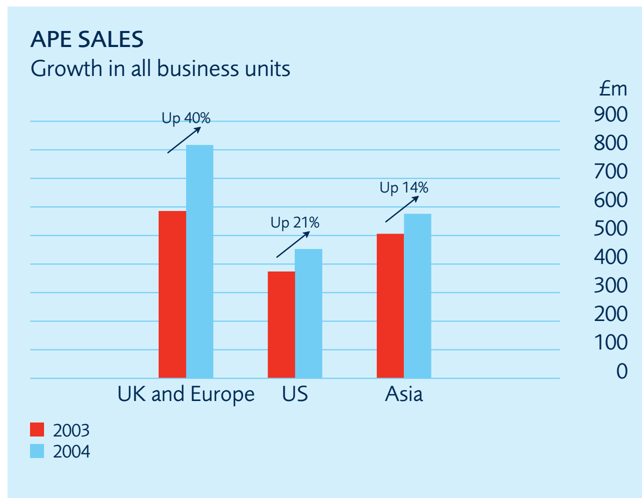
SALES AND FUNDS UNDER MANAGEMENT



Prudential delivered strong growth in sales during 2004 with total new insurance sales up 40 per cent to £12.1 billion at constant exchange rates (CER). This resulted in record insurance sales of £1.85 billion on the annual premium equivalent (APE) basis, an increase of 26 per cent on 2003. At reported exchange rates, APE was up 19 per cent on 2003.

In 2004, gross written premiums, including insurance renewal premiums, increased 19 per cent to £16.4 billion, reflecting the growth of new insurance sales in 2004 and the significant contribution from regular premium business written in previous years.

Total gross investment sales for 2004 were £25.1 billion, up 21 per cent on 2003 at CER. Net investment sales of £3.6 billion were up 23 per cent on last year at CER. The strong growth across a number of markets offset the high level of redemptions in Taiwan, which was the result of market concern about the liquidity of bond funds across the Taiwanese mutual fund market.

Total investment funds under management in 2004 increased by 19 per cent from £30.9 billion to £37.1 billion, reflecting net investment flows of £3.6 billion and net market and other movements of £2.6 billion.

At 31 December 2004, total insurance and investment funds under management were £187 billion, an increase of 11 per cent from 2003. This marked a record level of funds under management and the increase was primarily due to the combination of changes in the market value of investments and the impact of net insurance and investment sales achieved during the year.

BASIS OF PREPARATION OF RESULTS

Prudential is required to account for its long-term insurance business on the modified statutory basis (MSB) of reporting under UK accounting standards. The Group's primary financial statements are therefore prepared on this basis and broadly reflect the UK solvency-based reporting regime and, for overseas territories, adjusted local or US GAAP. In broad terms, MSB profit for long-term business reflects the aggregate of statutory transfers from with-profits funds and profits on a traditional deferral and matching approach for other long-term business. Although the statutory transfers from with-profits funds are closely aligned with cash flow generation, the pattern of MSB profit over time from shareholder-backed long-term businesses will generally differ from the cash flow pattern. Over time however, aggregate MSB profit will be the same as aggregate cash flow.

Life insurance products are, by their nature, long term and the profit on this business is generated over a significant number of years. MSB profit does not, in Prudential's opinion, properly reflect the inherent value of these future profit streams.

Accordingly, in common with other listed UK life assurers, Prudential also reports supplementary results for its long-term operations on the achieved profits basis. These results are combined with the statutory basis results of the Group's other operations, including fund management and banking businesses. Reference to operating profit relates to profit including investment returns at the expected long-term rate of return, but excludes amortisation of goodwill, exceptional items, short-term fluctuations in investment returns and the effect of changes in economic assumptions.

In the directors' opinion, the achieved profits basis provides a more realistic reflection of the current performance of the Group's long-term insurance operations than results on the MSB basis, as it reflects the business performance during the accounting period under review, although both bases should be considered in forming a view of the Group's performance.

There is further discussion on the development of accounting policies and the potential impact on the reported results of the Group on pages 24 to 27 of this Financial Review.

ACHIEVED PROFITS BASIS RESULTS

The achieved profits basis results for long-term business are prepared in accordance with the Association of British Insurers' (ABI) guidance for achieved profits reporting issued in December 2001. This guidance requires that for countries where capital markets are well developed, the economic assumptions used for the projection of cash flows are to be on an active basis, which is primarily based on appropriate government bond returns at each period end. The effects of changed economic assumptions on the adjusted opening balance sheet value are reflected in the profit reported for the year and excluded from operating profit.

The active basis is applied to UK and US operations, and those countries in Asia where there are well-developed government bond markets (Japan, Korea and US$-denominated business in Hong Kong). Assumptions in other Asian countries continue to be based on an assessment of long-term economic conditions.

In 2004, use of the active basis resulted in a decrease in the risk discount rate applied to the UK insurance operations from 7.4 per cent to 7.2 per cent, and a decrease in the UK investment return assumption for the UK with-profits fund from 6.8 per cent to 6.5 per cent. The decrease primarily reflects decreases in the 15-year gilt yield from 4.8 per cent at the end of 2003 to 4.6 per cent at the end of 2004. The risk margin over the risk free rate was maintained at 2.6 per cent. The expected long-term inflation rate assumption decreased from 3.1 per cent to 2.9 per cent, reflecting the difference between conventional and index-linked gilts. These changes are a function of the active basis rather than a change in Prudential's long-term view of future returns and levels of price inflation.

In the US, the risk discount rate has remained at 7.4 per cent. The level of capital required to support the business (the 'target surplus') has been taken, as in 2003, to be 200 per cent of the Company Action Level Risk Based Capital, calculated in accordance with the National Association of Insurance Commissioners' risk-based capital standards for life insurance companies.

In Asia, each country has its own specific discount rate. The weighted average risk discount rate, which is determined by weighting each Asian country's economic assumptions by reference to the achieved profits basis operating results for new business written in 2004, was 9.6 per cent in 2004, a decrease from 10.4 per cent in 2003. The discount rates used in various country operations range between five per cent to 19 per cent. The weighted risk discount rate declined during 2004 principally due to lower pre-tax expected long-term nominal rates of investment return and lower weighted long-term rate of inflation assumptions due to changes in the geographic mix of business in 2004.

The overall impact on the Group's achieved profits basis result for 2004 of using these revised economic assumptions compared with those used in 2003, was a reduction in new business achieved profit (NBAP) of around £13 million and a decrease in achieved profits basis shareholders' funds of £85 million.

Achieved Profits Basis Operating Profit

Total achieved profits basis operating profit from continuing operations was £1,124 million, up 39 per cent from 2003 at CER. At reported exchange rates, the result was up 31 per cent. This result reflects a combination of strong growth in the insurance and fund management businesses.

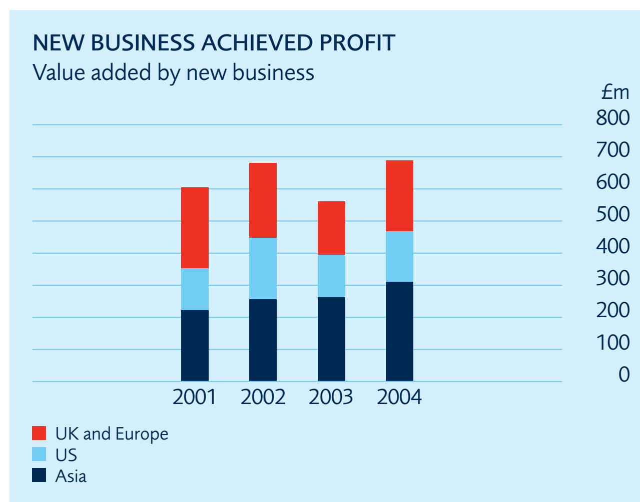
Prudential's insurance business achieved significant growth, both in terms of new business achieved profit (NBAP) and in-force profit, resulting in a 35 per cent increase in operating profit over 2003 at CER. NBAP of £688 million was up 23 per cent on the prior year at CER and up 14 per cent at reported exchange rates. In-force profit increased 51 per cent on 2003 at CER to £460 million. At reported exchange rates, in-force profit was up 46 per cent.

Results from fund management and banking business were £184 million, an increase of 26 per cent at CER on 2003. This was mainly driven by the significant contribution from M&G.

Other income and expenditure was negative £193 million compared with negative £178 million at CER in 2003. This reflected an increase in investment return on centrally held assets and other income offset by higher interest payable and head office costs.

New Business Achieved Profit

In 2004, the Group has generated record new business achieved profit (NBAP) from insurance business of £688 million which was 23 per cent above 2003 at CER, driven by strong sales momentum across all markets. At reported exchange rates, NBAP was up 14 per cent. The average Group NBAP margin of 37 per cent was slightly down from 38 per cent in 2003. The overall margin has been broadly maintained over the last two years, reflecting careful management of product mix within each business and across the three regions.



NBAP from the UK and Europe Insurance Operations was £220 million, an increase of 40 per cent on 2003. This reflected increased APE sales and a balanced shift in sales mix. This positive movement arose due to increased sales of more profitable bulk annuities partially offset by reduced sales of high margin with-profits bonds and increased sales of less profitable executive pensions.

Individual and bulk annuity margins remained strong at 43 per cent and 46 per cent respectively, partly as a consequence of nearly all annuity business now being written in Prudential Retirement Income Limited (PRIL), a shareholder-backed business. 88 per cent of

ACHIEVED PROFITS BASIS OPERATING PROFIT

	2004 (as reported) £m	2003 (at 2004 exchange rate) £m	Percentage change	**2004 (as reported) £m**	2003 (as reported) £m	Percentage change
Insurance business:						
UK and Europe	**450**	359	25%	**450**	359	25%
US	**317**	176	80%	**317**	197	61%
Asia	**381**	328	16%	**381**	365	4%
Development expenses	**(15)**	(24)	38%	**(15)**	(27)	44%
	1,133	839	35%	**1,133**	894	27%
Fund management business:						
M&G	**136**	83	64%	**136**	83	64%
US broker-dealer and fund management	**(14)**	(3)	(367)%	**(14)**	(3)	(367)%
Asia fund management	**19**	11	73%	**19**	13	46%
	141	91	55%	**141**	93	52%
Banking:						
Egg (UK)	**43**	55	(22)%	**43**	55	(22)%
Other income and expenditure	**(193)**	(178)	(8)%	**(193)**	(181)	(7)%
Operating profit from continuing operations	**1,124**	807	39%	**1,124**	861	31%

annuities business was written in shareholder-backed funds in 2004, compared with 56 per cent in 2003. Previously, a substantial proportion of annuity business was written in a subsidiary of the with-profits fund.

PRIL was established in September 2000, initially to write bulk annuity business. This was expanded to include external individual annuity business and Prudential-branded internal vestings (annuity business sales arising from maturing in-force pension books) in September 2001 and July 2004 respectively.

Business to Business (B2B) corporate pensions saw a fall in NBAP margins to nine per cent principally reflecting a change of mix towards the less profitable unit-linked products. Margins on with-profits bonds remained stable at 41 per cent.

As the unit-linked business has gained scale, with sales growing by 219 per cent in 2004, margins have approached a break-even position.

In the US, Jackson National Life's (JNL) NBAP of £156 million was up 18 per cent on 2003 at CER and up five per cent at reported rates. This increase was principally volume driven as a result of high sales levels recorded during the year. The NBAP margin was 34 per cent in 2004, a slight reduction from 35 per cent in 2003 due to a shift in product mix and a small impact from economic assumption changes.

JNL's expense ratio has fallen three basis points from 2002 to stand at 46 basis points at the end of 2004. We believe JNL benefits from its considerable expense advantage relative to its principal competitors enabling it to maintain these attractive margins.

The margin achieved on variable annuity business in 2004 was 37 per cent compared with 36 per cent in 2003. This improvement is a result of pricing changes instituted early in 2004. For fixed annuity business the margin declined by nine per cent over the last two years to 32 per cent at the end of 2004. The reduction in margin is due to a lower fund earned rate as yields have declined, however target spreads have been maintained.

In Asia, NBAP of £312 million was up 19 per cent at CER on 2003, reflecting a combination of increased sales and higher NBAP margin. During 2004, APE sales were up 14 per cent on 2003 and the NBAP margin was 54 per cent, compared with 52 per cent in 2003 at CER. The increase in margin was principally due to a combination of changes in country mix and product mix being offset by the impact of assumption changes.

In-Force Achieved Profit

Total in-force profit in 2004 was £460 million, an increase of 51 per cent on 2003 at CER. This was driven by the significant increase in the in-force profit in the US.

UK and European in-force profit of £230 million was up 19 per cent on 2003. The profit arising from the unwind of discount from the in-force book was partially offset by adverse operating assumption changes and other experience charges.

A charge of £66 million was made reflecting a 40 per cent strengthening of the persistency assumptions on the closed book of personal pensions business sold through the closed direct sales force channel. This assumption change reflects Prudential UK's experience over the last three years and, post-tax, represents about one per cent of the overall embedded value of the UK business.

Measures to manage and improve the conservation of in-force business have had a beneficial effect on persistency that Prudential UK expects to maintain or improve. Consequently, Prudential UK has not changed persistency assumptions for all other products.

Other charges of £34 million include £21 million of costs associated with complying with new regulatory requirements and restructuring.

In the US, the in-force profit of £161 million was more than three times higher than in 2003. This growth reflects improvements from 2003 in net experience variances to positive £33 million (an increase of £46 million at CER), changes in operating assumptions to negative £3 million (an increase of £16 million at CER) and changes in other items to positive £12 million (an increase of £37 million at CER). Included in other items is a £28 million favourable legal settlement.

The £33 million positive total experience variance includes a £43 million positive spread variance (net of risk margin reserve) primarily reflecting a favourable variance in the fixed annuity portfolio. The assumed spread on new fixed annuity business is 155 basis points grading to 175 basis points over five years.

Asia's in-force profit (before development expenses and the Asian fund management business) increased to £69 million in 2004 from £67 million in 2003 at CER. This reflects a higher unwind of the discount rate as the in-force business builds scale and lower experience variances, offset by assumption changes of £56 million. The assumption changes made in 2004 principally reflect a worsening persistency in Singapore and a revision to expense assumptions in Vietnam.

Non-Insurance Operations

M&G

M&G's operating profit was £136 million, an increase of 64 per cent on last year. This included £26 million in performance-related fees (PRF), of which £20 million was generated by PPM Ventures on the exceptionally profitable realisation of several investments during the year.

Underlying profit of £110 million was 57 per cent higher than 2003, achieved as a result of a strong performance across all of M&G's business lines. Significant growth was delivered in the areas of fixed income, retail and property; attributable to the continued development of new business streams and the recovery in stock markets during 2004. In addition, underlying profit was also boosted by £7 million of one-off provision releases in 2004 that will not recur in future years.

M&G's revenue growth continues to be combined with careful cost control. In 2004, M&G enjoyed the first full year of savings from the outsourcing of retail administration at the end of 2003. This, together with the tight management of overhead across the entire business, has resulted in costs remaining flat for the last four years.

US broker-dealer and fund management businesses

The broker-dealer and fund management operations, which include Curian Capital, reported a total loss of £14 million, compared with a £3 million loss in 2003. This primarily reflects increased losses at Curian Capital as the business continues to build scale.

Asia fund management business

Profit from Asia fund management operations was £19 million, up 73 per cent from 2003, reflecting a combination of increasing scale and profitability in the retail business, particularly from the joint venture with ICICI in India, and higher management fees from the UK and Asia life businesses.

Egg

Egg's total continuing operating profit in 2004 was £43 million, compared with £55 million in 2003, reflecting an increase in profit

from the UK business offset by a £17 million impairment charge on the underlying assets of Funds Direct.

Egg's UK business delivered a good set of results with a particularly encouraging performance in the second half of 2004. For the full year, a profit of £74 million was recorded, compared with £73 million in 2003. This represents a solid result considering the increased competition and rising interest rates that have impacted the credit card and personal loan markets.

Included in the continuing operating results was a charge of £3 million, which related to the migration and other exit costs associated with the transfer of the funds supermarket business to Fidelity FundsNetwork. The transfer will result in annual savings of around £3 million.

Following the decision to dispose of its investment in Funds Direct, its investment wrap platform business, Egg provided for a £17 million impairment charge against the full carrying value of the underlying assets of Funds Direct.

Others

Asia's development expenses (excluding the regional head office expenses) reduced by 38 per cent at CER to £15 million, compared with £24 million in 2003. These development expenses primarily related to repositioning the insurance operation in Japan.

Other net expenditure increased by £15 million to £193 million. This reflected an increase in investment return and other income offset by higher interest payable and head office costs. Head office costs (including Asia regional head office costs of £29 million) were £83 million, up £16 million on 2003. The increase mainly reflects the substantial work being undertaken for the implementation of International Financial Reporting Standards, Sarbanes-Oxley and other regulatory costs.

Total Achieved Profits Basis – Result Before Tax

(Year-on-year comparisons below are based on reported exchange rates.)

The result before tax and minority interests was a profit of £1,521 million, up 82 per cent on 2003. This primarily reflects the strong operating profit from continuing operations of £1,124 million and the lower negative effect of changes in economic assumption of £100 million, compared with negative £540 million in 2003. The result also benefited from strong investment performance which was ahead of the long-term investment assumptions.

The UK component of short-term fluctuations in investment returns of £402 million reflects the difference between an actual investment return delivered for the with-profits life fund of 13.4 per cent and the long-term assumed return of 6.5 per cent.

Short-term investment fluctuations in the US were £207 million. This includes a positive £161 million which represents the difference between actual net bond gains and the five-year average amount included in operating profit, and a positive £24 million in relation to changed expectations of future profitability on in-force variable annuity business, due to the separate account return exceeding the long-term return reported in operating profit. In 2004, actual net bond gains were £48 million, compared with £39 million of bond losses in 2003.

In Asia, short-term investment fluctuations were £48 million, compared with £1 million last year. This mainly reflects the rising equity markets in a number of countries and falling bond yields in Singapore.

In the UK, economic assumption changes of negative £19 million reflect the impact of the decrease in the future investment return assumption offset by the decrease in the risk discount rate.

In the US, economic assumption changes were negative £53 million and included a reduction in the projected fund earned rate, a reduction in the spread assumption for equity-linked indexed annuities business in force prior to 2002 and an increase in inflation rates.

Asia's negative economic assumption changes of £28 million primarily reflect a change in Taiwan as a result of an increase in the discount rate and a change in the fund earned rate assumption.

Amortisation of goodwill was £97 million in 2004 compared to £98 million in 2003.

Profit on the disposals of Jackson Federal Bank and the Group's 15 per cent interest in Life Assurance Holding Corporation Limited was £41 million and £7 million respectively.

In France, an exit cost provision of £113 million was established in July 2004 following Egg's announcement of its intention to withdraw from the French market. £96 million of the provision had been used by 31 December 2004 and it is expected that the withdrawal can be completed within the provision established.

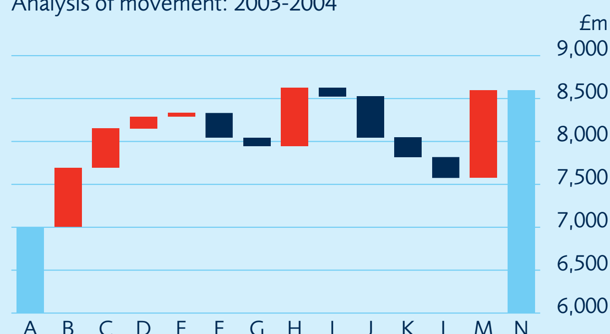
Total Achieved Profits Basis – Result After Tax

The result after tax of £485 million and minority interests of positive £10 million, was a profit of £1,046 million.

The effective tax rate at an operating profit level was 29 per cent, reflecting the lower effective tax rates in the UK and certain Asian territories.

The effective tax rate at a total achieved profit level was 32 per cent on a profit of £1,521 million. The higher effective rate of tax compared with that at an operating profit level is primarily due to amortisation of goodwill not being deductible for tax purposes.

ACHIEVED PROFITS BASIS SHAREHOLDERS' FUNDS
Analysis of movement: 2003-2004



A Opening 2004 achieved profits basis shareholders' funds (+£7,005m)
B New business achieved profit (+£688m)
C In-force achieved profit (+£460m)
D M&G (+£136m)
E Egg (+£43m)
F Other non-life operations (-£288m)
G Goodwill (-£97m)
H Short-term fluctuations in investment returns (+£679m)
I Economic assumption changes (-£100m)
J Tax, minority interests and others (-£479m)
K Foreign exchange movement (-£229m)
L Dividends paid to shareholders (net of Scrip) (-£243m)
M Rights Issue proceeds (+£1,021m)
N Closing 2004 achieved profits basis shareholders' funds (+£8,596m)

MODIFIED STATUTORY BASIS (MSB) RESULTS

MSB Operating Profit

Reference to operating profit relates to profit including investment returns at the expected long-term rate of return but excludes amortisation of goodwill, exceptional items and short-term fluctuations in investment returns.

Group operating profit from continuing operations on the modified statutory basis (MSB) was £603 million, an increase of 49 per cent from 2003 at CER. At reported exchange rates, operating profit was up 42 per cent on last year. This reflects strong growth in insurance and fund management businesses.

In the UK, MSB operating profit was £305 million in 2004, an increase of 19 per cent on 2003. This included a fourfold increase in PRIL's profit from £31 million to £124 million. This more than offset the £17 million reduction in the profit from the with-profits fund, which fell due to lower annual and terminal bonus rates announced in February 2004.

In the US, Jackson National Life's (JNL) operating profit from continuing operations of £182 million was up 46 per cent on 2003. Total MSB operating profit for long-term business from continuing operations was £196 million, up 53 per cent from £128 million in 2003.

Growth in the long-term business operating profit reflects JNL's clear focus on profitability and its ability to deliver improved investment returns. In 2004, spread income was £169 million higher than in 2003 and variable annuity fee income was at a record level due to the significant growth (47 per cent) in separate account assets. In addition, there were two one-off items, a favourable legal settlement of £28 million and a positive £8 million adjustment arising from the adoption of SOP 03-01 'Accounting and Reporting by Insurance Enterprises for Certain Non-traditional Long Duration Contracts and for Separate Accounts'. This adjustment relates to a change in the method of valuing certain liabilities.

Prudential Corporation Asia's operating profit for long-term business before development expenses of £15 million was £126 million, an increase of 64 per cent on 2003 at CER. At reported rates, operating profit was 48 per cent up on last year. The majority of this profit currently still comes from the larger and more established operations of Singapore, Hong Kong and Malaysia, which represented £110 million of the total in 2004, compared to £86 million last year. Five life operations made MSB losses; China, India and Korea reflecting their rapid building of scale while Thailand is marginally loss making and Japan's loss reduced significantly over 2003 due to lower new business strain, reduced management expenses and mark to market gains on investments.

Total MSB Profit – Result Before Tax

(Year-on-year comparisons below are based on reported exchange rates.)

MSB profit before tax and minority interests was £650 million in 2004, compared with £350 million in 2003. This mainly reflects growth in operating profit of £226 million and improvement in short-term fluctuations in investment return, up £138 million from last year to positive £229 million.

Amortisation of goodwill was £97 million in 2004 compared with £98 million in 2003.

Profit on the disposals of Jackson Federal Bank and the Group's 15 per cent interest in Life Assurance Holding Corporation Limited was £41 million and £7 million respectively.

In France, an exit cost provision of £113 million was established in July 2004 following Egg's announcement of its intention to withdraw from the French market. £96 million of the provision had been used by 31 December 2004 and it is expected that the withdrawal can be completed within the provision established.

MODIFIED STATUTORY BASIS OPERATING PROFIT

	2004 (as reported) £m	2003 (at 2004 exchange rate) £m	Percentage change	**2004 (as reported) £m**	2003 (as reported) £m	Percentage change
Insurance business:						
UK and Europe	**305**	256	19%	**305**	256	19%
US	**196**	128	53%	**196**	143	37%
Asia	**126**	77	64%	**126**	85	48%
Development expenses	**(15)**	(24)	38%	**(15)**	(27)	44%
	612	437	40%	**612**	457	34%
Fund management business:						
M&G	**136**	83	64%	**136**	83	64%
US broker-dealer and fund management	**(14)**	(3)	(367)%	**(14)**	(3)	(367)%
Asia fund management	**19**	11	73%	**19**	13	46%
	141	91	55%	**141**	93	52%
Banking:						
Egg (UK)	**43**	55	(22)%	**43**	55	(22)%
Other income and expenditure	**(193)**	(178)	8%	**(193)**	(181)	7%
Operating profit from continuing operations	**603**	405	49%	**603**	424	42%

Total MSB Profit – Result After Tax

MSB profit after tax and minority interests was £428 million, after a tax charge of £232 million.

The effective tax rate at an operating profit level was 30 per cent, a blend of the effective tax rates of 35 per cent in the US, 33 per cent in Asia and 28 per cent in the UK. The effective tax rate of 28 per cent on the UK results reflects the basis of taxation on profit arising from the life fund.

The effective tax rate at a total MSB profit level was 36 per cent on a profit of £650 million. The higher effective rate of tax compared with that at an operating profit level is primarily due to amortisation of goodwill not being deductible for tax purposes.

EARNINGS PER SHARE

Earnings per share, based on achieved profits basis operating profit after tax and related minority interests, but before amortisation of goodwill, were up 11.8 pence to 37.2 pence. The 2003 figure has been restated from 26.4 pence to 25.4 pence to adjust for the bonus element of the Rights Issue. Earnings per share, based on MSB operating profit after tax and related minority interests, but before amortisation of goodwill, were 19.2 pence, compared with a restated 2003 figure of 12.4 pence.

Basic earnings per share, based on total achieved profits basis profit for the year after minority interests, were 49.1 pence, compared with a restated figure of 23.4 pence in 2003. Basic earnings per share, based on MSB profit for the year after minority interests, were 20.1 pence, 10.1 pence up from a restated 2003 figure of 10.0 pence.

DIVIDEND PER SHARE

As outlined in the Rights Issue prospectus, Prudential has maintained its current dividend policy, with the proposed 2004 final dividend payment per share taking account of the bonus element of the Rights Issue.

The shares issued as part of the Rights Issue were issued at a discount to market price (308 pence per share versus a closing share price of 458 pence per share on the day immediately preceding the announcement of the Rights Issue). It is therefore necessary to restate the Company's previously reported earnings and previously declared dividends per share for this bonus element.

The bonus adjustment is equal to the closing share price on the final day Prudential's shares traded cum-rights (19 October 2004) divided by the theoretical ex-rights price (TERP) as outlined in the table below.

The resulting bonus adjustment factor used for restating earnings and dividends per share using the methodology outlined above is 0.9614.

The final dividend per share for 2003 was 10.29 pence after adjusting for the bonus element of the Rights Issue (10.70 pence before the adjustment). The interim dividend for 2004 was 5.40 pence (5.19 pence after adjustment for the Rights Issue).

The directors recommend that the shareholders declare a final dividend for 2004 of 10.65 pence per share. The total dividend for the year, comprising the adjusted interim dividend and the recommended final dividend, amounts to 15.84 pence per share, an increase of 3.0 per cent over the full year 2003 dividend of 15.38 pence per share after adjustment for the bonus element of the Rights Issue.

The 2004 dividend is covered 1.2 times by post-tax modified statutory basis profit for the financial year after minority interests.

BALANCE SHEET

Explanation of Balance Sheet Structure

The Group's capital on an MSB basis comprises shareholders' funds £4,281 million; subordinated long-term and perpetual debt of £1,429 million; other senior debt £1,761 million and the Fund for Future Appropriations (FFA) £16.7 billion.

Shareholders' funds include the £1,021 million of new share capital allotted as a result of the Rights Issue in October 2004.

Subordinated or hybrid debt is debt capital which has some equity-like features and which would rank below other senior debt in the event of a liquidation. These features allow hybrid debt to be treated as capital for Financial Services Authority (FSA) regulatory purposes. All of the Group's hybrid which qualifies in this way is held at the Group level and is therefore taken as capital into the parent solvency test under the EU Financial Groups Directive (FGD).

The FSA has established a structure for determining how much hybrid debt can count as capital which is similar to that used for banks. It categorises capital as Tier 1 (equity and preference shares), Upper Tier 2 debt and Lower Tier 2 debt. Up to 15 per cent of Tier 1 can be in the form of hybrid debt and called 'Innovative Tier 1'. At 31 December 2004, the Group held £638 million of Innovative Tier 1 capital, in the form of perpetual securities, nil Upper Tier 2 and £921 million of Lower Tier 2 capital. Following the implementation of the FGD, it is advantageous to the Group from a regulatory capital standpoint to raise its long-term debt in hybrid form and it is the Group's policy to take advantage of favourable market conditions as they arise to do so.

RIGHTS ISSUE BONUS ADJUSTMENT

Market price cum-rights (Tuesday 19 October 2004) (pence)	A	422.00
Rights Issue price (pence)	B	308.00
Number of shares pre Rights Issue (million)	C	2,023.29
Number of shares issued through Rights Issue (million)	D	337.22
Theoretical ex-rights price (pence)	$TERP = \frac{(A \times C) + (B \times D)}{C + D}$	405.71
Bonus adjustment	TERP/A	0.9614

The FFA represents assets in the life fund which have not yet been allocated either to policyholders or shareholders and which are not available to the Group as a whole other than as they emerge through the statutory transfer of the shareholders' share of the surplus as it emerges from the fund over time.

Asset and Liability Management

Prudential manages its assets and liabilities locally, in accordance with local regulatory requirements and reflecting the differing types of liabilities Prudential has in each business. As a result of the diversity of products Prudential offers and the different regulatory environments in which it operates, Prudential employs different methods of asset/liability management on both an in-force and new business basis. Stochastic modelling of assets and liabilities is undertaken in the UK, the US and Asia to assess economic capital requirements for different confidence intervals and time horizons. In addition, reserve adequacy testing under a range of scenarios and dynamic solvency analysis is carried out, including under certain scenarios mandated by the US, the UK and Asian regulators.

Weighted Average Cost of Capital

Our commitment to our shareholders is to maximise the value of Prudential over time by delivering superior financial returns. Prudential's weighted average cost of capital (WACC) is 8.7 per cent, which is based on the net core debt and shares outstanding at the end of 2004, an equity market premium of three per cent and a market Beta of 1.6. Prudential's core debt at the end of 2004 is net of the Rights Issue proceeds which have increased the proportion of the Group's capital funded by equity and therefore increased the Group's WACC.

RIGHTS ISSUE

The strength of Prudential's businesses and positive developments in a number of its markets represent an opportunity to enhance its market position and generate improved returns for its shareholders. A strong financial position at a Group level will provide increased financial flexibility and allow Prudential to capitalise on these opportunities as they arise.

In response to these developments the Board took the decision in October 2004 to launch a 1 for 6 Rights Issue.

The majority of the net proceeds of the Rights Issue (£1,021 million) will be used to provide capital to support Prudential's growth plans for the UK and to fund a potential opportunity to increase its ownership from 26 per cent to 49 per cent of its joint venture life insurance business with ICICI in India. The remainder of the proceeds will be used to ensure that Prudential meets the parent company solvency test under the EU Financial Groups Directive (FGD) that became effective from 1 January 2005. The proceeds of the Rights Issue have initially been invested centrally within the Group in fixed interest securities.

SHAREHOLDERS' FUNDS

On the achieved profits basis, which recognises the shareholders' interest in long-term businesses, shareholders' funds at 31 December 2004 were £8.6 billion, up £1.6 billion from 31 December 2003.

Modified statutory basis (MSB) shareholders' funds, which are not affected by fluctuations in the value of investments in the Group's with-profits funds were £4.3 billion, an increase of £1.1 billion from 31 December 2003.

INTERNAL RATE OF RETURN OF INSURANCE OPERATIONS

United Kingdom and Europe

Prudential allocates shareholder capital to support new business growth across a wide range of products in the UK. The weighted average post-tax Internal Rate of Return (IRR) on the capital allocated to new business growth in the UK in 2004 was 12 per cent. This reflected an IRR of 20 per cent for annuity products, seven per cent for unit-linked bonds, three per cent for corporate pensions and one per cent for protection products.

By the financial year ending 2007, Prudential is targeting an IRR of 14 per cent on the capital required to support new business sold in that year in the UK, including individual product targets of 20 per cent for annuity products, eight per cent for unit-linked bonds, 15 per cent for corporate pensions and 15 per cent for protection products.

United States

For Jackson National Life, the average IRR on new business was 13 per cent which we believe to be above the returns being earned currently in the US life insurance industry.

Asia

In Asia we have target IRRs on new business at a country level of 10 per cent over the country risk discount rate. Risk discount rates vary from five per cent to 19 per cent depending upon the maturity of the market. These target rates of return are average rates and the marginal return on capital on a particular product could be above or below the target.

We have, however, achieved or exceeded the target in each of Asia's markets in 2004 except for Thailand and Japan. In Japan the returns on capital are below our target, a result of restructuring and withdrawing from some business lines in 2003. The restructured business needs to build scale to achieve its target. In Thailand the returns on capital are below our target as this operation is relatively small. In aggregate, IRR on new business exceeded 20 per cent on average risk discount rates for 2004 of 9.6 per cent.

CASH FLOW

The table on page 19 shows the Group holding company cash flow. Prudential believes that this format gives a clearer presentation of the use of the Group's resources than the FRS 1 statement required by UK GAAP.

The Group received £521 million in cash remittances from business units in 2004 (2003: £586 million) comprising the shareholders' statutory life fund transfer of £208 million relating to earlier bonus declarations, together with dividends and interest from subsidiaries of £313 million. The shareholder transfer in 2005 representing 2004's profit from the PAC with-profits fund, is expected to be approximately £198 million.

Prudential UK paid a £100 million special dividend from the PAC shareholders' funds in respect of profit arising from earlier business disposals. A similar amount will also be distributed from PAC shareholders' funds in 2005. The level of scrip dividend take-up in 2004 (for both the 2003 final and 2004 interim dividend) was greater than the corresponding take-up in 2003, in part due to the change in basis of the election offered to shareholders. After dividends and interest paid, there was a net inflow of £173 million (2003: £42 million).

During 2004, the Group invested £31 million in corporate activities (2003: £58 million receipt, arising from disposal proceeds and exceptional tax receipts).

The Group invested £347 million during 2004 in its business units (2003: £173 million). Investment in the UK amounted to £189 million. This amount is expected to increase to around £250 million in 2005. Investment in Asia in 2004 of £158 million is expected to remain broadly the same in 2005. In 2006, based on current plans and expectations, Prudential expects Asia to be a net capital provider to the Group.

Together with the proceeds from the Rights Issue of £1,021 million, there was a total increase in cash of £850 million (2003: £4 million).

SHAREHOLDERS' BORROWINGS AND FINANCIAL FLEXIBILITY

As a result of the holding company's net funds inflow of £850 million and exchange conversion gains of £49 million, net core borrowings at 31 December 2004 were £1,236 million, compared with £2,135 million at 31 December 2003.

After adjusting for holding company cash and short-term investments of £1,561 million, core structural borrowings of shareholder-financed operations at the end of 2004 totalled £2,797 million, compared with £2,567 million at the end of 2003. This increase reflected the issue of US$250 million (£137 million at transaction rate) Perpetual Subordinated Capital Securities and additional short-term borrowings of £150 million, partially offset by exchange conversion gains of £57 million. Core long-term loans at the end of 2004 included £1,762 million at fixed rates of interest with maturity dates ranging from 2005 to perpetuity. £898 million of the core borrowings were denominated in US dollars, to hedge partially the currency exposure arising from the Group's investment in Jackson National Life (JNL).

Prudential has in place an unlimited global commercial paper programme. At 31 December 2004 commercial paper of £517 million, US$761 million and €445 million had been issued under this programme. Prudential also has in place a £5,000 million medium-term note (MTN) programme. At 31 December 2004 subordinated debt outstandings under this programme were £435 million and €520 million, and senior debt outstandings were US$18 million. In addition the holding company has access to £1,400 million committed revolving credit facilities, provided by 14 major international banks and a £500 million committed securities lending liquidity facility. These facilities have not been drawn on during the year. The commercial paper programme, the MTN programme, the committed revolving credit facilities and the committed securities lending liquidity facility are available for general corporate purposes and to support the liquidity needs of the parent company.

GROUP HOLDING COMPANY CASH FLOW

	2004 £m	2003 £m
Cash remitted by business units:		
UK life fund transfer*	**208**	286
UK other dividends (including special dividend)	**100**	120
JNL	**62**	48
Asia	**67**	48
M&G	**84**	84
Total cash remitted to Group	**521**	586
Net interest paid	**(144)**	(127)
Dividends paid	**(323)**	(447)
Scrip dividends and share options	**119**	30
Cash remittances after interest and dividends	**173**	42
Tax received	**34**	77
Corporate activities	**(31)**	58
Cash flow before investment in businesses	**176**	177
Capital invested in business units:		
UK and Europe	**(189)**	(23)
JNL	**0**	0
Asia	**(158)**	(145)
Other	**0**	(5)
(Decrease) increase in cash before Rights Issue proceeds	**(171)**	4
Rights Issue proceeds	**1,021**	0
Increase in cash	**850**	4

* In respect of prior year bonus declarations.

The Group is funded centrally, except for Egg, which is responsible for its own financing. The Group's core debt is managed to be within a target level consistent with its current debt ratings. At 31 December 2004, the gearing ratio, on an achieved profits basis including hybrid debt (net of cash and short-term investments) was 13 per cent compared with 23 per cent at 31 December 2003.

Prudential plc enjoys strong debt ratings from both Standard & Poor's and Moody's. Prudential long-term senior debt is rated AA– (negative outlook) and A2 (stable outlook) from Standard & Poor's and Moody's respectively, while short-term ratings are A1+ and P-1.

Based on the achieved profits basis operating profit from continuing operations and interest payable on core structural borrowings, interest cover was 8.3 times in 2004 compared with 6.6 times in 2003 (or 7.0 times based on restated achieved profit in 2003).

TREASURY POLICY

The Group operates a central treasury function, which has overall responsibility for managing its capital funding programme as well as its central cash and liquidity positions.

The aim of Prudential's capital funding programme, which includes the £5,000 million medium-term note programme together with the unlimited commercial paper programme, is to maintain a strong and flexible funding capacity.

In the UK and Asia, Prudential uses derivatives to reduce equity risk, interest rate and currency exposures, and to facilitate efficient investment management. In the US, Jackson National Life (JNL) uses derivatives to reduce interest rate risk, to facilitate efficient portfolio management and to match liabilities under equity-indexed policies.

It is Prudential's policy that all free-standing derivatives are used to hedge exposures or facilitate efficient portfolio management. Amounts at risk are covered by cash or by corresponding assets.

Due to the geographical diversity of Prudential's businesses, it is subject to the risk of exchange rate fluctuations. Prudential's international operations in the US, Asia and Europe, which represent a significant proportion of operating profit and shareholders' funds, generally write policies and invest in assets denominated in local currency. Although this practice limits the effect of exchange rate fluctuations on local operating results, it can lead to significant fluctuations in Prudential's consolidated financial statements upon conversion of results into pounds sterling. The currency exposure relating to the conversion of reported earnings is not separately managed, as it is not in the economic interests of the Group to do so. The impact of gains or losses on currency conversions is recorded as a component of shareholders' funds within the consolidated statement of total recognised gains and losses. The impact of exchange rate fluctuations in 2004 is discussed elsewhere in this Financial Review.

FUND FOR FUTURE APPROPRIATIONS

During 2004, the Fund for Future Appropriations, which represents the excess of assets over policyholder liabilities for the Group's with-profits funds on a statutory basis, grew to £16.7 billion from £12.7 billion in 2003. This reflects an increase in the cumulative retained earnings arising on with-profits business that have yet to be allocated to policyholders or shareholders. The change in 2004 predominantly reflects the positive investment return earned by the PAC with-profits fund as a result of investment gains in the UK equity market.

DEVELOPMENTS IN REGULATORY SOLVENCY REQUIREMENTS

The Financial Groups Directive (FGD), which affects groups with significant cross-sector activities in insurance and banking/investment services, came into force for Prudential from 1 January 2005. Prior to this, since 1 January 2001 Prudential was required to meet the solvency requirements of the Insurance Groups Directive (IGD), as implemented by the Financial Services Authority (FSA). The FSA has implemented the FGD by applying the sectoral rules of the largest sector, hence a group such as Prudential is classified as an insurance-led conglomerate and is required to focus on the capital adequacy requirements of the IGD, the Fourth Life Directive and the Insurance Company Accounts Directive.

The FGD requires a continuous parent company solvency test which requires the aggregating of surplus capital held in the regulated subsidiaries, from which group borrowings are deducted, other than those subordinated debt issues which qualify as capital. The test is passed when this aggregate number is positive. A negative result at any point in time is a notifiable breach of UK regulatory requirements. Additionally, the FSA has indicated that it will require public disclosure of the FGD solvency position from 31 December 2005, for which the detailed rules on disclosure have yet to be published. In practice, whether Prudential is classified as a financial conglomerate or insurance group, there is very little difference in application of the rules. This is because the FSA has decided to make the test mandatory from 31 December 2006 to all insurance groups, and requires public disclosure of the group solvency position from 31 December 2005.

Due to the geographically diverse nature of Prudential's operations, the application of these requirements to Prudential are complex. In particular, for many of our Asian operations, the assets, liabilities and capital requirements have to be recalculated based on FSA regulations as if the companies were directly subject to FSA regulation. Our current estimate of our FGD position is that at the end of 2004 we had a surplus of at least £800 million, excluding goodwill but including the surplus regulatory capital of Egg.

The European Union is continuing to develop a new prudential framework for insurance companies, 'the Solvency II project'. The main aim of this framework is to ensure the financial stability of the insurance industry and protect policyholders through establishing solvency requirements better matched to the true risks of the business. Like Basel 2, the new approach is expected to be based on the concept of three pillars – minimum capital requirements, supervisory review of firms' assessments of risk and enhanced disclosure requirements. In particular, companies will be encouraged to improve their risk management processes, including making use of internal economic capital models to enable a better understanding of the business. The emphasis on transparency and comparability would help ensure a level playing field.

Solvency II is being lead by the European Commission's (EC) Internal Market Director-General. The EC have directed the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) to provide input on many technical aspects of the framework. To this end, the EC and CEIOPS have jointly issued Calls for Advice in order to incorporate broader feedback from industry.

The expected outcome of the CEIOPS working groups is a draft directive for the EC. Final agreement on the terms of the new Directive is not expected before 2007 followed by implementation in 2009.

FINANCIAL STRENGTH OF INSURANCE OPERATIONS

United Kingdom

A common measure of financial strength in the United Kingdom for long-term insurance business is the free asset ratio. The free asset ratio is the ratio of assets less liabilities to liabilities, and is expressed as a percentage of liabilities. On a comparable basis with 2003, the free asset (or previous regulatory Form 9) ratio of the Prudential Assurance Company (PAC) long-term fund was approximately 14.8 per cent at the end of 2004, compared with 10.5 per cent at 31 December 2003.

The valuation has been prepared, in our opinion, on a conservative basis in accordance with the current FSA valuation rules, and without the use of implicit items. No allowance has been taken for the present value of future profits and the PAC long-term fund has not entered into any financial reinsurance contracts. Certain reinsurance treaties with a value of approximately £49 million, which were transferred from Scottish Amicable Life when that Company's business transferred into the PAC long-term fund at the end of 2002, were converted into a contingent loan during 2004.

The fund is very strong with an inherited estate measured on an essentially deterministic valuation basis of more than £6.5 billion compared with approximately £6 billion at the end of 2003. On a realistic basis, with liabilities recorded on a market consistent basis, the free assets of the With-Profits Sub-Fund are valued at around £5 billion before a deduction for the risk capital margin. Additional information on the effects of the realistic basis on the PAC long-term fund is shown on pages 103, 104 and 107.

The PAC long-term fund is rated AA+ (stable outlook) by Standard & Poor's and Aa1 (stable outlook) by Moody's.

The table below shows the change in the investment mix of Prudential's main with-profits fund.

For the UK main with-profits fund 86 per cent of fixed income securities are investment grade with 23 per cent rated AA or above. For Prudential Annuities Limited 98 per cent of the fixed income securities are investment grade with 46 per cent rated AA or above. For Prudential Retirement Income Limited 98 per cent of total assets are investment grade with 57 per cent rated AA or above.

With-profits contracts are long-term contracts with relatively low guaranteed amounts, the nature of which permits Prudential to invest primarily in equities and property. However, over the period from 1999 to mid-2001 the fund reduced its exposure to equities. There was also a reweighting within equities out of the UK and into overseas equities. This change in asset mix reflected Prudential's view that equity valuations were high and that other assets, particularly corporate bonds, were relatively attractive. The change within equities improved the fund's diversification and reduced expected fund volatility. The change in asset mix in recent years has had a substantial beneficial impact on investment returns. The broad asset mix will continue to be reviewed as the economic environment and market valuations change.

The investment return on the Prudential main with-profits fund was 13.4 per cent in the year to 31 December 2004 compared with the rise in the FTSE All Share (Total Return) Index of 12.8 per cent over the same period. Over the last 10 years the with-profits fund has consistently generated positive fund returns with three, five and 10 year compound returns of 6.7 per cent per annum, 3.8 per cent per annum and 10.3 per cent per annum respectively. These returns demonstrate the benefits of the fund's strategic asset allocation and long-term outperformance. During 2004 there was no change to the strategic asset allocation of the fund. There has been no significant reduction in the level of the fund's equity holdings during the year or subsequently.

United States

The capital adequacy position of Jackson National Life (JNL) remains strong, with a strong risk-based capital ratio of 4.3 times the National Association of Insurance Commissioners (NAIC) Company Action Level Risk Based Capital. JNL's financial strength is rated AA by Standard & Poor's (negative outlook) and A1 by Moody's.

JNL's invested asset mix on a US regulatory basis (including JNL of New York but excluding policy loans and reverse repo leverage) in the table below.

Asia

Prudential Corporation Asia maintains solvency margins in each of its operations so that these are at or above the local regulatory requirements. Across the region, approximately 30 per cent of non-linked funds are invested in equities.

In the life operations with larger in-force books, both Singapore and Malaysia have discrete life funds. As a result of good investment returns in 2004, the free asset ratios of these funds increased. The Hong Kong life operation is a branch of UK's Prudential Assurance Company Limited and its solvency is covered by that operation. Taiwan has Risk Based Capital regulatory solvency margins and Prudential ensures sufficient capital is retained in the business to cover these requirements.

INVESTMENT MIX OF THE UK MAIN WITH-PROFITS FUND

	1999 %	2003 %	**2004 %**
UK equities	58	33	**33**
International equities	14	15	**15**
Bonds	13	31	**29**
Property	11	17	**18**
Cash and other asset classes	4	4	**5**
Total	100	100	**100**

INVESTMENT MIX OF THE US

	2002 %	2003 %	**2004 %**
Bonds:			
Investment Grade Public	60	58	**60**
Investment Grade Private	20	19	**19**
Non Investment Grade Public	4	5	**4**
Non Investment Grade Private	3	2	**2**
Commercial Mortgages	8	10	**11**
Private equities and real estate	3	4	**3**
Equities, cash and other assets	2	2	**1**
Total	100	100	**100**

REDRESS OF MORTGAGE ENDOWMENT PRODUCTS

Prudential Assurance's main long-term business with-profits fund paid compensation of £16 million in 2004 in respect of mortgage endowment product mis-selling claims and held provisions of £61 million at 31 December 2004 to cover further claims. These provisions have no impact on policyholders' asset shares. As a result, policyholders' bonuses and the shareholders' share of these bonuses are unaffected, resulting in no impact on the Group's profit before tax.

A provision of £7 million was held at 31 December 2004 by shareholders' funds to cover potential compensation in respect of mis-selling claims for Scottish Amicable mortgage endowment products sold since the acquisition of Scottish Amicable in 1997. In addition, a provision of £47 million was held at 31 December 2004 for the closed Scottish Amicable Insurance Fund (SAIF) in respect of mortgage endowment products sold prior to acquisition. This provision has no impact on shareholders. No further Scottish Amicable mortgage endowment products were sold after April 2001.

INHERITED ESTATE

The long-term fund contains the amount that the Company expects to pay out to meet its obligations to existing policyholders and an additional amount used as working capital. The amount payable over time to policyholders from the With-Profits Sub-Fund is equal to the policyholders' accumulated asset shares plus any additional payments that may be required for smoothing or to meet guarantees. The balance of the assets of the With-Profits Sub-Fund is called the 'inherited estate' and represents the major part of the working capital of Prudential's long-term fund which enables the Company to support with-profits business by:

- providing the benefits associated with smoothing and guarantees;
- providing investment flexibility for the fund's assets;
- meeting the regulatory capital requirements, which demonstrate solvency; and
- absorbing the costs of significant events, or fundamental changes in its long-term business without affecting bonus and investment policies.

The size of the inherited estate fluctuates from year to year depending on the investment return and the extent to which it has been required to meet smoothing costs, guarantees and other events.

The Company believes that it would be beneficial if there were greater clarity as to the status of the inherited estate and therefore it has discussed with the Financial Services Authority (FSA) the principles that would apply to any re-attribution of the inherited estate. No conclusions have been reached. Furthermore, the Company expects that the entire inherited estate will need to be retained within the long-term fund for the foreseeable future to provide working capital and so it has not considered any distribution of the inherited estate to policyholders and shareholders.

The costs associated with the mis-selling review of Prudential's with-profits personal pensions have been met from the inherited estate. Accordingly, these costs have not been charged to the asset shares used in the determination of policyholder bonus rates. Hence policyholders' pay out values have been unaffected by personal pension mis-selling.

In 1998, Prudential stated that deducting personal pension mis-selling costs from the inherited estate of the With-Profits Sub-Fund would not impact the Company's bonus or investment policy. The Company gave an assurance that if this unlikely event were to occur, it would make available support to the fund from shareholder resources for as long as the situation continued, to ensure that policyholders were not disadvantaged.

The assurance was designed to protect both existing policyholders at the date it was announced, and policyholders who subsequently purchased policies while the pension mis-selling review was continuing. This review was completed on 30 June 2002 and consequently the assurance has not applied to new business issued since 1 January 2004. New business in this context consists of new policies, new members to existing pension schemes plus regular and single premium top-ups, transfers and switches to existing arrangements. The assurance will continue to apply to any policy in force as at 31 December 2003, both for premiums paid before 1 January 2004 and for subsequent regular premiums (including future fixed, retail price index or salary related increases and Department for Work and Pensions rebates).

The maximum amount of capital support available under the terms of the assurance will reduce over time as claims are paid on the policies covered by it.

The bonus and investment policy for each type of with-profits policy is the same irrespective of whether the assurance applies. Hence removal of the assurance for new business has had no impact on policyholder returns and this is expected to continue for the foreseeable future.

DEFINED BENEFIT PENSION SCHEMES

The Group operates three defined benefit schemes in the UK, of which the principal scheme is the Prudential Staff Pension Scheme (PSPS). The level of surplus or deficit of assets over liabilities for defined benefit schemes is currently measured in three ways, namely the triennial actuarial valuation, SSAP 24 and FRS 17 bases.

Defined benefit schemes are generally required to be subject to full actuarial valuation every three years to assess the appropriate level of funding for schemes having regard to their commitments. These valuations include assessments of the likely rate of return on the assets held within the separate trustee administered funds. PSPS was last actuarially valued as at 5 April 2002 and this valuation demonstrated the Scheme to be 110 per cent funded, with an excess of actuarially determined assets over liabilities of 10 per cent, representing a fund surplus of £376 million. As a result, no change in employers' contributions from the current 12.5 per cent of salaries was required.

The employers' contribution is required to be paid as a minimum in future years, irrespective of assets in the Scheme and, under the current Scheme rules, access to the surplus through refunds from the Scheme is not available. Accordingly, the surplus is not recognised as an asset in the Group's financial statements that would normally, subject to amortisation, be appropriate under the requirements of SSAP 24 which the Group continues to adopt rather than FRS 17. The continued use of SSAP 24 is permitted under the provisions of FRS 17 until 2005, at which point the requirements of International Accounting Standards, in particular IAS 19, will apply.

In the meantime, companies are required to publish details of pension scheme surpluses and deficits on the FRS 17 basis by way of disclosure.

Under FRS 17 the basis of valuation differs markedly from the full triennial valuation and SSAP 24 bases. In particular, it would require assets of the Scheme to be valued at their market value

at the year end, while pension liabilities would be required to be discounted at a rate consistent with the current rate of return on a high-quality corporate bond. As a result, the difference between FRS 17 basis assets and liabilities can be volatile for value movements in assets and a basis of setting inflation assumptions that is referenced to market expectations implied within index-linked bonds. For those schemes such as PSPS, which hold a significant proportion of their assets in equity investments, the volatility can be particularly significant.

If FRS 17 had been fully implemented for 2004, it is estimated that a £10 million shareholder charge (after tax) in the profit and loss account, and a shareholder charge of £6 million (after tax) in the statement of total recognised gains and losses would have been reported.

Surpluses and deficits on the Group's defined benefit schemes are apportioned to the Prudential Assurance Company (PAC) life fund and shareholders' funds depending on an estimation of the activity of the personnel involved. Such apportionment is necessary to properly reflect the economic interests in and exposures to the schemes' financial position. The aforementioned volatility can be illustrated by considering the movements in the surplus and deficit over the last three years. For the PAC life fund the estimated interest, net of tax, in the pension schemes' FRS 17 basis financial position has changed from a surplus at 31 December 2001 of £392 million to a deficit at 31 December 2002 of £380 million, a deficit at 31 December 2003 of £411 million and a deficit at 31 December 2004 of £444 million. For the shareholders' fund the estimated interest, net of tax in the pension schemes' FRS 17 basis financial position, has changed from a surplus at 31 December 2001 of £101 million to a deficit at 31 December 2002 of £85 million, a deficit at 31 December 2003 of £101 million, and a deficit at 31 December 2004 of £109 million. The large reduction in 2002 reflects the steep fall in equity markets in that year. The modest changes in 2003 and 2004 reflect the negative impact of increased inflation assumptions, that are implicit within the yields on index-linked gilts, being offset by the positive value movements in scheme assets arising from the strong recovery in equity markets.

RISK MANAGEMENT

A significant part of the Group's business involves the acceptance and management of risk. The Group's risk management model requires the primary responsibility for risk management at an operational level to rest with business unit chief executives. The second line of defence of risk comprises oversight functions reporting to the Group Chief Executive together with business unit risk functions and risk management committees. The third line of defence comprises independent assurance from Internal Audit reporting to business unit and Group audit committees.

The Group operates a comprehensive planning process. The Board receives regular reports on the performance of the Group against plan with frequent financial projections.

All the insurance operations of the Group prepare a financial condition report which is reported on to the Board, who receive regular reports from the Group Finance Director on the financial position of the Group.

The Group's risk management procedures are further described in the Corporate Governance Report. Further discussion on key risk factors of the Group is included on pages 110 to 112.

PRODUCTS AND DRIVERS OF INSURANCE OPERATIONS' PROFIT

United Kingdom and Europe

In common with other UK long-term insurance companies, Prudential's products are structured as either with-profits (or participating) products, or non-participating products including annuities in payment and unit-linked products. Depending upon the structure, the level of shareholders' interest in the value of policies and the related profit or loss varies.

With-profits policies are supported by a with-profits fund and can be single premium (for example, Prudence Bond) or regular premium (for example, certain corporate pension products). Prudential's primary with-profits fund is part of Prudential Assurance Company's (PAC) long-term fund. The return to shareholders on virtually all with-profits products is in the form of a statutory transfer to PAC shareholders' funds which is analogous to a dividend from PAC's long-term fund and is dependent upon the bonuses credited or declared on policies in that year. Prudential's with-profits policyholders currently receive 90 per cent of the distribution from the main with-profits fund as bonus additions to their policies and shareholders receive 10 per cent as a statutory transfer.

The profits from almost all Prudential's new non-participating business written since 1 July 2004 accrue solely to shareholders. Such business is written in the non-profit sub-fund within PAC's long-term fund, or in various shareholder-owned direct or indirect subsidiaries, the most significant of which is Prudential Retirement Income Limited (PRIL). There is a substantial volume of in-force non-participating business in PAC's with-profits fund and that fund's wholly-owned subsidiary Prudential Annuities Limited (PAL); profits from this business accrue to the with-profits fund. The vast majority of external non-profit annuity business is now written in PRIL and, with effect from 1 July 2004, immediate annuities arising from vesting deferred annuity policies were reinsured to PRIL.

United States

Jackson National Life's (JNL) principal retail savings products are sold as single premium fixed, variable or equity-linked indexed deferred annuities.

Interest-sensitive fixed annuities are products which allow for tax-deferred accumulation of funds, with flexible payout options. They are used for retirement planning and for providing income in retirement. The policyholder pays JNL a single premium, which is credited to the policyholder's account. Periodically, interest is credited to the policyholder's account and administrative charges are deducted, as appropriate. JNL may reset the interest rate on each policy anniversary, subject to a guaranteed minimum, in line with state regulations. When the annuity matures, JNL either pays the policyholder the amount in the policyholder account or begins making payments to the policyholder in the form of an immediate annuity product. This latter product is similar to a UK annuity in payment. Fixed annuity policies provide for early surrender charges for the first seven to nine years of the policy. In addition, the policy may be subject to a market value adjustment at the time of early surrender. JNL's profit on fixed annuities arise primarily from the spread between the return it earns on investments and the interest credited to the policyholder's account (net of any surrender charges or market value adjustment) less management expenses.

Equity-linked indexed annuities are deferred annuities that enable policyholders to obtain a portion of an equity-linked return but provide a guaranteed minimum return. JNL guarantees an annual

minimum interest rate of three per cent, but actual earnings may be higher and are based on a participation in an equity index over its indexed option period. JNL's profit arises from the difference between a) the premiums received plus the associated investment income and b) the combined cost of expenses (general expenses, costs of purchasing fixed interest securities and options) and the policyholder's account value (which is subject to the minimum guarantee).

Variable annuities are tax advantaged deferred annuities where the rate of return depends upon the performance of the underlying portfolio, similar in principle to UK unit-linked products. They are used for retirement planning and to provide income in retirement. The policyholder's premiums are held apart from other assets, in a separate account, which is analogous to a unit-linked fund. The policyholder can allocate the premiums between a variety of variable sub-accounts with a choice of fund managers and/or to guaranteed fixed-rate options. The value of the portion of the separate account allocated to variable sub-accounts fluctuates with the underlying investment. Variable annuity policies provide for early surrender charges.

JNL offers a choice of guarantee benefit options within its variable annuity product range which customers can elect and pay for. These include the guaranteed minimum death benefit, which guarantees on death the policyholder receives a minimum value regardless of past market performance. These guaranteed death benefits might be expressed as the return of original premium, the highest past anniversary value of the policy, or as the original premium accumulated at a fixed rate of interest. In addition there are two other types of guarantee, guaranteed minimum withdrawal benefits (GMWB) and guaranteed minimum income benefits (GMIB). GMWB provides a guaranteed return of the principal invested by allowing for periodic withdrawals which are limited to a maximum percentage of the initial premium. GMIB provides for a minimum level of benefits upon annuitisation regardless of the value of the investments under the contract at the time of annuitisation. This is fully reinsured.

JNL earns fee income on the underlying investment, earns profits from the spread between what it earns on investments in fixed rate accounts and the interest credited, and fee income for certain additional performance guarantees in the contract.

Asia

The life insurance products offered by Prudential Corporation Asia include a range of with-profits (participating) and non-participating term, whole life and endowment and unit-linked policies. Prudential also offers health, disablement, critical illness and accident cover to supplement its core life products.

Prudential's business in Asia is focused on regular premium products that provide both savings and protection benefits. In 2004, the new business achieved profit mix was 47 per cent unit-linked, 26 per cent non-linked and 27 per cent Accident and Health (A&H) products.

Unit-linked products combine savings with protection and the cash value of the policy depends on the value of the underlying unitised funds. Participating products provide savings with protection where the basic sum assured can be enhanced by a profit share (or bonus) from the underlying fund as determined at the discretion of the insurer. Non-participating products offer savings with protection where the benefits are guaranteed or determined by a set of defined market related parameters. A&H products provide mortality or morbidity benefits and include health, disablement, critical illness and accident covers. A&H products are commonly offered as supplements to main life policies but can also be sold separately.

The profits from participating policies are shared between the policyholder and insurer (typically in a 90:10 ratio) in the same way as with-profits business in the UK. Under unit-linked products the profits that arise from managing the policy, its investments and the insurance risk accrue entirely to shareholders, with investment gains accruing to the policyholder within the underlying unitised fund. The profits from non-participating products consist of any surplus remaining after paying the defined policy benefits. All the profits from A&H products accrue to shareholders.

Unit-linked products tend to have higher profits on the achieved profits basis of reporting than traditional non-linked products as expenses and charges are better matched and solvency capital requirements are lower. At the end of 2004 Prudential Corporation Asia offered unit-linked products in 10 of the 12 countries in Asia in which it operates.

In addition to the life products described above, Prudential offers mutual fund investment products in India, Taiwan, Japan, Singapore, Malaysia, Hong Kong and Korea, allowing customers to participate in debt, equity and money market investments. The Company earns a fee based on assets under management.

ACCOUNTING POLICIES AND DEVELOPMENT

UK GAAP

There have been no changes in accounting policies for the preparation of the 2004 UK GAAP results with the exception of UITF Abstract 38 'Accounting for ESOP Trusts'. Under UITF Abstract 38 the cost of acquiring shares held in trusts for employee incentive plans is required to be presented as a deduction from shareholders' funds. The effect of the change in policy is to reduce shareholders' funds at 1 January 2004 from the previously published 31 December 2003 level by £38 million. The impact on the profit and loss account is immaterial.

The Accounting Standards Board (ASB) published FRS 27 'Life Assurance' in December 2004. The implementation of FRS 27 is governed by a Memorandum of Understanding (MoU) agreed between the UK's leading life assurance companies, the Association of British Insurers and the ASB. Under the terms of the MoU, certain unaudited narrative and numerical disclosures are required to be published in the companies' annual reports.

As the amount of information required to be published is considerable, it is reported in a separate section of the Financial Review on pages 100 to 109.

International Financial Reporting Standards

Background

The European Union (EU) requires that all listed European groups prepare their 2005 financial statements in accordance with EU approved International Financial Reporting Standards (IFRS). The IFRS basis of reporting will replace the current modified statutory basis (MSB) of reporting. In common with other major groups, Prudential has a well-developed programme to implement the necessary changes.

The Group will report interim 2005 IFRS basis results in July 2005. Aside from the fact that JNL's hedging strategy is brought more into focus than under UK GAAP (see below), the IFRS changes of themselves are not material to an understanding of the Group's financial position. However, we recognise that the market will need time to become familiar with the changes and their impact on the presentation of the financial statements, so it is our intention to publish comparative IFRS basis results on 2 June 2005.

IASB and EU developments on technical requirements
The International Accounting Standards Board (IASB) has now, with some exceptions, completed its deliberations, and fully issued all of the standards to constitute the stable platform for 2005 reporting. New standards issued from 1 April 2001 are called IFRSs whilst those issued prior to this date (including those amended subsequently under the IASB's improvement project) are referred to as International Accounting Standards (IASs).

Substantially all of these standards have been subjected to a process of review under EU auspices, recommended for approval by the EU's Accounting Regulatory Committee (ARC), and then formally approved.

The IASB is continuing to consider the restrictions that should apply under IAS 39 (on financial instruments) to companies' ability to record the fair value movements on assets and liabilities to the profit and loss account. The IASB's continued consideration of these issues reflects concern expressed by some European institutions at the current version of the standard.

Application of IFRS to Prudential
The description that follows of the expected impact on the results of the Prudential Group reflects the version of IAS 39 in place at the date of signing of the annual report and the expected version of IAS 19 on employee benefits, which incorporates pension costs. In addition, due to the recent changes made by the IASB, the latest version of IAS 19 which permits actuarial gains and losses to be accounted for directly within equity, has yet to be approved by the ARC. In the event that the IASB subsequently makes further changes to these or other accounting standards, or the ARC does not approve them, the descriptions below of the expected effect on the results may require revision.

Expected impact of application of IFRS basis reporting
Insurance operations
Insurance contract accounting:
Under IFRS 4 'Insurance Contracts' for those contracts with significant insurance risk and those with discretionary participating features (such as conventional and unitised with-profits contracts), UK GAAP will continue to apply until the IASB introduces a comprehensive (Phase 2) standard for insurance contracts. Under IFRS 4, we estimate that about 85 per cent of the Group's insurance contracts are classified in this category.

It should be noted however that, by the UK insurance industry's adoption of the requirements of FRS 27, UK GAAP for with-profits contracts of UK life funds will also alter to reflect the FSA realistic reporting regime. The change essentially alters the basis of providing for future bonuses on, and valuing guarantee features of, with-profits contracts. In turn this affects the residual amount that has yet to be allocated between policyholders and shareholders (the Fund for Future Appropriations). The estimated impact on the 2004 year end position is shown on pages 103 and 104. Profit recognition for this business on the UK GAAP and IFRS bases will though continue to reflect the Company's 10 per cent interest in the actuarially determined surplus for distribution.

Contracts where UK GAAP will no longer apply for 2005 IFRS basis reporting are those contracts which do not contain significant insurance risk. The only area where Prudential's contracts are potentially affected by the measurement changes required under IFRS to any degree of significance is those unit-linked contracts in the UK that will be required to be valued as investment contracts under IAS 39. Given the weighting within the UKIO book of in-force contracts and 2004 product sales mix the impact of the IFRS changes for 2004 in this area is though likely to be modest.

It should be emphasised that the IFRS changes to profit recognition for these contracts are merely of timing. Cash flow in any particular period from these contracts, as they mature and regulatory basis surpluses emerge, will of course be unaffected, as is the aggregate profit for the contracts over their life.

For UK unit-linked contracts to be accounted for under IAS 39 the main effects will be for the elimination of certain actuarial liabilities, restriction on the deferral of acquisition costs to incremental costs, principally external commission, and the amortisation profile of deferred acquisition costs and front end fees.

The impact of the changes on the result in any given period depends upon the level of deferred acquisition costs under previous (UK GAAP) and revised (IFRS) basis. In general under IFRS, one would expect that with a growing book of unit-linked business, emergence of profit will be delayed.

Guaranteed Investment Contracts (GICs) of Jackson National Life, and a very small number of contracts in the Group's Asian operations are also subject to potential measurement change under IAS 39. The current measurement approach for GICs is though almost the same as the amortised cost approach being applied under IFRS. The potential changes to the Asian contracts are immaterial in their financial effect.

On presentational effects, under IAS 39, premiums and claims on these UK unit-linked contracts, GICs and minor Asian contracts will be recorded as movements on contract liabilities in the balance sheet. Although profit does not alter for this change, the presentation in the Group's income statement is affected so that premium income and the charge for claims and surrenders are reduced. In this regard the change is similar conceptually to that required under deposit accounting as applied under US GAAP.

It should be noted, for the avoidance of confusion, that IFRS 4 rules are very different from those under US GAAP as to the category of policies that are classified as 'investment contracts'. Most of the Group's contracts that would be classified as investment contracts under US GAAP, will continue to be accounted for under IFRS as either insurance contracts, or investment contracts with discretionary participating features with the facility to continue to account under IFRS on UK GAAP (the MSB method of reporting).

Unallocated surplus:
Notwithstanding the fact that the IFRS basis of reporting in 2005 will incorporate the FSA's realistic basis of provisioning for UK with-profits funds, IFRS 4 permits unallocated surplus, that is the IFRS equivalent of the Fund for Future Appropriations, to continue to be accounted for as a liability in the balance sheet. It is the Group's intention to continue to account for unallocated surplus on this basis.

Investment valuation and derivative accounting:
Under IAS 39, except for loans and receivables, and unless designated under the very restrictive held to maturity classification on an asset by asset basis, most financial assets, including derivatives, are carried in the balance sheet at fair value. To this extent IAS 39 is in many areas similar to the requirements of the US GAAP standards FAS 115 and FAS 133 and at a practical level, is consistent with the basis of valuation applied under UK GAAP for the vast majority of financial assets of the Group's UK and Asian operations.

On application of IAS 39, movements in the fair value of investments are recorded in either the profit and loss account or directly to shareholder reserves in the balance sheet, depending upon the designation and the impact of hedge accounting rules. Derivative instruments are generally also carried at fair value with

movements in value being recorded in the profit and loss account. Hedge accounting, whereby value movements on derivatives and hedged items are recorded together in the performance statements, is permissible only if certain hedge effectiveness criteria are met.

The changes from UK GAAP treatment arising from these requirements is expected to be concentrated on the accounting for the investments and derivatives of Jackson National Life (JNL). Currently, under UK GAAP the fixed income securities of JNL are, unless impaired, accounted for at amortised cost with derivatives similarly treated. In applying IFRS the Group has decided to account for JNL's fixed income securities on an 'available for sale' (AFS) basis whereby the fixed income securities are accounted for at fair value with movements in that fair value being recorded in shareholders reserves rather than the income statement. In this respect the treatment is as applied by many US insurers under US GAAP. Value movements for JNL's derivatives will however be booked in the income statement as required by IAS 39.

For derivative instruments of JNL, we have carefully considered at length whether it is appropriate to undertake the necessary operational changes to enable hedge accounting so as to achieve matching of value movements in hedging instruments and hedged items in the performance statements. In reaching our decisions a number of factors were particularly relevant. These are:

- IAS 39 hedging criteria has been designed primarily in the context of hedging and hedged instruments that are assessable as financial instruments that are either stand-alone or separable from host contracts, rather than, for example, duration characteristics of insurance contracts;
- the high hurdle levels under IAS 39 of ensuring hedge effectiveness at the level of individual hedge transactions for specific transactions;
- the difficulties in applying the macro hedge provisions under IAS 39 (which are more suited to banking arrangements) to JNL's derivative book;
- the complexity of asset and liability matching of US life insurers such as those with JNL's product range; and finally
- whether it is possible or desirable, without an unacceptable level of costs and restraint on commercial activity, to achieve the accounting hedge effectiveness required under IAS 39.

In this regard, the issues surrounding IAS 39 application are very similar to those considered by other US life insurers when FAS 133 was first applied for US GAAP reporting. Taking account of these considerations, we have decided that, except for certain minor categories of derivatives, it is not sensible to seek to achieve hedge accounting under IAS 39 by completely reconfiguring the structure of JNL's derivative book. As a result of this decision the total profit and loss account results will be more volatile as the movements in value of JNL's derivatives will be reflected within it. This is despite the fact that JNL's derivative activity achieves a high level of economic hedge effectiveness. It is recognised that as an accompaniment to future IFRS basis results announcements the Group will need to demonstrate this economic hedge effectiveness.

We intend under IFRS to continue to analyse the total pre shareholder tax results between an operating profit based on longer-term investment returns, short-term fluctuations in investment returns, and exceptional items. Movements in the value of JNL's derivative book will be included within short-term fluctuations in investment returns.

Banking operations

The introduction of IFRS will not significantly affect Egg's underlying business or the cash flows. However, it does represent a significant change to its accounting and reporting. Wholesale assets will be classified as AFS and held at fair value with unrealised gains and losses reflected in equity rather than the income statement. Liabilities will be measured at amortised cost with no effect compared to UK GAAP except where set-up fees had been previously expensed but will under IFRS, be capitalised and amortised.

Derivatives will be the only products for which changes in fair value will affect the result for the year. However, for interest rate swaps that economically hedge fixed rate personal loans, by matching them against the variable rate savings book, Egg will apply macro cash flow hedge accounting under IAS 39. Changes in the fair value of these hedges will be recorded direct to equity in the balance sheet and not the income statement (except where hedging is ineffective).

The impact of other IFRS changes to the accounting for retail products such as adjustments for effective interest rate calculations, dormant accounts, and bad debts is dependent on a range of factors but, based on current indications, is expected to be relatively neutral overall.

Other IFRS changes

Two other areas will involve significant change on the adoption of IFRS, namely goodwill and pension cost accounting. For goodwill, subject to regular impairment testing, amortisation charges will no longer be necessary. For pension cost accounting, the latest version of IAS 19 is similar to the requirements of FRS 17. Details of the FRS 17 effect are shown in note 17 to the financial statements.

Reported shareholders' funds will also be affected by the requirement under IFRS not to accrue dividend declarations made after the reporting period date.

There are many other changes arising from IFRS adoption but these are not expected to be material to an understanding of the Group's financial position. The main other changes that affect the Group's income statement and balance sheet are in respect of:

- stock based compensation. However, it should be noted that, in relative terms to some companies, the size of share based emoluments for Prudential is low;
- property, which is mostly held by the PAC with-profits fund;
- consolidation of investment funds and venture fund investments of the PAC with-profits fund. IFRS has different criteria for when consolidation is required;
- grossing up adjustments for carrying values of derivative assets and liabilities; and
- deferred tax effects of these and the other IFRS adjustments described above.

The main impact of the property, consolidation and grossing up changes is almost wholly confined to altering the line by line consolidation rather than shareholder results. The line items affected include carrying values of certain properties and related finance lease obligations, category of investment classification for newly consolidated investment funds, and goodwill and non-recourse borrowings on the face of the balance sheet for newly consolidated venture fund investments.

Transition arrangements on first time adoption of IFRS

Timetable

Under UK Listing Authority requirements, the Group will be obliged to publish IFRS basis results for the first time for interim 2005 reporting. The Group intends publishing comparative IFRS basis results for 2004 on 2 June 2005.

Adoption date

We expect that the first time adoption date for conversion to IFRS will be 1 January 2004. However, as the Group is also listed in the US, we also have to comply with the requirements of the Securities Exchange Commission (SEC). These requirements have yet to be finalised but we anticipate that the SEC will confirm that comparative results will be required for only one rather than the usual two years. Should this not be the case, the adoption date will be 1 January 2003. The main practical effect of this uncertainty on IFRS financial statements is as to the start point for the discontinuance of amortisation of goodwill.

Basis of adoption of IAS 32, IAS 39 and IFRS 4

It is the Group's intention to formally adopt IAS 32 (on disclosures on financial instruments), IAS 39 and IFRS 4, as permitted under IFRS, prospectively from 1 January 2005. The results for the half year 2005 will include a cumulative transitional adjustment for the impact on shareholders' funds for the adoption of these standards. The most significant element of the adjustment will be for the mark to market value of JNL's fixed income securities and derivative book.

The comparative basis results to be published in June 2005 will be accompanied by pro forma basis information on a basis that incorporates the effects of IAS 39 and IFRS 4 on the results of the Group's insurance operations. This is so as to act as a guide to the market of the scale of the changes to the 2004 results consistent with the accounting policies to be applied for 2005.

However, in common with many other banks, 2004 results on an IAS 39 measurement basis will not be provided for Egg. This is because the lack of availability of hedge accounting for 2004 under IAS 39 makes results on this basis unrepresentative of the basis going forward, where as described above, macro hedge accounting will be applied.

The use of a pro forma-based approach to comparative results reflects the mixed nature of the Group's activities and the approach taken to hedging for the different operations.

Achieved Profits Basis Reporting

Prudential's results are prepared on two bases of accounting, the supplementary achieved profits basis and the modified statutory basis (MSB) prepared under the Companies Act. Over the life of any given product, the total profit recognised will be the same under either the MSB or the achieved profits basis. However, the two methods recognise the emergence of that profit differently, with profit emerging earlier under the achieved profits basis than under MSB. This section explains how the two bases operate and why they are used.

Prudential's primary financial statements are prepared in accordance with the MSB of reporting of long-term business, in full compliance with the revised Statement of Recommended Practice issued by the Association of British Insurers (ABI) in November 2003. In broad terms, MSB profit for long-term business reflects the aggregate of statutory transfers from with-profits funds and profit on a traditional deferral and matching approach for other long-term business.

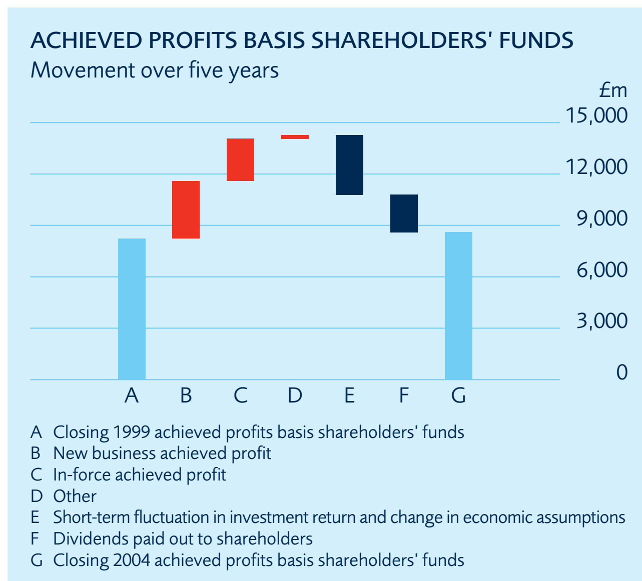
However, the products sold by the life insurance industry are by their nature long term, as it commits to service the products for many years into the future. In many cases policies require customers to continue to pay further premiums in the future. The profit on these insurance sales is generated over a significant number of years and MSB profit does not, in Prudential's opinion, properly reflect the inherent value of these future profit streams.

Therefore, since 1997 Prudential and other major UK-quoted financial groups have adopted the achieved profits basis as a supplementary accounting measure in order to give a better reflection of the value attaching to long-term insurance business. Achieved profits basis financial statements are prepared under guidance issued by the ABI in December 2001.

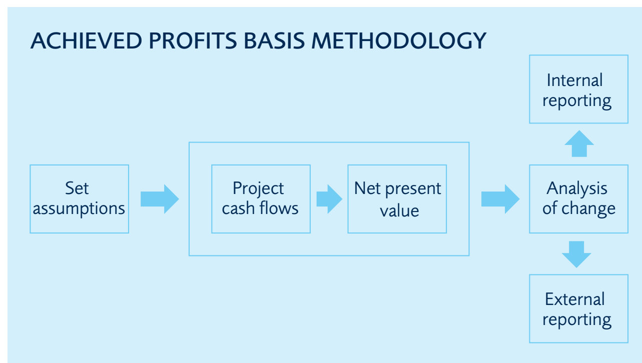
The achieved profits method not only provides a good indicator of the value being added by today's management in a given accounting period but it also demonstrates whether shareholder capital is being deployed to best effect. Indeed insurance companies in many countries use comparable bases of accounting for management purposes. Prudential believes that the achieved profits basis provides useful information for shareholders. In contrast, for many types of contract, the MSB result does not reflect the long-term benefit that will arise in the future from current management initiatives and capital expenditure in the year under review, as it focuses instead on the amounts accruing to shareholders in the current year only from business already in force.

The achieved profits basis is a value based method of reporting in that it reflects the change in value of the business over the accounting period. This value is called the shareholders' funds on an achieved profits basis which, at a given point in time, is the value of future cash flows expected to arise from the current book of long-term insurance business plus the net worth of the Company. In determining these expected cash earnings, Prudential makes full allowance for the risks attached to their emergence and associated cost of capital and takes into account recent experience in assessing likely future persistency, mortality and expenses. Economic assumptions as to future investment returns and inflation are based on market data.

The change in value is typically analysed as shown in the achieved profits basis shareholders' funds chart into the following components: the value added from new business sold during the year; the change in value from existing business already in place at the start of the year; short-term fluctuations in investment returns and economic assumption changes; other items (for example, profit from other Group operations, tax, foreign exchange, exceptional items); and dividends.



The value added from new business (being the present value of the future cash flows arising from new business written in the year) is a key metric used in the management of the business. The change in value of business in force at the start of the year demonstrates how the existing book is being managed. Together they provide management and shareholders with valuable information about the underlying development of the business and the success or otherwise of management actions.



As indicated above, achieved profits basis results are prepared by first of all making assumptions about all relevant factors including levels of future investment return, expenses, surrender levels and mortality. These best estimate assumptions are used to project future cash flows. The present value of the future cash flows is then calculated using a discount rate which reflects both the time value of money and the risks associated with the cash flows. The risk discount rate is determined using the actual yield on long-term government bonds plus a risk margin. The projected future cash flows are prepared on a single set of assumptions specific to each business unit and the actual outcome may be different from that projected. Where the actual outcome is different, this will be reflected in the experience variances for that year.

The total profit that emerges over the lifetime of an individual contract as calculated using the achieved profits basis is the same as that calculated under the modified statutory basis. However, since the achieved profits basis reflects discounted future cash flows under this methodology the profit emergence is advanced, thus more closely aligning the timing of the recognition of benefits with the efforts and risks of current management actions, particularly with regard to business sold during the year.

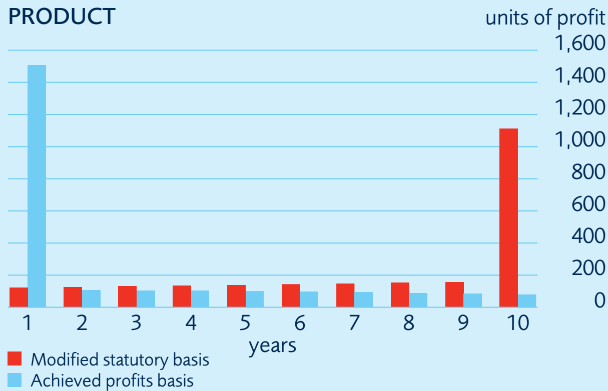
The assumptions used for the achieved profits basis of accounting are set out on page 116 in the notes that accompany the supplementary achieved profits basis accounts. An indication of the sensitivity of the results to changes in the key assumptions of interest rate and investment return is provided on page 124.

The achieved profits basis can be illustrated by considering a theoretical individual contract. Using assumptions for the drivers of future income and expenditure (including levels of future investment return, expenses, surrender levels and mortality) a profile of future cash flows can be estimated. These cash flows are then discounted back to the point of sale to give a new business profit.

The achieved profits basis profit emerging in each subsequent accounting period will comprise the unwinding of the discount (which arises from discounting future cash flows for one fewer period) and the profit or loss arising from any difference between the actual cash flow and the cash flow which had been assumed in the accounting period under review, together with the effect of any changes of assumption where the directors believe a revision is required to the original estimates of future experience.

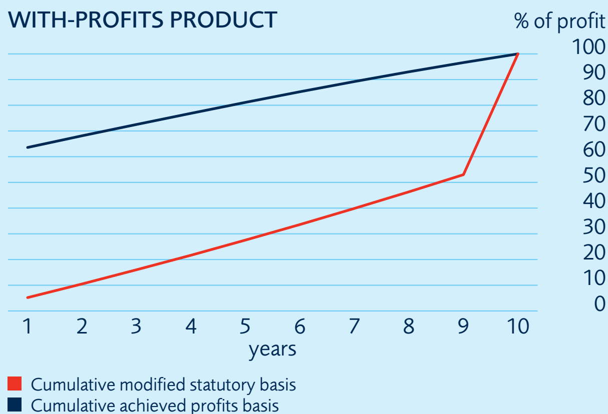
Set out on the following page is an illustrative profit profile for a typical with-profits product. The pattern of actual profit emergence will vary by product.

ILLUSTRATION
MODIFIED STATUTORY BASIS AND ACHIEVED PROFITS BASIS PROFIT PROFILES FOR A TYPICAL WITH-PROFITS PRODUCT



The different timing of profit recognition under the two bases is demonstrated in the next chart, which shows the cumulative level of profit recognition for the yearly profit shown in the previous chart. It illustrates that under the achieved profits basis profit emerges earlier, but the eventual total profit is the same under both bases.

ILLUSTRATION
MODIFIED STATUTORY BASIS AND ACHIEVED PROFITS BASIS CUMULATIVE PROFIT PROFILES FOR A TYPICAL WITH-PROFITS PRODUCT



European Embedded Value Reporting

In May 2004 the CFO Forum, representing the Chief Financial Officers of 19 European insurers, published the European Embedded Value (EEV) Principles which are designed to improve the transparency and consistency of embedded value reporting. Member companies, of which Prudential is one, agreed to adopt the Principles for supplementary reporting no later than the financial year end commencing 1 January 2005. Prudential will fully adopt the Principles for the first time in respect of full year 2005 results.

For Prudential, EEV reporting represents an evolution from the current achieved profits basis used for supplementary reporting and we welcome the improved clarity and consistency of information that it will provide to investors. We reiterate our view that embedded value information provides investors with a more realistic reflection of the current performance of life insurance business. In summary, the principal changes from current achieved profits reporting are in respect of three areas:

- inclusion of an explicit allowance for the impact of options and guarantees. This will typically require stochastic calculations, under which a large number of simulations are performed that provide a representation of the future behaviour of financial markets;
- more active allowance for the combined impact of risk profile, encumbered capital and explicit valuation of options and guarantees in the selection of discount rates. This will ensure that the risks to the emergence of shareholder cash flows are properly accounted for; and
- enhanced disclosure that will enable informed investors to more fully understand the key risks within the business together with management's approach to them, and the basis of preparation of results.

In other respects we expect the EEV basis of reporting to be similar to the achieved profits basis.

Philip Broadley
GROUP FINANCE DIRECTOR