40,000 administration enquiries (+15% on 2009). The speed of answer was well maintained with 85% of calls handled inside 20 seconds and 80% of correspondence being actioned inside 3 working days. We worked hard to improve the quality of the calls with additional coaching, refresher training and incentive schemes launched.

Our future - 2011

Our main aim for 2011 is to implement a restorative capital management plan. The year will see a considerable reduction in new business compared to recent years as well as a reduction in costs, whilst we continue to enhance capital management systems and processes.

Conclusion

The Society has reached a pivotal point that will be critical to defining our future success. 2011 has presented us with fresh challenges which we will meet head on. I would like to thank the National Friendly teams who have worked with dedication and heart throughout to move National Friendly forwards. I would also like to add my thanks and appreciation for the fantastic support the Society has received both from our members and from our suppliers and stakeholders.

We have affirmed our vision for the organisation. It will be an extremely challenging year, but we have an exceptional team of people and whatever the future brings, we will remain focused on putting our members' needs first and hope to continue on our strategic journey.

Richard Sear Chief Executive
7 June 2011

Treating Customers Fairly

What Treating Customers Fairly (TCF) means to National Friendly.

- Every member of staff and third party supplier knows and understands our values.
- We develop innovative products and services through continued research into emerging customers' needs.
- We continue to improve the clarity and effectiveness of communications to customers.
- We deliver on our promises.
- We enable our customers to have the freedom to manage their financial products.
- We understand our customers' needs in order to support and help their decision making.

The Society is committed to both achieving the outcomes expected by the FSA, and to improving the customer journey for our members. This year our focus has been:

Delivering our strategy. Our members can be confident that they are dealing with a firm where fair treatment is central to the corporate culture. This is achieved by:	<ul style="list-style-type: none"> ■ Raising staff awareness through induction and refresher training. ■ Developing our TCF dashboards and management information. ■ A comprehensive review of Training and Competence requirements across the Society.
Providing products and services that are marketed and sold in the retail market, are designed to meet the needs of identified consumer groups and are targeted accordingly. We have undertaken:	<ul style="list-style-type: none"> ■ Consumer market research ■ The collection and evaluation of customer feedback across the Society in conjunction with complaints surveys. ■ Extensive sign off processes to manage website content.
Ensuring our members are provided with clear information and are kept appropriately informed before, during and after the point of sale. We undertake to:	<ul style="list-style-type: none"> ■ Obtain feedback through our Member Relations strategy. ■ Maintain product literature that clearly reflects risks, rewards and product limitations where they apply. ■ Continue to commit to developing the use of plain language. ■ Continually review any claims statistics to ensure any links between documentation and declined claims are identified.
Members do not face unreasonable post-sale barriers imposed by us. We ensure:	<ul style="list-style-type: none"> ■ All means of contacting the Society continue to be accessible to the member. ■ We continue to guide customers through the complaints procedures and to ensure these remain as straightforward as possible. ■ No unreasonable exit penalties are incurred on key products. ■ Complaints procedures are in line with the regulatory requirements and are monitored to ensure these requirements are met.
Where our members receive advice, the advice is suitable and takes account of their circumstances. Developments include:	<ul style="list-style-type: none"> ■ Strengthened controls in place around the provision of information rather than advice across the Society. ■ The acquisition of 425 Direct who are able to provide an Independent Financial Advisory service to customers if required. Firm controls, including external quality checking, are in place to ensure that 425 Direct meet high quality standards for their advice.
Providing members with products that perform as we have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect. We commit to:	<ul style="list-style-type: none"> ■ Maintaining defined service levels that are monitored to ensure members receive a timely and efficient service. ■ Investing in accordance with investment strategy that is reviewed regularly by the Investment Committee. ■ Protecting the interests of our with-profit policyholders through the With Profit Committee. ■ Protecting the interests of non with-profit policyholders through the Board.

Corporate Governance Review



Jonathan Long

The Board continues to view good corporate governance as fundamental to the Society's operations. National Friendly complies with all aspects of the Combined Code on Corporate Governance annotated by The Association of Mutual Insurers unless the contrary is stated in this report.

Role of the Board

The principal role of the Board is to provide entrepreneurial leadership enabling the necessary financial and human resources are in place to meet the strategic objectives detailed by the Society's strategy. The Board meets at least 6 times a year – and more often if necessary.

It is also the role of the Board to determine and review:

- Values, standards and ethics.
- Strategy and objectives, approving the annual business plan and monitoring performance in achieving it.
- Solvency and capital management.
- Treating Customers Fairly – policy and principles.
- Significant risks affecting the Society, and the action being taken to manage and mitigate them.
- Investment strategy.
- Financial management.
- Pension and remuneration policies.
- Acquisition or disposal of any significant asset.

The Board reviews the operation and effectiveness of the Society's internal controls throughout the course of the year to confirm that they are adequate and are operating as prescribed.

The Society maintains liability insurance for all officers throughout the year.

Chairman and Chief Executive

There is a clear division of responsibilities between running the Board and responsibility for running the Society's business. The role of Chairman and Chief Executive are clearly defined and are distinct and separate.

The Chairman of the Board is responsible for leadership of the Board, ensuring its effectiveness on all aspects of its role and setting its agenda. The Chief Executive has overall responsibility for managing the Society and its subsidiaries and for implementing the strategies and policies agreed by the Board.

Board Balance and Independence

The Board consists of five Non-Executive Directors and two Executive Directors.

The Board continues to review its own balance, completeness and appropriateness to meet the ever increasing complexities of the business. The Board has and will continue to assess the balance of skills and where necessary will appoint individuals to meet the demands.

The independence of the Non-Executive Directors has been reviewed and it was noted that one of our Non-Executive Directors, Tracy Morshead provided ad hoc strategic consultancy advice that falls outside of his duties as a Non-Executive Director. These services are provided on normal commercial terms and disclosed as a related party transaction in note 21.

Alan Lewis became Chairman of the Board upon Don Burgess's retirement at the end of the 2010 AGM. Alan Lewis is also on the board of LSE listed Safestore Holding Plc and is Chairman of both Leeds Bradford International Airport Limited and Porterbrook, a train leasing business.

Appointments to the Board

The Nominations Committee meets as appropriate to review the structure, size and composition of the Board and to make recommendations to the Board with regard to any adjustments that are deemed necessary.

Professional recruitment consultants can and are normally consulted so that vacancies on the Board are considered appropriately. In appointing a new Chairman of the Board it was recognised that several members had been recently recruited through the use of external consultants and that the appropriate skill set already existed within our current Non-Executive Directors therefore Alan Lewis was appointed to this role, following internal advertising to all Non-Executive Directors, without the use of external consultants.

Information and Professional Development

The Chairman of the Board ensures all directors receive accurate, reliable information which is fundamental to the effective function of the Board.

On appointment of Non-Executive Directors, the Chairman of the Board ensures that Non-Executive Directors receive a comprehensive induction programme.

All Board members have access to independent professional advice at the Society's expense where considered necessary to discharge their responsibilities.

Performance Evaluation

A formal performance evaluation scheme is in place for all Society staff including the Executive Directors.

Non-Executive remuneration is not performance related, however, an annual appraisal process is undertaken. Fees paid to Non-Executive Directors recognise the responsibilities of Non-Executive Directors and are designed to attract individuals with the necessary skills and expertise to fill the role.

Re-election

The appointment of Non-Executive Directors is generally for a period of three years and is subject to election and re-election at the Society's Annual General Meeting.

Audit Committee

The Audit Committee consists of three Non-Executive Directors and is chaired by Peter McIlwraith. The main role and responsibilities of the Committee are set out in formal Terms of Reference and include:

- Monitoring the integrity of the financial statements of the Society
- Reviewing the Society's internal financial controls and reviewing the Society's internal control and risk management systems.
- Monitoring and reviewing the effectiveness of the company's internal audit function.
- Making recommendations to the Board in relation to the appointment, reappointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor.
- Monitoring and reviewing the external auditors independence and objectivity and effectiveness of the audit process (in particular in respect of the engagement of the external auditor to supply non-audit service to the Society).

Other Committees

The Committee structure of the Society comprises:

- Investment Committee
- Nomination Committee
- Remuneration Committee
- Risk Management Committee
- With Profits Committee

The roles and responsibilities of each committee are formally documented by way of Terms of Reference. Each Committee is chaired by a Non-Executive Director and all members are considered to have appropriate skills and expertise to undertake their role within the Committees. Full details of committee membership and outlined responsibilities are contained on page 20. The Terms of Reference of all Committees are available on the Society's website and on request from the Company Secretary.

Annual General Meeting

The 2010 Annual General Meeting was held in Bristol and was attended by Members, Board Members and Officers of the Society.

A number of resolutions were voted on including:

- The Board Report
- The Directors Remuneration Report
- The Auditor's Report and the Annual Report and Accounts
- Reappointment of PricewaterhouseCoopers as auditors
- Re-election of one Executive Director and one Non-Executive Director.

There was an excellent response from members submitting their postal/proxy forms with just over 12% of members eligible to vote electing to do so.

The Society wishes to encourage more members to attend the AGM and arrangements are in place for the 2011 AGM to be held again in Bristol.

Sub-Committees

Audit committee	
Members	Responsibilities
Peter McIlwraith (Chairman) Mark Jackson Tracy Morshead	<p>The Audit Committee meets at least four times a year at appropriate times in the financial reporting and audit cycle and assists the Board in meeting its responsibilities in respect of systems and controls and external financial reporting.</p> <p>It considers the appointment of and fees for both external and internal auditors, ensures that their objectivity and independence is safeguarded in respect of any non-audit services and takes an independent view of the appropriateness of the Society's accounting policies and practices.</p>
Investment committee	
Members	Responsibilities
Alan Lewis (Chairman) Azim Dinani (Head of Actuarial Function) John Greenhalgh Jonathan Long Peter McIlwraith Richard Sear	<p>The Investment Committee meets as required at least four times a year to ensure compliance with the terms of the Principles and Practices of Financial Management in relation to the investment strategy and review its continuing appropriateness in the light of changing circumstances with consideration to the needs of both With-Profit and non With-Profit policyholders.</p> <p>The Investment Committee also has responsibility for:</p> <ul style="list-style-type: none"> ■ Appointing the Society's Fund Managers. ■ Determining the asset allocation and performance benchmarks. ■ Monitoring the performance of the Funds.
Nomination committee	
Members	Responsibilities
Peter McIlwraith (Chairman) John Greenhalgh Richard Sear	<p>The Nomination Committee meets as required to lead the appraisal process for appointments to the Board and to make recommendations to the Board and members on the appointment or re-appointment of Directors.</p> <p>The Nomination Committee meets to make recommendations for appointment based upon merit and on objective criteria to ensure that the Board maintains an appropriate balance of skills and experience.</p>
Remuneration committee	
Members	Responsibilities
Peter McIlwraith (Chairman) Mark Jackson Tracy Morshead	<p>The Remuneration Committee meets at least once a year to review the remuneration policy and determines the remuneration packages of the Executive Directors and senior managers. There is a performance related element within the remuneration, which is linked to the achievement of objectives.</p> <p>The remuneration of Non-Executive Directors is based upon a survey of similar organisations carried out and recommended by the Executive Directors and approved by the Board. Further details on Directors' remuneration are set out in the Directors' Remuneration Report on pages 26 and 27.</p>

Risk management committee	
Members	Responsibilities
John Greenhalgh (Chairman) Alan Lewis Jonathan Long Fay Randall Richard Sear Azim Dinani (Head of Actuarial Function)	The Risk Management Committee meets at least four times a year to ensure that robust risk management systems are in place to cover: <ul style="list-style-type: none"> ■ Governance and oversight. ■ Risk appetite. ■ Implementing risk management. ■ Management information on risk. ■ Management of impact of ICAS.

With-profit committee	
Members	Responsibilities
John Greenhalgh (Chairman) Tracy Morshead Stephen Ainsworth (With-Profits Actuary)	The With-Profit Committee meets as required and at least once a year to independently monitor and bring independent judgment on the extent to which procedures, systems and controls are adequate and effective to ensure that the Society complies with the requirements of the FSA Handbook over the management and governance of With-Profit business.

The Terms of Reference of all Sub-Committees are available on the Society's website and on request to the Company Secretary.

	Board		Audit Committee		Remuneration Committee		Nominations Committee	
	Meetings attended	Meetings held*	Meetings attended	Meetings held*	Meetings attended	Meetings held*	Meetings attended	Meetings held*
Non Executive								
D C Burgess**	4	4	-	-	-	-	1	1
J Greenhalgh	10	10	-	-	1	***	1	****
M Jackson	9	10	3	4	2	2	1	1
A Lewis	10	10	-	-	2	***	-	-
P Mcllwraith	10	10	4	4	2	2	****	1
T Morshead	10	10	4	4	2	2	****	1
Executive								
J J Long	10	10	4	***	-	***	-	-
R Sear	10	10	4	***	2	***	1	1

* Meetings held whilst appointed to Board/Committee

** Retired at end of AGM on 8th June 2010

*** Attendance at audit and/or remuneration committee on an invitation basis

**** J Greenhalgh replaced P Mcllwraith and T Morshead at the agreement of the Nomination Committee

Jonathan Long **Company Secretary**

7 June 2011

The Board Report

The Board



Alan Lewis
(Chairman)

Alan, an MBA, was with Black & Decker and RTZ before spending 30 years in the Private Equity industry. Firstly with 3i, then as a founding Partner of Bridgepoint (previously Natwest Ventures) where he is now an Advisory Partner. He has served on over 20 boards in the UK, France, Italy, Holland and Finland. He is Chairman of both Leeds Bradford Airport and Porterbrook, the train leasing company, and on the board of LSE listed Safestore plc.



Richard Sear
(Chief Executive)

Richard was appointed as a Director on 1 January 2008. He has extensive experience in financial services, having held positions at Simplyhealth Group, HealthSure, Royal Liver Assurance and Shepherds Friendly Society. Before Royal Liver, Richard held senior positions at the CWS Ltd culminating as head of Logistics for the Non-Food Marketing and Distribution Group. He is a fellow of the Royal Society of Arts, a qualified Chartered Secretary and has a post graduate business qualification.



John Greenhalgh
(Non-Executive Director)

John was appointed as a Director on 1 October 2007. He is a qualified Actuary and has extensive experience in financial services, having worked for Wesleyan & General, Worldwide Reassurance and Hearts of Oak Friendly Society.



Jonathan Long
(Finance Director)

Jonathan was appointed as a Director on 1 May 2007. After qualifying as a Chartered Accountant at Coopers & Lybrand, he went on to perform a variety of financial, strategic and business development roles at Prudential and Barclays before joining the Society in 2006.



Peter McIlwraith
(Senior Independent Non-Executive Director)

Peter is a Chartered Accountant. He was a partner with PricewaterhouseCoopers (and prior to that Price Waterhouse) and was the Regional Chairman for the West and Wales and Senior Partner in Bristol from 1991 to 2001. Peter is also a Non-Executive Director of Bristol Water Plc.



Mark Jackson
(Non-Executive Director)

Mark is a medical doctor, a former GP and successful businessman. Mark was CEO of Helphire which he founded and developed to the point of flotation on the main London Stock Exchange. He was also the co-founder and Non-Executive Chairman of The Assura Group from 2003 to 2008, and Non Executive Deputy Chairman of Saga Independent Living, a division of the Acromas Group.



Tracy Morshead
(Non-Executive Director)

Tracy has held senior management positions with three major Building Societies, Birmingham Midshires, Principality, where he was MD, and Nationwide where he was Divisional Director. He is a Fellow of the Chartered Institute of Marketing and is a chartered marketer. Tracy is also a Non-Executive Director of Assurant Group Limited and is Non-Executive Chairman of a leading financial services software company.

A modern mutual for the 21st century

Board of Directors

A list of Directors of the Board who held office during the year, appears on pages 22 and 23. In addition, Don Burgess held office as Chairman of the Board until his retirement on 8th June 2010.

Corporate Governance

The Board supports the general principles of corporate governance and is committed to maintaining a high standard. Our approach to corporate governance is set out in our report on pages 18 and 19.

Business Objectives and Activities

The Society's objective is to promote the financial well being of its members through the provision of healthcare, protection and life assurance. The Society also seeks to maximise the returns and benefits to its members through investment performance and by cost control.

The Board sets key performance indicators (KPIs) and targets, which it monitors on a regular basis throughout the year. These KPIs change in line with the Society's objectives and priorities. For 2010 the KPIs were focused on financial performance, in particular, cost effective new business growth, administration efficiency and capital management. The financial performance of the Society, including the KPIs, is reviewed by the Chief Executive on pages 6 to 16.

Statement of Responsibilities of the Directors

The following statement should be read in conjunction with the statement of responsibilities of the Directors and auditors on page 28 and is made by the Directors to explain their responsibilities for the preparation of the financial statements.

The Directors are responsible for preparing the Annual Report, the Board Report and the financial statements in accordance with applicable law and regulations.

Friendly Society law requires the Directors to prepare Group and Society financial statements for each financial year. Under that law they have elected to prepare the Group and Society financial statements in accordance with the Friendly Societies (Accounts and Related Provisions) Regulations 1994, UK Accounting Standards and applicable law (UK Generally Accepted Accounting Practice).

The Group and Society financial statements are required by law to give a true and fair view of the state of affairs of the Group and the Society as at the end of the financial year and of the income and expenditure of the Group and of the Society for the financial year.

In preparing these financial statements the Directors are required to:

- Select suitable accounting policies and then apply them consistently;
- Make judgements and estimates that are reasonable and prudent;
- State whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- Prepare the statements on the going concern basis unless it is inappropriate to presume that the Group and the Society will continue in business.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Group and Society and enable them to ensure that its financial statements comply with the Friendly Societies Act 1992 and the regulations made under it.

The Directors are also responsible for preparing a Report of the Directors in accordance with the Friendly Societies Act 1992 and the regulations made under it.

The Directors have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

The maintenance and integrity of the Group and Society's website is the responsibility of the Directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

The Directors confirm that the financial statements comply with the above.

Disclosure of information to auditors

The Directors who held office at the date of approval of this Director's Report confirm that, so far as they are aware, there is no relevant audit information of which the Society's auditors are unaware, and each Director has taken all the steps he ought to have taken as a Director to make himself aware of any relevant audit information and to establish that the Society's auditors are aware of that information.

Going Concern

The Society's business activities, together with the factors likely to affect its future development, performance and position are set out in the Chief Executive's Report for the year. The financial position of the Society, its cashflows, liquidity position and borrowing facilities have also been considered by the Board. The Society's policies and processes for managing capital are highlighted in Note 16 to the financial statements. Although the Society is currently in breach of its statutory minimum capital requirements it has developed a capital restoration plan to rectify this and so considers that it has adequate financial resources, supported by long-term relationships with its policyholders and suppliers. As a consequence, the Directors believe that the Society is well placed to manage its business risks in respect of liquidity and cashflows. After making enquiries, the Directors have a reasonable expectation that the Society has adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual report and accounts.

Statement of Solvency

As at 31st December 2010 the Society was in breach of the minimum capital requirement prescribed by the Financial Services Authority's 'Prudential Source Book for Insurers', further details of this are set out in Note 16 to the financial statements.

Employees

The average number of Directors and staff employed by the Society totalled 67 (2009: 84).

The aggregate remuneration paid to Directors and staff employed by the Society during the year amounted to £3.2 million (2009: £3.3 million).

Communication with staff is undertaken through a weekly communication circle (with upward feedback positively encouraged) open meetings with the Chief Executive and also through an Employee Forum.

The Society is committed to the ongoing development of its staff and has been recognised as an "Investor in People" since 2005, we were reaccredited with the award in 2008.

Member Relations

The Board is committed to maintaining good communications with members. In order to fulfil this commitment, a Members' Focus Group and Research Community have been established. Engagement with these forums has been positive and feedback valued.

The Board also firmly believes in the principles of Treating Customers Fairly (TCF) and adheres to these in its day to day operation. Our approach to TCF is set out on page 17.

Complaints Policy

The Society aims to deliver the highest possible level of service to members. If any member believes that the Society has failed in this aim they have recourse to the Society's Complaints Procedure.

The Society has a documented procedure for the handling and recording of complaints. The Board regularly review the number and type of complaint received in order to monitor that complaints are properly dealt with and corrective action has been taken to prevent recurrence.

Charitable Donations

The National Deposit Foundation Fund, whose activities are described on page 12, made charitable donations of £2,000 (2009: £1,600). In addition, the Society's charitable donations totalled £5,275 (2009: £1,312). There were no political donations (2009: £nil).

Re-appointment of Auditors

A resolution to re-appoint PricewaterhouseCoopers LLP as Auditors will be proposed at the forthcoming Annual General Meeting.

By order of the Board
Jonathan Long Company Secretary
 7 June 2011



Directors' Remuneration Report



Peter Mcllwraith

Introduction

This report sets out the remuneration policy for the Society in 2010.

The report has been prepared to comply with the requirements of the Combined Code on Corporate Governance annotated for mutual insurers, the Directors' Remuneration Report Regulations 2002.

The composition and responsibilities of the Society's

Remuneration Committee are set out on page 20.

The Remuneration Committee keeps itself informed of relevant developments and best practice and is authorised at its discretion to obtain advice from external advisers.

Policy

It is the Society's policy to enable it to attract, retain and motivate good quality staff.

Remuneration for Executive Directors is in three parts comprising a basic salary, a non-pensionable annual performance award linked to each individual Director's own contribution to the Society, a non pensionable long term incentive plan ('LTIP') linked to the achievement of strategic objectives over a four year period, all designed to enhance overall business performance. In addition, Executive Directors receive a company car (or cash allowance) and access to benefits such as membership of a pension

scheme, private medical insurance and death in service benefit.

Remuneration for Non-Executive Directors comprises a basic fee plus a supplement for the Chairman of the Board. Additional amounts may be paid to Chairmen of Sub-Committees.

Summary

This report, together with the disclosures opposite, is provided to give members a full explanation of the policy and application of Directors' remuneration. A resolution will be put to the Annual General Meeting inviting members to vote on the Directors' Remuneration Report. This vote is advisory and the Board will consider what action is required.

Peter Mcllwraith Chairman
7 June 2011

Directors' emoluments

	Salaries & Fees £	Performance Related Pay and LTIP bonus+ £	Other Benefits# £	Total 2010 £	Total 2009 £
Chairman					
Don Burgess (Resigned 8/6/10)	9,250	-	-	9,250	18,500
Alan Lewis*	28,000	-	-	28,000	8,923
Executive Directors					
Richard Sear	150,000	117,000	28,920	295,920	209,545
Jonathan Long	105,000	68,900	22,200	196,100	144,381
Alan Gledhill (Resigned 31/10/09)	-	-	-	-	85,058
Non-Executive Directors					
John Greenhalgh	21,000	-	-	21,000	17,000
Mark Jackson (Appointed 11/6/09)	25,279	-	-	25,279	8,417
Peter Mcllwraith	22,000	-	-	22,000	19,000
Tracy Morshead (Appointed 11/6/09)	20,250	-	-	20,250	8,644
Dozie Azubike (Resigned 11/4/09)	-	-	-	-	4,667
Colin Bielckus (Resigned 13/2/09)	-	-	-	-	2,250
Edmund Malden (Resigned 11/6/09)	-	-	-	-	7,250

Other benefits include pension scheme contributions, car allowances, medical and other benefits in kind or their equivalent monetary value.

* Alan Lewis was appointed to the Board on 11/6/09 and was appointed Chairman on 8/6/10

+ Payment of the performance related pay has been deferred

Pension Entitlement						
	Years of Service	Pension accrued during 2010 £	Accrued pension as at 31/12/2010 £	Accrued pension as at 31/12/2009 £	Transfer value of accrued pension as at 31/12/2010 £	Increase in transfer value during the year net of Director's contribution £
Executive Directors						
Richard Sear	3	208	3,125	2,917	32,032	2,517
Jonathan Long	4	312	3,281	2,969	25,422	2,535

Executive Directors

Base salaries

Base salaries are normally reviewed annually by reference to jobs carrying similar responsibilities in comparable organisations. Salary amendments are normally effective from 1 January each year.

Performance Related Pay

The Executive Directors have a part of their total emoluments linked to performance. The current annual performance related pay scheme represents up to a maximum of 30% of base salaries.

The performance related pay scheme comprises two elements. The first which is assessed on a collective basis has identified six major corporate objectives and all Executive Directors participate on the same basis. The maximum amount payable under this element is 10% of base salaries.

The second element is an individual performance related programme where each Executive Director is assessed against personal goals and objectives. The individual performance related element of the scheme can award up to a maximum 20% of base salaries.

LTIP Milestone Completion Bonuses

The Remuneration Committee have set in place a four year LTIP for the Executive Directors that encourages successful delivery of the Strategy by the end of 2011, as determined by the achievement of pre-defined financial milestones, by a lump sum payment at either the end of the period or earlier if the milestones are achieved in advance. A further lump sum may be payable if the milestones are exceeded by a predefined amount.

The milestones address key aspects of the corporate strategy which was put in place at the beginning of the period

and included stretching targets. They cover the level of administration surplus (to be calculated after charging an appropriate cost for amounts earned under LTIP), the achievement of new business represented by APE, the cost of acquiring new business based on an amount per £ of APE and the level of claims compared with the original business model for the Healthcare products. In the event of out-performance by 25% on any of the first three of these criteria, a further bonus will become payable. The maximum available to all the Executive Directors for achieving all of the first four criteria is £500,000 and a maximum of a further £500,000 is available if all the second three criteria are met. A payment totalling £140,000 was authorised in 2010 to be paid in January 2011 made in respect of performance achieved. It is not currently expected that any further amounts will be paid under the terms of the Scheme.

Retirement and Related Benefits

The Executive Directors are members of the National Deposit Staff Superannuation Scheme. This is a defined benefit retirement plan that closed to future accrual on 31 May 2009. A defined contribution pension scheme is now in place to which the Society contributes up to a maximum of 12% per Director, dependent upon personal contribution levels.

Other Benefits

Executive Directors are entitled to private medical insurance, death in service benefit of four times basic salary and a company car or car cash allowance.

Directors' Contract

The Executive Directors have service agreements which incorporate their terms and conditions of employment. Service agreements are normally terminable by the Society giving twelve

months' notice or by the Executive Director giving twelve months' notice.

Non-Executive Directors

All Non-Executive Directors including the Chairman have letters of appointment which set out their duties and responsibilities. The appointment of Non-Executive Directors is generally for a period of three years and is subject to election and re-election at the Society's Annual General Meeting.

Fees are benchmarked against similar roles in comparable organisations. Fees are calculated on an annual rather than a daily basis. However, it is assumed that to fulfil the basic role of a Non-Executive Director, an average of two days minimum is required per month for review work and attendance at regular Board meetings, the Society's Annual General Meeting, Special General Meetings where appropriate, other ad hoc meetings with regulators and advisers as may be required and training courses.

Non-Executive Directors' remuneration is not performance related nor pensionable and Non-Executive Directors do not participate in any incentive plans. However, a formal annual appraisal process is undertaken where the views of all Directors are taken into consideration and the outcome of this is ratified by the Board.

Fees for Non-Executive Directors are determined by the Executive Directors and subject to approval of the Board as a whole. They are designed to recognise the responsibilities of Non-Executive Directors and to attract individuals with the necessary skills and experience to contribute to the operations of the Society. In addition to the basic annual fee additional fees may be awarded for the chairmanship of any Committees although no such fees are being made currently.

Auditor's Report

Independent auditors' report to the members of National Deposit Friendly Society Limited and Group

We have audited the financial statements of National Deposit Friendly Society Limited for the year ended 31 December 2010 which comprise the Group and Society Income Statement, the Group and Society Balance Sheet, the Group and Society Statement of Total Recognised Gains and Losses and the related notes. 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).

Respective responsibilities of the Directors and auditors

As explained more fully in the Statement of Responsibilities of the Directors set out on page 24, the Directors are responsible for preparing financial statements which give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Society's members as a body in accordance with the Friendly Societies Act 1992 and the Regulations made under it and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of the audit of the financial statements

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

Joanne Leeson Senior Statutory Auditor

For and on behalf of
PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Bristol
7 June 2011

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view, in accordance with UK Generally Accepted Accounting Practice, of the state of the Society's and the Group's affairs as at 31 December 2010 and of the income and expenditure of the Society and the Group for the year then ended; and
- have been properly prepared in accordance with the Friendly Societies Act 1992.

Emphasis of matter

In forming our opinion, which is not modified, we have considered the adequacy of the disclosures made in the financial statements concerning the capital position of the Society. As set out in Note 16, the Society has insufficient assets to meet its regulatory minimum capital requirement and has prepared a capital restoration plan, which is subject to agreement with the Financial Services Authority. Achievement of the plan is subject to a number of risks as set out in Note 16 and to the extent that these risks emerge this may adversely affect the ability of the Society to restore its capital position.

Opinion on other matters prescribed by the Friendly Societies Act 1992

In our opinion the Report of the Committee of Management has been prepared in accordance with the Friendly Societies Act 1992 and the regulations made under it, and the information given therein is consistent with the financial statements for the financial year.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Friendly Societies Act 1992 requires us to report to you if, in our opinion:

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

Income Statement

For the year ended 31 December 2010

	Notes	Group				Society			
		2010		2009		2010		2009	
		£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Earned premiums and payments to deposits	2	17,368		12,343		17,368		12,343	
Less reinsurance premiums		(36)		(36)		(36)		(36)	
			17,332		12,307		17,332		12,307
Investment income	3	9,478		3,457		9,478		3,457	
Unrealised gains									
- Investments	3	4,707		16,999		4,707		16,999	
- Assets held to cover linked liabilities	3	214		446		214		446	
Other technical income	4	616		113		57		8	
			32,347		33,322		31,788		33,217
Claims			17,040		11,515		17,040		11,515
Change in long term funds									
Long term business provision			9,616		8,894		9,616		8,894
Claims outstanding			97		562		97		562
Provision for linked liabilities			72		280		72		280
Bonuses and rebates			94		1,535		94		1,535
Net operating expenses	5a								
Acquisition costs		8,786		6,791		8,186		6,482	
Change in deferred acquisition costs		-		910		-		910	
Administrative costs		3,384		3,084		3,146		3,084	
			12,170		10,785		11,332		10,476
Other technical charges - project costs	5b	1,904		2,101		1,904		2,101	
- other		191		49		191		49	
Investment expenses	6	1,248		443		1,248		443	
Impairment of subsidiary	20	-		-		527		-	
Redundancy and end of contract term payments		147		356		147		356	
Additional FRS17 retirement benefit costs		-		33		-		33	
Tax attributable to long term business	8a	501		599		501		599	
Transfer from fund for future appropriation		(10,733)		(3,830)		(10,981)		(3,626)	
			32,347		33,322		31,788		33,217

All operating activities relate to continuing operations conducted in the United Kingdom. The information on pages 33 to 49 form an integral part of these financial statements.

Balance Sheet

As at 31 December 2010

	Notes	Group				Society			
		2010		2009		2010		2009	
		£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
ASSETS									
Goodwill	9		21		28		-		-
Investments									
Land and buildings	10	32,104		31,458		32,104		31,458	
Other financial investments	11	119,846		118,172		119,846		118,172	
Investment in subsidiaries	20	-		-		78		325	
			151,950		149,630		152,028		149,955
Assets held to cover linked liabilities	12		2,364		2,087		2,364		2,087
Debtors									
Debtor arising from direct insurance operations		558		488		520		476	
Other debtors		11		10		273		295	
			569		498		793		771
Other assets									
Tangible assets	13	427		462		272		249	
Cash at bank and in hand	11	1,398		3,797		1,210		3,711	
Net pension asset	17	-		-		-		-	
Deferred tax asset	8c	230		590		230		590	
Reinsurance asset		405		447		405		447	
			2,460		5,296		2,117		4,997
Prepayments and accrued income									
Accrued interest and rent		191		216		191		216	
Other prepayments and accrued income		340		189		289		129	
			531		405		480		345
			157,895		157,944		157,782		158,155

The information on pages 33 to 49 form an integral part of these financial statements.

Balance Sheet - continued

As at 31 December 2010

	Group				Society				
	Notes	2010		2009		2010		2009	
		£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
LIABILITIES									
Fund for future appropriations			8,351	19,008		8,351		19,256	
Technical provisions									
Long term business provision	15	142,103		132,487		142,103		132,487	
Claims outstanding		659		562		659		562	
Provision for bonuses		1,629		1,535		1,629		1,535	
			144,391	134,584		144,391		134,584	
Linked liability fund provision			1,814	1,742		1,814		1,742	
Provisions for other risks and charges									
Net pension liability	17		-	76			-	76	
Creditors									
Arising out of direct insurance operations		49		107		49		107	
Other creditors including taxation and social security		894		702		842		674	
Accruals and deferred income		2,396		1,725		2,335		1,716	
			3,339	2,534		3,226		2,497	
			157,895	157,944		157,782		158,155	

The information on pages 33 to 49 form an integral part of these financial statements.

These accounts were approved by the Board on 7 June 2011.

Alan Lewis
Chairman

Richard Sear
Chief Executive

Jonathan Long
Company Secretary

Statement of total recognised gains and losses

For the year ended 31 December 2010

	Group		Society	
	2010 £'000	2009 £'000	2010 £'000	2009 £'000
Notes				
Deficit for the financial year	(10,733)	(3,830)	(10,981)	(3,626)
Actuarial gain/(loss) on pension scheme	17 79	(2,211)	79	(2,211)
Movement in deferred tax on pension scheme	(3)	79	(3)	79
Total recognised gains and losses relating to the year	(10,657)	(5,962)	(10,905)	(5,758)

The information on pages 33 to 49 form an integral part of these financial statements.

Notes to the accounts

For the year ended 31 December 2010

(1) Accounting policies

Basis of preparation

The accounts have been prepared in accordance with The Friendly Societies (Accounts and Related Provisions) Regulations 1994, with applicable accounting standards in the United Kingdom and with the Statement of Recommended Practices issued by the Association of British Insurers.

Basis of consolidation

The Group accounts comprise the assets, liabilities and income and expenditure account transactions of the Society and its subsidiary 425 Direct Limited. The net results are included in the fund for future appropriations for the Group. The activities of the Society and Group are accounted for in the income statement.

Premiums

Premiums are accounted for when due for payment. Payments to Healthcare Deposit Accounts are accounted for when received.

Investment income

Income from rents and securities is taken into account on an accruals basis. Dividends are accounted for on the date the shares become quoted ex-dividend. UK dividends are shown excluding their irrecoverable associated tax credit.

Realised and unrealised gains and losses

Realised investment gains and losses represent the difference between the sale proceeds and original cost. Unrealised investment gains and losses represent the net movement in the market value of investments during the year after allowing for realised gains and losses recognised in the technical account.

Claims

Maturity claims and annuities are charged against income when due for payment. Surrenders are accounted for when paid or, if earlier, on the date when the policy ceases to be included within the calculation of the long term business provision.

Death claims and all other claims including Healthcare are accounted for when notified.

Long term business provision

The long term business provision is determined by the Society's Board and is calculated on a statutory solvency basis to comply with reporting requirements under the Prudential Sourcebook for Insurers. The calculation uses a net premium method for with-profit policies and as such includes explicit provision for annual reversionary bonuses declared prior to the valuation date. Implicit provision is made for future bonuses by using a valuation rate of interest lower than the expected return on the assets.

For conventional non-profit business, a gross premium valuation method is used, which brings into account the full premiums receivable under contracts written by the Society, estimated renewal and maintenance costs and contractually guaranteed benefits.

The calculation of the long term business provision for unit linked policies is based on the fund valuation at the valuation date.

Claims Outstanding

The claims outstanding provision provides for all the Healthcare and Healthguard claims payable as at 31 December, the claim has been approved yet the claims provider has not been invoiced.

Bonuses

Bonuses charged to the long term business technical account in a given year comprise:

- new reversionary bonuses declared in respect of that year which are provided within the calculation of the long term business provision.
- terminal bonuses paid out to policyholders on maturity and included within claims paid.

Depreciation Properties

Investment properties – no depreciation has been provided in accordance with SSAP 19.

Non-Investment properties – no depreciation has been provided as the Society's policy is to maintain the properties in good condition. Accordingly the Board consider that the lives of these assets and their residual values are such that their depreciation is insignificant and is thus not provided. The underlying assets are reviewed for impairment annually.

Tangible assets

Depreciation has been provided at the rates calculated to write off each asset over its estimated useful life.

Motor vehicles and computer equipment are depreciated at 25% per annum on a straight line basis.

Goodwill

Goodwill is amortised at 25% per annum on a straight line basis from the first full month after acquisition.

An impairment review is undertaken after the first full year of acquisition and subsequently if adverse events indicate that the carrying value may not be recoverable.

Notes to the accounts (Continued)

For the year ended 31 December 2010

(1) Accounting policies (Continued)

Project costs

Project costs comprise expenditure on acquisitions and on business process improvements which are intended to deliver future financial benefits to the Society through reducing operating costs and/or creating operational efficiencies.

Projects costs are charged to the income statement with the exception of major projects where the outcome is assessed to be reasonably certain as regards viability and feasibility. Amortisation is charged once the economic benefits of the project start to be realised.

Pension costs

The Society operates a defined benefit pension scheme. This scheme closed to new entrants and future accrual on 31 May 2009. A pensions asset / liability is calculated as the recoverable amount of the scheme's assets less the present value of the scheme's liabilities. Any net asset arising is not recognised in the balance sheet as, under the terms of the scheme, the Society is unable to recover the surplus either through reduced contributions in the future or refunds from the scheme. A net liability is recognised to the extent that it represents a legal or constructive obligation of the Society.

The pension cost for the scheme is analysed between current service cost, past service cost and net return on pension scheme. Current service cost is the actuarially calculated present value of the benefits earned by the active employees in each period. Past service costs relating to employee service in prior periods arising in the current period as a result of the introduction of, or improvement to, retirement benefits, are recognised in the profit and loss account on a straight-line basis over the period in which the increase in benefits vest.

The actuarial gains and losses which arise from a valuation and from updating the latest actuarial valuation to reflect conditions at the balance sheet date are taken to the statement of total recognised gains and losses for the period to the extent they are attributable to members. The attributable deferred taxation is shown separately in the statement of total recognised gains and losses.

Taxation

Deferred tax is provided using the full provision method. Deferred tax is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date. It is calculated at rates expected to be applicable when the asset or liability crystallises on a non-discounted basis. Deferred tax assets are recognised only to the extent that there will be sufficient foreseeable future taxable profits from which the future reversal of timing differences can be deducted.

Cash flow statement

The Society, being a mutual life assurance company, is exempt from the requirement under Financial Reporting Standard 1 'Cash Flow Statements' ('FRS1') to produce a cash flow statement.

Investments

Listed securities are shown in the accounts at mid market value. Properties are shown in the accounts at open market value.

Mortgages and loans are valued at the estimated net realisable value after provision for doubtful debts, if this is considered necessary.

Investments in subsidiary companies are held at cost less any provisions for diminution in value. In accordance with Financial Reporting Standard 11 'Impairment of fixed assets and goodwill' ('FRS11'); the carrying value of the subsidiary undertaking is compared to its recoverable amount.

Acquisition costs

Acquisition costs represent commission payable and other related expense of acquiring insurance policies written during the financial year. Acquisition costs which relate to subsequent periods are deferred and charged to the accounting periods in which related premiums are earned.

Deferred acquisition costs are amortised over a period no longer than that which the new policies are expected to remain profitably on the books.

Fund for future appropriations

The fund for future appropriations incorporates amounts which have yet to be allocated to participating policyholders. Any surplus or deficit arising in the technical account is transferred to or from the fund on an annual basis. Surpluses are allocated by the Directors to participating policyholders by way of bonuses. Any unallocated surplus is carried forward in the fund for future appropriations.

Operating leases

The Society leases motor vehicles under contracts of operating leases. The leases are cancellable. The lease expenses are accounted for as an operating expense as incurred.

Notes to the accounts (Continued)

For the year ended 31 December 2010

	Society	
	2010 £'000	Reclassified 2009 £'000
(2) Earned premiums		
Assurance	5,222	5,114
Bonds and other single premiums	774	1,644
Healthcare and Healthguard	10,760	4,999
Payments to deposit	515	475
Unit Linked	97	111
	17,368	12,343

The Society only transacts long term business within the United Kingdom.

The note has been re-analysed and re-formatted from the prior year. £4,999,000 of premiums previously reported as "Payments to deposit" have been reported as "Healthcare and Healthguard" and £475,000 of premiums previously reported as "Sickness premiums" have been previously reported as "Payments to deposit."

	Society	
	2010 £'000	2009 £'000
(3) Investment return		
Income from:		
Fixed interest stocks	159	33
Ordinary shares	691	935
Listed investments	850	968
Land and buildings	1,820	2,091
Mortgages and ground rents	10	14
Realised gains	6,754	341
Bank Interest	44	43
Investment income	9,478	3,457
Movement in unrealised gains and losses in the year	4,921	17,445
Total investment return	14,399	20,902

Investment income from land and buildings in 2009, included a deduction of £388,068 for direct property expenses, which have been recognised within investment expenses in 2010 (see note 6).

Notes to the accounts (Continued)

For the year ended 31 December 2010

	Group		Society	
	2010 £'000	2009 £'000	2010 £'000	2009 £'000
(4) Other technical income				
Insurance commission	588	113	29	8
Other income	28	-	28	-
	616	113	57	8

	Group		Society	
	2010 £'000	2009 £'000	2010 £'000	2009 £'000
(5) Net operating expenses				
(a) Included in operating expenses are:				
Fees payable to external auditors				
Auditing of accounts and other services pursuant to legislation	140	143	135	137
Services relating to taxation	51	60	48	55
Fees payable to internal auditors in respect of:				
Internal audit	42	25	38	25
Actuarial fees	323	444	323	444
Depreciation of tangible assets	152	139	95	128
Amortisation of goodwill	7	2	-	-

(b) Project costs:				
Cost & process efficiency	1,093	1,321	1,093	1,321
Product and proposition development	231	204	231	204
People & communication	115	122	115	122
Capital management	92	74	92	74
CRM	106	199	106	199
Costs re potential acquisitions	14	15	14	15
Other costs	232	166	232	166
Business intelligence	21	-	21	-
Total project costs	1,904	2,101	1,904	2,101

Part (b) of this note has been re-analysed and re-formatted from the prior year

Notes to the accounts (Continued)

For the year ended 31 December 2010

	Group		Society	
	2010 £'000	2009 £'000	2010 £'000	2009 £'000
(6) Investment expenses				
Investment management expenses	797	443	797	443
Investment property direct costs	451	-	451	-
	1,248	443	1,248	443

Investment property direct costs of £388,068 were netted off investment income in 2009 (see note 3)

	Group		Society	
	2010	2009	2010	2009
(7) Staff costs				
Average number of employees:				
Administration	51	70	51	70
Sales	36	38	16	14
	87	108	67	84

Includes temporary, part-time and fixed contract staff of 9 (2009:9) and excludes Non-Executive Directors of 5 (2009:6).

	Group		Society	
	2010 £'000	2009 £'000	2010 £'000	2009 £'000
Wages and salaries (inc commission)	3,377	2,809	2,766	2,793
Social security costs	370	327	306	311
Pension costs	164	203	163	203
	3,911	3,339	3,235	3,307

This includes Executive Director's emoluments totalling £617,799 for the year (2009: £533,635). Details of Director's remuneration are set out on page 26.

Notes to the accounts (Continued)

For the year ended 31 December 2010

(8) Taxation

(a) Attributable to long term business

Tax charged in the long term business technical account comprises:

Current tax

	Group & Society	
	2010 £'000	2009 £'000
UK corporation tax	166	251
Prior year adjustments	(25)	(88)
Total current tax	141	163
Deferred tax		
Origination and reversal of timing differences	360	436
Total deferred tax	360	436
Total tax charged in the long term business technical account	501	599

(b) Factors that may affect future tax charges

The deferred tax assets which have not been recognised due to the uncertainty of their recoverability in the foreseeable future comprise:

	Group & Society	
	2010 £'000	2009 £'000
Realised capital losses	453	539
Pension business losses	389	301
Accelerated capital allowances	126	83
Expenses deductible in future periods	405	-
Unrealised capital losses	110	-
Undiscounted deferred tax asset balance	1,483	923

These deferred tax assets may be realised, and therefore reduce future tax payable, when net gains chargeable to corporation tax are realised or when there is sufficient taxable income with which to offset carried forward expenses and/or losses. This will therefore depend substantially upon future movements in the stock market and on future taxable income which cannot be predicted with certainty.

Notes to the accounts (Continued)

For the year ended 31 December 2010

(8) Taxation (Continued)

(c) Balance sheet

The deferred tax balance included within other assets comprises:

	Group & Society	
	2010 £'000	2009 £'000
Unrelieved expenses carried forward	57	346
Accelerated capital allowances	-	72
Unrealised gains on investments	173	172
Undiscounted deferred tax asset balance	230	590
(d) Reconciliation of deferred taxation balances		
Opening deferred tax asset	590	1,026
Credit/(charge) to operating profit	(360)	(436)
Closing deferred tax asset	230	590

(9) Intangible assets

Goodwill:

Cost

At 1 January

	Group £'000
At 1 January	30
Additions	-
At 31 December	30
Depreciation	
At 1 January	2
Provided in the year	7
At 31 December	9
Net book value	
31 December 2010	21
31 December 2009	28

The goodwill arose in 2009 when the Group, through 425 Direct Limited, acquired by way of asset purchase agreement a part of the operations of AWD Direct Limited. £30,100 of goodwill arose through the transaction.

Notes to the accounts (Continued)

For the year ended 31 December 2010

	Society			
	2010 £'000 Cost	2010 £'000 Valuation	2009 £'000 Cost	2009 £'000 Valuation
(10) Investments				
Land and buildings				
Freehold investment properties	22,749	20,407	21,301	19,773
Freehold properties fully occupied by the Society	1,102	2,282	1,079	2,325
	23,851	22,689	22,380	22,098
Long leasehold properties	10,254	9,415	10,254	9,360
	34,105	32,104	32,634	31,458

The Society's properties are included at open market values. Significant property holdings are valued independently by Mellersh and Harding, Chartered Surveyors, on an open market value basis on a triennial basis. The most recent valuation being at 31 December 2008. This valuation was carried out in accordance with the Royal Institute of Chartered Surveyors appraisal and valuation standards. The remaining properties are valued by the Society's Property Manager, and reviewed by the Board, at the same date on an existing use basis. Property valuations are adjusted for the results of annual reviews carried out by the Society's Property Manager, and reviewed by the Board, to reflect fluctuations in the market values arising between the triennial valuations.

	Society			
	2010 £'000 Cost	2010 £'000 Valuation	2009 £'000 Cost	2009 £'000 Valuation
(11) Other financial investments				
Listed fixed interest securities	72,518	89,263	72,939	84,829
Listed shares	20,740	28,233	25,815	32,910
Deposits with credit institutions	2,022	2,022	-	-
Mortgages	295	295	417	417
Freehold ground rent	8	33	8	16
	95,583	119,846	99,179	118,172

Of the listed fixed interest securities £779,625 (2009: £756,000) relates to overseas fixed interest securities, with the remainder relating to UK fixed interest securities.

Of the listed shares £nil (2009: £615,284) relates to overseas investments, with the remainder relating to UK investments. Deposits with credit institutions was previously classified within cash at bank and in hand.

(12) Assets held to cover linked liability

Included within assets held to cover linked liabilities is £550,509 (2009: £344,590) representing units not yet purchased by policyholders.

Notes to the accounts (Continued)

For the year ended 31 December 2010

	Group				
	Computer Equipment £'000	Office Equipment £'000	Motor Vehicles £'000	Assets under Construction £'000	Total £'000
Cost					
At 1 January	3,973	705	26	-	4,704
Additions	107	16	-	-	123
Disposals	(3,489)	(442)	(26)	-	(3,957)
At 31 December	591	279	-	-	870
Depreciation					
At 1 January	3,680	542	20	-	4,242
Provided in the year	108	43	1	-	152
Disposals	(3,488)	(442)	(21)	-	(3,951)
At 31 December	300	143	-	-	443
Net book value					
31 December 2010	291	136	-	-	427
31 December 2009	293	163	6	-	462

	Society				
	Computer Equipment £'000	Office Equipment £'000	Motor Vehicles £'000	Assets under Construction £'000	Total £'000
Cost					
At 1 January	3,831	620	26	-	4,477
Additions	107	16	-	-	123
Disposals	(3,488)	(442)	(26)	-	(3,956)
At 31 December	450	194	-	-	644
Depreciation					
At 1 January	3,671	537	20	-	4,228
Provided in the year	72	22	1	-	95
Disposals	(3,488)	(442)	(21)	-	(3,951)
At 31 December	255	117	-	-	372
Net book value					
31 December 2010	195	77	-	-	272
31 December 2009	160	83	6	-	249

Computer and office equipment at a cost of £3,930,000 and £nil net book value were removed from the fixed asset register in 2010 as they are no longer in active use within the business.

(14) Capital commitments

Amounts authorised and contracted for at 31 December 2010 were £nil (2009 £nil).

Notes to the accounts (Continued)

For the year ended 31 December 2010

(15) Long term business provision

The long term business provision has been calculated on the basis of the following principal assumptions:

Rates of Interest	2010 Valuation Assumptions	2009 Valuation Assumptions
Old deposit contracts	3.42% per annum.	4.13% per annum.
Healthcare and Healthguard contracts	3.62% per annum.	4.13% per annum.
Other PHI contracts	3.14%	3.81%
With profits life assurance policies	2.62% per annum for tax exempt policies and 2.10% per annum for taxable policies.	3.24% per annum for tax exempt policies and 2.59% per annum for taxable policies.
With profits bonds and investment ISAs	Not applicable since the basic reserve is equal to current death benefits.	Not applicable since the basic reserve is equal to current death benefits.
With profits personal pensions and retirement annuities	3.94% per annum before vesting and 2.59% per annum after vesting (for retirement annuities).	4.54% per annum before vesting and 2.48% per annum after vesting (for retirement annuities).
Other non profit business	3.14% per annum for tax exempt policies, 2.51% for taxable policies and 0.52% for short term non-profit bonds.	3.81% per annum for tax exempt policies, 3.05% for taxable policies and 1.05% for short term non-profit bonds.

Rates of Mortality	2010 Valuation Assumptions	2009 Valuation Assumptions
DBO (Death Benefit Only) contracts	33% of the AMN00 and 39% of the AFN00 ultimate table for assured lives (assumed to be transferred to suspense at age 100).	60% of the AMN00 and 70% of the AFN00 ultimate table for assured lives (assumed to be transferred to suspense at age 100).
Deposit (non-DBO) contracts	75% of the AMN00 and 85% of the ultimate table for assured lives.	75% of the AMN00 and 85% of the ultimate table for assured lives.
Healthcare contracts	75% of the AMN00 and 85% of the ultimate table for assured lives.	75% of the AMN00 and 85% of the ultimate table for assured lives.
PHI (Permanent Health Insurance) deferred sickness claims in payment	Nil.	Nil.
Other PHI contracts	75% of the AMN00 ultimate table for assured lives.	75% of the AMN00 ultimate table for assured lives.
Critical illness policies	Table provided by reinsurer combining mortality and sickness rates.	Table provided by reinsurer combining mortality and sickness rates.
50+ life plan policies	135% of the AMN00 ultimate table for non-smokers or 150% of the AMS00 ultimate table for smokers.	150% of the AMN00 ultimate table for non-smokers or 150% of the AMS00 ultimate table for smokers.
Other life assurance policies	72% of the AMN00 ultimate table for assured lives or 90% of the AMS00 ultimate table for smokers.	80% of the AMN00 ultimate table for assured lives or 100% of the AMS00 ultimate table for smokers.

Rates of Mortality	2010 Valuation Assumptions	2009 Valuation Assumptions
Healthcare and Healthguard contracts	Morbidity assumptions are based on the Society's actual experience plus a margin for prudence.	Morbidity assumptions are based on the Society's actual experience plus a margin for prudence.

Full details of the method and assumptions used in calculating the long term business provision are given in the Society's FSA Return.

Notes to the accounts (Continued)

For the year ended 31 December 2010

(16) Capital management

	Society	
	Funding position as at 31 December 2010 £'000	Funding position as at 31 December 2009 £'000
Total balance sheet assets	157,782	158,155
Inadmissible assets	(679)	(1,056)
Total statutory assets	157,103	157,099
Total statutory reserves	145,802	135,879
Total other liabilities	3,226	2,572
Total statutory liabilities	149,028	138,451
Statutory surplus (before capital requirement)	8,075	18,648
Total minimum capital requirement	14,317	9,899
Excess/(deficit) over minimum capital requirement	(6,242)	8,749

	Society	
	2010 £'000	2009 £'000
Changes in capital		
Statutory surplus at 1 January	18,648	21,247
Net new business	(5,069)	(11,284)
Adjustment to terminal bonus rates	-	(1,533)
Adjustment to IPT rates	(596)	-
Provision for bonuses/benefits	(74)	(781)
Adjustment to per policy expenses	3,333	-
Adjustment to decrement assumption (ii)	15,483	8,441
Adjustment to morbidity assumption	(22,126)	(6,400)
Adjustment to interest rates	(3,318)	(106)
Adjustment to guarantees	776	-
Adjustment to cost of pension guarantees	1,668	-
Change in top up reserves	-	392
Change in statutory assets	4	9,547
Change in other liabilities	(654)	(875)
Statutory surplus as at 31 December	8,075	18,648

(i) This note has been re-formatted from the prior year.

(ii) Decrement assumptions cover future policy movements such as lapses and exits on death.

Notes to the accounts (Continued)

For the year ended 31 December 2010

(16) Capital management (Continued)

The Society maintains a single long term business fund. The available capital for the fund is represented by the fund for future appropriations which represents the difference between the assets and liabilities of the Society and Group. For statutory purposes certain assets are deemed inadmissible for meeting the capital requirement. As at the date of these accounts the most significant item deemed inadmissible was the deferred tax asset.

The capital requirement for the Society is determined as the greater of the statutory requirement based on formulae and calculations specified by regulations and the capital requirement determined by reference to the Society's Individual Capital Assessment (ICA). The ICA is subject to guidance but is not prescriptive and involves a significant level of judgement to be exercised by the Board. The ICA requirement is subject to review by the FSA and an additional capital requirement known as an ICG may be imposed. For the Society, it is the statutory basis that provides the greater capital requirement.

The available capital resources in excess of the capital requirements on the statutory basis have decreased by £14.9m. This sharp deterioration in capital position has resulted in the Society having insufficient assets to meet its minimum capital requirement determined by the statutory requirement resulting in a breach of £6.2m. The Society has informed the FSA of this position and has prepared a capital restoration plan to ensure that this is corrected as soon as practicable.

The main items that have affected the capital position are the capital strain of writing new business in 2010 and a significant deterioration in morbidity experience. The impact of these has been partially offset by changes in the lapse rate, per policy expense and economic and demographic assumptions used to calculate the long term business provision.

With a significant reduction in capital resources, the Board has already undertaken action to mitigate the risks of further reduction in capital resources in the short term and to increase the overall capital position in the mid to longer term, including reducing exposure to market risk on free assets through the sale of equities and re-investment into fixed interest assets, reducing future administration and acquisition cost, and, for the short term, ceasing to enter into new contracts of insurance.

In addition, where significant losses are being incurred on specific policy books action has been taken or is planned to be taken, in applying the mechanism within the policy terms to mitigate this cost, for example the increase in own share contribution to claims made on some of our Healthcare policies.

The capital restoration plan, which is subject to agreement with the FSA, demonstrates that, on the basis of having taken the action set out above, capital resources will be

restored as the prudential margins in the existing policy book unwind over the next three years and it explores options that achieve this more quickly. The key risks to achieving this plan are set out below under capital resource sensitivities and if these are realised this may delay the timing for the restoration of capital and of the operations of the Society. The Directors are confident that they will be able to achieve the capital restoration plan within the stated timeframe.

The solvency position of the Society is continually monitored and the level of liquid assets is managed to ensure that sufficient liquid funds are held to cover liabilities and claims as they fall due.

Capital resource sensitivities

The preparation of the Society's capital position requires management to make complex judgments based on information and financial data that may change in future periods. Although the estimates are based on management's best knowledge of current facts as at the reporting date, taking into account matters that have arisen following the year end but before the accounts are finalised, the actual outcome may differ from those estimates, impacting the Society's future capital position and the ability of management to achieve the capital restoration plan.

The key assumptions underlying the capital position are discussed below.

A key determinant of our capital position is morbidity assumptions and modest changes in morbidity experience can cause significant movements in reserves as experienced towards the end of 2010 and early in 2011. We have estimated our future claims experience based upon our current experience plus a margin for future adverse experience. We monitor claims closely to assess the continued validity of these assumptions.

The capital position is also sensitive to changes in market conditions, due to both changes in the value of the assets and the effect that changes in investment conditions may have on the value of the liabilities. The most significant sensitivity arises from the market risk in relation to the with-profit business, which would arise if adverse changes in the value of the assets supporting this business could not be reflected in payments to policyholders because of the effect of guarantees and options. The capital position of this business would also deteriorate if increases to the market cost of derivatives resulted in an increase in the liability for guarantees and options.

The capital position is also sensitive to assumptions and experience relating to expenses and persistency.

Notes to the accounts (Continued)

For the year ended 31 December 2010

(16) Capital management (Continued)

	Society	
	2010 £'000	2009 £'000
Analysis of Policy Holders Liabilities		
With profit liabilities		
Guarantees and options	3,047	4,780
Other policyholder obligations	72,968	71,224
	76,015	76,004
Unit linked	1,838	1,742
Deposit and other non-profit liabilities	67,947	58,133
	145,800	135,879

(17) Pensions

National deposit staff superannuation fund

The Fund is a defined benefit arrangement which provides retirement benefits based on final pensionable salary. The Fund was closed to new entrants and future accrual from 31 May 2009.

The valuation used for FRS17 disclosures has been based on a full assessment of the liabilities of the Fund.

The present values of the defined benefit obligation, the related current service cost and any past service cost (if applicable) were measured using the projected unit method.

The amounts recognised in the balance sheet on closure are as follows:-

	2010 £'000	2009 £'000
Fair value of fund assets	18,203	18,019
Present value of funded obligations	(18,203)	(18,098)
	-	(79)
Liability recognised on the balance sheet	-	(79)
Related deferred tax asset	-	3
Net pension liability	-	(76)
Amounts in the balance sheet		
Assets	-	-
Liabilities	-	(76)
Net pension liability	-	(76)

Notes to the accounts (Continued)

For the year ended 31 December 2010

(17) Pensions (Continued)

The amounts recognised in income statement are as follows:

	2010 £'000	2009 £'000
Current service cost	-	53
Interest on obligation	1,007	948
Expected return on fund assets	(1,007)	(890)
Gains on curtailments	-	(78)
Expense recognised in income statement	-	33
Actual return on fund assets	1,814	2,379

Changes in the present value of the defined obligation are as follows:

	2010 £'000	2009 £'000
Opening defined benefit obligation	18,098	14,566
Service cost	-	53
Interest cost	1,007	948
Contributions by members	-	38
Actuarial losses	154	3,700
Gains on curtailments	-	(77)
Benefits paid	(1,056)	(1,130)
Closing defined benefit obligation	18,203	18,098

Notes to the accounts (Continued)

For the year ended 31 December 2010

(17) Pensions (Continued)

	2010 £'000	2009 £'000
Opening fair value of fund assets	18,019	16,456
Expected return	1,007	890
Actuarial gains	233	1,489
Contributions by employer	-	276
Contributions by member	-	38
Benefits paid	(1,056)	(1,130)
Closing fair value of fund assets	18,203	18,019

Analysis of amounts recognised in statement of total recognised gains and losses (STGRL)		
Total actuarial gains/(losses)	79	(2,211)
Total gain/(loss) in STGRL	79	(2,211)
Cumulative amount of loss recognised in STGRL	(5,210)	(5,289)

The major categories of fund assets as a percentage of the total fund assets are as follows:	%	%
Equities	36	34
Gilts	20	15
Corporate bonds	24	25
Index linked bonds	6	6
Property	13	19
Cash	1	1

Notes to the accounts (Continued)

For the year ended 31 December 2010

(17) Pensions (Continued)

Principal actuarial assumptions at the balance sheet date (expressed as weighted averages (where applicable)).

	2010 %pa	2009 %pa
Discount rate at 31 December	5.4	5.7
Expected return on fund assets at 31 December (for following year)	6.1	6.8
Rate of increase in pensionable salaries	4.6	4.8
Rate of increase in deferred pensions	3.6	3.8
Rate of increase in pensions in payment – service pre 06/04/2005	3.4	3.5
Rate of increase in pensions in payment – service post 06/04/2005	2.2	2.3

Mortality assumptions

The mortality assumptions are based on standard mortality tables which allow for future mortality improvements. The assumptions are that a member aged 65 will live on average until age 87 if they are male and until 90 if female. For a member currently aged 50 the assumptions are that if they attain age 65 they will live on average until age 89 if they are male and until 91 if female.

Description of the basis used to determine the expected rate of return

The employer adopts a building block approach in determining the expected rate of return on the fund's assets. Historic markets are studied and assets with high volatility are assumed to generate higher returns consistent with widely accepted capital market principles.

Each different asset class is given a different expected rate of return. The overall rate of return is then derived by aggregating the expected return for each asset class over the actual asset allocation for the fund at the year end.

Employee benefit obligations for National Deposit Friendly Society Limited

Amounts for the current and previous periods are as follows:

	2010 £'000	2009 £'000	2008 £'000	2007 £'000	2006 £'000
Defined benefit obligation	18,203	18,098	14,568	18,284	18,014
Fund assets	18,203	18,019	16,456	19,621	19,629
Surplus/(deficit)	-	(79)	1,888	1,337	1,615
Experience gains/(losses) on fund assets	263	1,489	(3,831)	(657)	(138)
Experience gains/(losses) on fund liabilities	319	525	363	(252)	687
Change in assumptions underlying the present value of fund liabilities	(473)	(4,225)	3,948	579	370
Experience gain/(losses) on fund liabilities	(154)	(3,700)	4,311	327	1,057

Defined contribution scheme

The contributions to the defined contribution scheme amounts to :£163,406 (2009: £99,168).

Notes to the accounts (Continued)

For the year ended 31 December 2010

(18) Assets attributable to the long term business fund

Other than assets of £2,364,305 (2009: £2,086,989) used to match linked liabilities all of the assets shown on page 30 are attributable to the long term business fund.

(19) Operating lease commitments

The Society leases various motor vehicles and office equipment under cancellable operating lease agreements. The lease terms are for 36 months, with penalty for early cancellation.

The future aggregate minimum lease payments under cancellable operating leases are as follows:

	Society	
	2010 £'000	2009 £'000
No later than 1 year	-	40
Later than 1 year and no later than 3 years	42	56
Greater than 3 years	20	-
Total	62	96

(20) Subsidiary undertakings

The Society has two wholly owned subsidiary companies incorporated in the United Kingdom. 425 Direct Limited and ND Member Services Limited. ND Member Services Limited is dormant and therefore has not been consolidated within the Group accounts. During the year additional capital of £280,000 was provided to 425 Direct Limited.

425 Direct Limited operates a call centre giving financial advice. 425 Direct Limited is held at a value of £78,000 (2009: £325,000) after an impairment charge of £527,000 (2009: £nil). The results of 425 Direct Limited for the year ended 31 December 2010 have been consolidated into the Group accounts.

(21) Related party transactions

The Society paid £584,112 (2009: £84,432) in commission to its wholly owned subsidiary, 425 Direct Limited, in respect of products sold on its behalf. 425 Direct Limited was charged £355,597 (2009: £40,342) by the Society in respect of lead generation costs and service charges.

As at 31 December 2010, 425 Direct Limited owed the Society a net amount of £261,203 (2009: £248,403) and ND Member Services Limited owed the Society a net amount of £11,295 (2009: £10,294).

Tracy Morshead, a non-executive Director, provided consultancy services to the Society beyond the scope of the contractual duties of a non-executive Director to the value of £33,562 (2009: £16,107). These services are provided on normal commercial terms.

(22) Post balance sheet events

An opt-out clause to the European Union (EU) Gender Directive has permitted insurers to take gender into account as a risk factor when pricing contracts. In March 2011 the European Court of Justice (ECJ), ruling on a test case, deemed that the opt-out infringes fundamental European rights for equal treatment of men and women. Under the ruling, the ECJ requires the UK Government to amend domestic regulation on or before 21 December 2012 to reflect the ruling.

It is anticipated that such changes will alter the future market and prices for insurance products to a significant extent. The potential impact on the Society is being assessed. Any financial impact is uncertain until such time as the ruling is formally adopted into UK domestic legislation and the current uncertainty on retrospection is clarified.

The Finance Act (No.2) 2010 reduced the rate of corporation tax from 28% to 27% with effect from 1 April 2011. The Chancellor's Budget, announced on 23 March 2011, further reduced the rate of corporation tax to 26% with effect from 1 April 2011. The reduction to 26% is not estimated to have a significant effect on deferred tax assets and liabilities as at 31 December 2010 and will be reflected in the financial statements for the year ended 31 December 2011. The Chancellor also announced that the tax rate would fall to 23% by 2014. The impact of these proposed changes cannot be reliably estimated.

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