Notes on the Group financial statements

A: Background and adoption of International Financial Reporting Standards (IFRS)

A1: Nature of operations

Prudential plc (the Company) together with its subsidiaries (collectively, the Group or Prudential) is an international financial services group with its principal operations in the UK, the US and Asia. The Group operates in the UK through its subsidiaries, primarily The Prudential Assurance Company Limited (PAC), Prudential Annuities Limited (PAL), Prudential Retirement Income Limited (PRIL), M&G Group Limited and Egg plc. In the US, the Group's principal subsidiary is Jackson National Life Insurance Company (JNL). The Group also has operations in Hong Kong, Malaysia, Singapore, Taiwan and other Asian countries. Prudential offers a wide range of retail financial products and services and fund management services throughout these territories. The retail financial products and services principally include life insurance, pensions and annuities as well as collective investments and deposit and mortgage banking services.

Long-term business products written in the UK and Asia are principally with-profits deposit administration, other conventional and unitised with-profits policies and non-participating pension annuities in the course of payment. Long-term business also includes linked business written in the UK and Asia. The principal products written by JNL are interest-sensitive deferred annuities and whole-life policies, variable annuities, guaranteed investment contracts, fixed index deferred annuities and term life insurance.

Prudential plc is a public limited company incorporated and registered in England and Wales. The registered office is:
Laurence Pountney Hill
London
EC4R 0HH
Registered number: 1397169

A2: Basis of preparation

The consolidated financial statements consolidate the Group and the Group's interest in associates and jointly controlled entities. The parent company financial statements present information about the Company as a separate entity and not about the Group.

The consolidated financial statements have been prepared and approved by the directors in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU). The Company has elected to prepare its parent company financial statements in accordance with UK Generally Accepted Accounting Principles (GAAP). These are presented on pages 186 to 195.

The Group has applied all IFRS and interpretations adopted by the EU at 31 December 2005, and has early adopted the amendment to IAS 39, 'The Fair Value Option' and IAS 19, 'Employee Benefits' (as amended in 2004).

The accounting policies set out below have, unless otherwise stated, been applied consistently to all periods presented in these Group financial statements and in preparing an opening IFRS balance sheet at 1 January 2004 for the purposes of the transition to IFRS. The principal exception is that, as more fully explained below, financial instruments and insurance accounting is determined on different bases in 2005 and 2004 due to the basis of application of the transitional provisions of IFRS 1, 'First-time Adoption of International Financial Reporting Standards' in relation to the standards IAS 32, IAS 39 and IFRS 4.

A3: Critical accounting policies, estimates and judgements

(a) Critical accounting policies

Adoption of IAS 32, IAS 39 and IFRS 4

Three standards, IAS 32, 'Financial Instruments: Disclosure and Presentation', IAS 39, 'Financial Instruments: Recognition and Measurement' and IFRS 4, 'Insurance Contracts', have been adopted as at 1 January 2005 rather than 1 January 2004. This treatment is consistent with the policy typically applied by groups with banking operations where the practical consequences of adopting these standards for 2004 are significant.

Accordingly, the amounts recorded for revenue and expenses and assets and liabilities of certain items reflected in the Group's financial statements are not on a consistent basis in 2005 compared to amounts recorded for the comparative period. The main area where this inconsistency applies is valuation and accounting presentation of fair value movements of derivatives and debt securities of JNL (as described below). In addition, the measurement of assets and liabilities and income and expenses of those UK unit-linked contracts, and those with similar features, that do not contain significant insurance risk, is altered.

The Group has chosen to report separately pro forma results, as supplementary information that does not form part of the Group financial statements, that show the 2004 results attributable to shareholders as if the Group had applied these standards to its insurance operations from 1 January 2004. The pro forma results are shown on pages 198 to 200.

Insurance contract accounting

With the exception of contracts described in note D1, the Group's life assurance contracts are classified as insurance contracts and investment contracts with discretionary participating features. As permitted by IFRS 4, assets and liabilities of these contracts (see below) are accounted for under previously applied GAAP. Accordingly, except as described below, the modified statutory basis (MSB) of reporting as set out in the revised Statement of Recommended Practice (SORP) issued by the Association of British Insurers (ABI) in November 2003 has been applied for the 2005 results.

In the UK, for the 2004 comparative results, with the exception of minor accounting adjustments, the technical provisions reflect the UK regulatory basis of reporting that has applied previously for many years. This effectively constitutes the Peak 1 basis under the current Financial Services Authority (FSA) regime.

A3: Critical accounting policies, estimates and judgements continued

From 1 January 2005 the Group has chosen to improve its accounting for UK regulated with-profits funds by the voluntary application of the UK accounting standard FRS 27, 'Life Assurance'. Under this standard, the main accounting changes that are required for UK with-profits funds are:

- Derecognition of deferred acquisition costs and related deferred tax; and
- replacement of MSB liabilities with adjusted realistic basis liabilities.

The primary effect of these changes is to fundamentally alter the basis of accounting and carrying value of deferred acquisition costs (as set out in note H2) and the reported level of unallocated surplus of with-profits funds (as set out in note H12).

Under UK GAAP, the fund for future appropriations (FFA) represents the excess of assets over policyholder liabilities for the Group's with-profit funds. Under IFRS the FFA is termed unallocated surplus and the Group has opted to account for it wholly as a liability with no allocation to equity. This treatment reflects the fact that shareholders' participation in the cost of bonuses arises only on distribution. As a consequence of this accounting treatment, shareholder profits on with-profits business continue to reflect the one-ninth cost of declared bonus previously applied under UK GAAP.

For JNL, applying the MSB as applicable to overseas operations, the assets and liabilities of insurance contracts are accounted for under insurance accounting prescribed by US GAAP. For Asian operations the local GAAP is applied with adjustments, where necessary, to comply with UK GAAP. For Asian operations in countries where local GAAP is not well established and in which the business written is primarily non-participating business, US GAAP is used as the most appropriate proxy to local GAAP.

The usage of these bases of accounting has varying effects on the way in which product options and guarantees are measured. For UK regulated with-profits funds, for the 2005 results, options and guarantees are valued on a market consistent basis. The basis is described in note D2(d)(ii). For other operations a market consistent basis is not applied under the accounting basis described in note A4. Details of the guarantees, basis of setting assumptions, and sensitivity to altered assumptions are described in notes D3 and D4.

Valuation and accounting presentation of fair value movements of derivatives and debt securities of JNL

Under IAS 39, derivatives are required to be carried at fair value. Unless hedge accounting is applied, value movements on derivatives are recognised in the income statement.

For derivative instruments of JNL, the Group has considered at length whether it is appropriate to undertake the necessary operational changes to qualify for hedge accounting so as to achieve matching of value movements in hedging instruments and hedged items in the performance statements. In reaching the decision a number of factors were particularly relevant. These were:

- IAS 39 hedging criteria has been designed primarily in the context of hedging and hedging 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 the IAS 39 application are very similar to those considered by other US life insurers when the US financial reporting standard FAS 133 was first applied for US GAAP reporting. Taking account of these considerations the Group has decided that, except for certain minor categories of derivatives, it is not appropriate 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 income statement results are more volatile as the movements in the value of JNL's derivatives are reflected within it.

Under IAS 39, unless carried at amortised cost (subject to impairment provisions where appropriate) under the held-to-maturity category, debt securities are also carried at fair value. The Group has chosen not to classify any financial assets as held-to-maturity. Debt securities of JNL are designated as available-for-sale with value movements being recorded as movements within shareholders' equity.

Presentation of results before tax

The total tax charge for the Group reflects tax that in addition to relating to shareholders' profits is also attributable to policyholders and unallocated surplus of with-profits funds and unit-linked policies. This is explained in more detail in note F5. However, pre-tax profits are determined after transfers to or from unallocated surplus of with-profits funds. These transfers are in turn determined after taking account of tax borne by with-profits funds. Consequently reported profit before the total tax charge is not representative of pre-tax profits attributable to shareholders. In order to provide a measure of pre-tax profits attributable to shareholders the Group has chosen to adopt an income statement presentation of the tax charge and pre-tax results that delineates between policyholder and shareholder components.

A3: Critical accounting policies, estimates and judgements continued

Supplementary analysis of results and earnings attributable to shareholders

With the exception of debt securities held by JNL and Egg and assets classified as loans and receivables, all financial investments are designated as fair value through profit and loss. Short-term fluctuations in investment returns on such assets held by with-profits funds, and those of investment property for the accounting treatment is similarly based, do not affect reported shareholder results. This is because (i) unallocated surplus of with-profits funds are accounted for as liabilities and (ii) excess or deficits of income and expenditure of the funds over the required surplus for distribution are transferred to or from unallocated surplus. However, for shareholder-backed businesses the short-term fluctuations affect the result for the year and the Group provides additional analysis of results to provide information on results beforehand after short-term fluctuations in investment returns.

Previously under UK GAAP, the Group used operating profit based on longer-term investment returns before amortisation of goodwill as a supplemental measure of its results. For the purposes of measuring operating profit, investment returns on shareholder-financed business were based on the expected longer-term rates of return. For debt securities, the longer-term returns (including losses arising on the recognition of permanent diminutions in value) were averaged over five years for inclusion in operating profit. Under IFRS, the Group continues to use operating profit based on longer-term investment returns as a supplemental measure of its results, although the basis of calculation has been improved, as disclosed in note A4 (b) (iv) on page 81.

(b) Critical accounting estimates and judgements

Investments

Determining the fair value of unquoted investments

Of the Group's financial investments, assets with a fair value of £4.9 billion are not quoted on active markets. Their fair values are determined in full or in part by using valuation techniques. These techniques include discounted cash flow analysis, option-adjusted spread models and enterprise valuation and may include a number of assumptions relating to variables such as credit risk and interest rates. Changes in assumptions relating to these variables could positively or negatively impact the reported fair value of these instruments. This impact would, however, be mostly mitigated by an equal and offsetting transfer to the liability for unallocated surplus as the majority of these investments are held by the UK with-profits fund. Further information on these instruments is provided in note G1.

Determining impairments relating to financial assets

Available-for-sale securities

Financial investments carried on an available-for-sale basis, such as JNL's debt securities portfolio, are considered to be impaired if there has been a significant and prolonged period of decline in fair value below its amortised cost or if there is objective evidence of impairment. The consideration of this requires management's judgement. Among the factors considered is whether the decline in fair value results from a change in quality of the security itself, or from a downward movement in the market as a whole and the likelihood of recovering the carrying value based on the current and short-term prospects of the issuer. Unrealised losses that are considered to be primarily the result of market conditions, such as increasing interest rates, unusual market volatility, or industry-related events, and where the Group also believes there is a reasonable expectation for recovery and, furthermore, it has the intent and ability to hold the investment until maturity or the market recovery, are usually determined to be temporary. Prudential's review of fair value involves several criteria including economic conditions, credit loss experience, other issuer-specific developments and future cash flows. These assessments are based on the best available information at the time. Factors such as market liquidity, the widening of bid/ask spreads and a change in cash flow assumptions can contribute to future price volatility. If actual experience differs negatively from the assumptions and other considerations used in the consolidated financial statements, unrealised losses currently in equity may be recognised in the income statement in future periods.

Assets held at amortised cost

For financial assets carried at amortised cost, the Group measures the amount of the impairment loss by comparing the carrying amount of the asset with the present value of its estimated future cash flows.

In estimating the future cash flows, the Group looks at the expected cash flows of the assets and applies historical loss experience of assets with similar credit risks which have been adjusted for conditions in the historical loss experience which no longer exist, or for conditions which are expected to arise. The estimated future cash flows are discounted using the financial asset's original or variable effective interest rate and exclude credit losses that have not yet been incurred.

The risks inherent in reviewing the impairment of any investment include the risk that market results may differ from expectations; facts and circumstances may change in the future and differ from estimates and assumptions; or the Group may later decide to sell the security as a result of changed circumstances.

Insurance contracts

Product classification

IFRS 4 requires contracts written by insurers to be classified as either 'insurance contracts' or 'investment contracts' depending on the level of insurance risk transferred. If significant insurance risk is transferred by the contract then it is classified as an insurance contract. Contracts that transfer financial risk but not significant insurance risk are termed investment contracts. Furthermore, some contracts, both insurance and investment, contain discretionary participation features representing the contractual right to receive additional benefits as a supplement to guaranteed benefits. Accordingly, insurers must perform a product classification exercise across their portfolio of contracts issued to determine the allocation to these various categories. Further details of this exercise are given in note D1.

A3: Critical accounting policies, estimates and judgements continued

Valuation assumptions

The Group's insurance contracts and investment contracts with discretionary participation features are primarily with-profits and other protection type policies. For UK regulated with-profits funds for 2005 the contract liabilities are valued by reference to the UK FSA's realistic basis. This is described in note D2. For other contracts, and for UK with-profits contracts in 2004, the liabilities are estimated using actuarial methods based on assumptions relating to premiums, interest rates, investment returns, expenses, mortality and surrenders. The assumptions to which the estimation of these reserves is particularly sensitive are the interest rate used to discount the provision and the assumed future mortality experience of policyholders. Further information on valuation assumptions in respect of the Group's insurance contracts is provided in section D. From the perspective of shareholder's results, the key sensitivity relates to assumed future investment returns for the Taiwan life operation. This sensitivity is discussed in more detail in note D4(h).

Deferred acquisition costs

Significant costs are incurred in connection with acquiring new insurance business. Except for acquisition costs of with-profits contracts of the UK regulated with-profits funds, which are accounted for under the realistic FSA regime as described in note A4, these costs, which vary with, and are primarily related to, the production of new business, are capitalised and amortised against margins in future revenues on the related insurance policies. The recoverability of the asset is measured and the asset is deemed impaired if the projected future margins are less than the carrying value of the asset. To the extent that the future margins differ from those anticipated, then an adjustment to the carrying value of the deferred acquisition cost asset will be necessary.

The deferral and amortisation of acquisition costs is of most relevance to the Group's reported profits for shareholder-financed long-term business operations, principally JNL in the US. In 2005 and 2004, except as described in sections D3(f) and D4(f), the amortisation of deferred acquisition costs was at expected levels.

Pensions

The Group applies the requirements of IAS 19, 'Employee Benefits' to its defined benefit pension schemes. The economic participation in the deficits attaching to the main Prudential Staff Pension Scheme (PSPS) and the smaller Scottish Amicable Pension Scheme (SAPS) are shared between the PAC with-profits sub-fund (WPSF) and shareholder operations. The economic interest reflects the source of contributions over the scheme life, which in turn reflects the activity of the members during their employment. In the case of PSPS, at 31 December 2004, the attribution between WPSF and shareholders' funds was in the ratio 80/20. In 2005, following extensive analysis, this ratio was revised to 70/30. For SAPS the ratio for both 2005 and 2004 is estimated to be 50/50 between the WPSF and shareholders' funds.

Deferred tax

Deferred tax assets are recognised to the extent that they are regarded as recoverable, that is to the extent that, on the basis of all the available evidence, it can be regarded as more likely than not that there will be suitable taxable profits against which the losses can be relieved. The UK taxation regime applies separate rules to trading and capital profits and losses. The distinction between temporary differences that arise from items of either a capital or trading nature may affect the recognition of deferred tax assets. The judgements made, and uncertainties considered, in arriving at deferred tax balances included in the financial statements are discussed in note H4.

Goodwill

Goodwill impairment testing requires the exercise of judgement by management as to prospective future cash flows.

A4: Significant accounting policies

(a) Background

Description of the accounting policies applied in the 2005 financial statements is complicated by the basis of adoption and application of IFRS standards for 2005 and the 2004 comparative results. Accordingly, the policies set out in note A4(b) below should be read in the context of this background information.

With the three exceptions, referred to in note A3(a) above, all IFRS standards have been adopted on transition to IFRS from 1 January 2004 on the basis described in this note. The effect of adoption of these standards on previously published 2004 results is explained in note A5.

IAS 32, IAS 39 and IFRS 4 standards have been adopted from 1 January 2005 when, at the same time, the Group has improved the policy applied for UK regulated with-profits funds. Comparatives have not been restated for this change. Note A6 provides a summary of the changes made in 2005 and their numeric effect on shareholders' equity at 1 January 2005.

In summary, the accounting bases applied across the two years reflect the following:

Financial instruments (other than long-term business contracts classified as financial instruments)

For 2004, previous UK GAAP has been applied. For 2005, the adoption of the standards IAS 32 and IAS 39 gives rise to presentation, recognition and measurement changes. The most significant changes relate to the measurement basis of the debt securities and derivatives of JNL. The accounting policies are described in note (b) (i) below.

A4: Significant accounting policies continued

Long-term business contracts

Income statement

For 2004, the income statement includes premiums and claim payments on all contracts that were then classified under previous GAAP as insurance, including deposit style 'investment contracts' where the insurance risk in the contracts is insignificant. For 2005, the recognition basis in the income statement remains the same except for investment contracts, as defined under IFRS 4, which do not contain discretionary participation features, where the accounting reflects the deposit nature of the arrangement. Consequently, premiums and claims on these contracts are not recognised in the income statement.

UK regulated with-profits funds

The UK GAAP basis applied in 2004 was the MSB, which closely reflected the Peak 1 regulatory basis of the UK FSA with the addition of deferred acquisition costs. For 2005, this basis has been replaced under a policy improvement to align with the UK accounting standard FRS 27, 'Life Assurance'.

Other insurance contracts

UK GAAP has been applied in both 2004 and 2005. In this respect UK GAAP also reflects the MSB. For overseas operations local GAAP or, in some cases, US GAAP has been applied but with the necessary changes to comply with UK GAAP.

Investment contracts

UK GAAP has been applied for 2004. Investment contracts with discretionary participation features are also accounted for in accordance with UK GAAP in 2005, in common with insurance contracts. For 2005, investment contracts without discretionary participation features are accounted for on a basis that reflects the hybrid nature of the arrangements whereby the deposit component is accounted for as a financial instrument under IAS 39 and the service component is accounted for under IAS 18, 'Revenue'.

Other assets, liabilities, income and expenditure

All other items are accounted for in both the 2004 and 2005 results and notes on the financial statements under the relevant IFRS standard.

Presentation of supplementary analysis of profit before tax attributable to shareholders

The Group has adopted a policy of presenting an analysis of profit before tax attributable to shareholders that distinguishes operating profit based on longer-term investment returns from other constituent elements of the total profit. It should be noted that the comparative analysis for 2004 is prepared on an inconsistent basis from that in 2005 as a result of the delayed adoption of insurance contract and financial instrument standards as referred to above, from 1 January 2005, as permitted under IFRS 1 transition rules.

The summary above should be read in conjunction with the full description of significant accounting policies described elsewhere in this note and in notes A5 and A6 for a comprehensive explanation.

(b) Accounting policies applied

(i) Financial instruments (other than long-term business contracts classified as financial instruments under IFRS 4)

2004

Previous UK GAAP has been applied as follows:

Other than banking business

Equity securities and debt securities

Equity securities were carried at fair value. Debt securities were carried at fair value, except those held by JNL which, subject to provision for permanent diminutions in value, were carried at amortised cost. Fair value was based on quoted market prices for listed securities, and on quotations provided by external fund managers, brokers, independent pricing services or values as determined by the directors for unlisted securities. Changes in fair value were recognised in investment returns during the year of the change. Debt securities held by JNL were carried at amortised cost as permitted by paragraph 24 of schedule 9A to the Companies Act 1985. The amortised cost basis of valuation was appropriate under the provisions of the ABI SORP for JNL's redeemable debt securities as they were deemed held as part of a portfolio of such securities intended to be held to maturity.

Mortgages and other loans

Loans collateralised by mortgages and other unsecured loans were carried at unpaid principal balances, net of unamortised discounts and premiums and an allowance for loan losses, except for loans held by UK insurance operations which were carried at fair value. The allowance for loan losses was maintained at a level considered adequate to absorb losses in the mortgage loan portfolio.

Loans to policyholders

Loans to policyholders were carried at unpaid principal balances and fully collateralised by the cash value of policies.

Deposits with credit institutions

Deposits with credit institutions were carried at fair value. Changes in fair value were included in investment income for the year.

Derivatives

With the principal exception of derivatives held by JNL, these instruments were carried at fair value with changes in fair value included in investment income. Derivative instruments of JNL and certain other minor holdings were accounted for at amortised cost.

A4: Significant accounting policies continued

Banking business

Debt securities intended to be held for continuing use were carried at cost less any provision for permanent diminution in value. Discount or premiums on purchase were amortised through the profit and loss account over the period from date of purchase to date of maturity.

Debt securities, which were held for resale, were stated at their net realisable value.

Derivative instruments were accounted for in a manner consistent with the assets and liabilities or positions being hedged. Profits or losses and interest on these instruments were recognised in accordance with the accounting treatment of the underlying transaction as an adjustment to interest receivable or interest payable.

2005

The accounting policies for financial instruments in 2005 are changed in a number of areas, as described in note A6. In general, where a fair value basis of measurement was applied for 2004, this basis has been continued for 2005. However, for instruments previously carried at cost, or amortised cost, the general effect of the standards adopted is for the use of fair value to be extended. The most significant changes relate to the measurement basis of the debt securities and derivatives of JNL.

The accounting policies applied in 2005 are as follows:

Investment classification

Upon initial recognition, financial investments are measured at fair value. Subsequently, the Group is permitted, subject to specific criteria, to designate its investments as either financial investments at fair value through profit and loss, financial investments held on an available-for-sale basis, financial investments held to maturity, or loans and receivables. The Group holds financial investments on the following bases:

(i) Financial investments at fair value through profit and loss – this comprises assets designated by management as fair value through profit and loss on inception. These investments are measured at fair value with all changes thereon being recognised in investment income.

(ii) Financial investments on an available-for-sale basis – this comprises assets that are designated by management and/or do not fall into any of the other categories. These investments are carried at fair value. Interest income is recognised on an effective interest basis in the income statement. Unrealised gains and losses relating to changes in fair value are recognised in equity. Upon disposal or impairment, accumulated unrealised gains and losses are transferred from equity to the income statement as realised gains or losses.

(iii) Loans and receivables – this comprises investments that have fixed or determinable payments and are not designated as fair value through profit and loss or available-for-sale. These investments include loans collateralised by mortgages, deposits, loans to policyholders and other unsecured loans and receivables. These investments are carried at amortised cost using the effective interest method.

The Group has designated certain financial assets as fair value through profit and loss as these assets are managed and their performance is evaluated on a fair value basis. These assets represent all of the Group's financial assets except all loans and receivable and debt securities held by JNL and Egg. Debt securities held by JNL and Egg are accounted for on an available-for-sale basis. The use of the fair value option is consistent with the Group's risk management and investment strategies.

The Group uses the trade date method to account for regular way purchases and sales of financial assets with the exception of Egg's loans and advances to customers which are on a settlement day basis.

Use of fair values

The Group uses current bid prices to value its quoted investments. Actively traded investments without quoted prices are valued using external broker bid prices. If there is no active established market for an investment, the Group applies an appropriate valuation technique such as a discounted cash flow technique.

Impairments

The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or group of financial assets not held at fair value through profit and loss is impaired. A financial asset or group of financial assets is impaired and impairment losses are incurred only if there is objective evidence of impairment as a result of one or more events that have occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. Objective evidence that a financial asset or group of financial assets is impaired includes observable data that comes to the attention of the Group. For assets designated as available-for-sale, the impairment is measured as the difference between the amortised cost of the asset and its fair value, removed from the available-for-sale reserve within equity and recognised in the income statement.

For loans and receivables carried at amortised cost, the impairment amount is the difference between amortised cost and the present value of the expected cash flows discounted at the original effective interest rate.

If, in subsequent periods, an impaired debt security held on an available-for-sale basis or an impaired loan or receivable recovers in value (in part, or in full), and this recovery can be objectively related to an event occurring after the impairment, then the previously recognised impairment loss is reversed through the income statement (in part, or in full).

A4: Significant accounting policies continued

Derivatives and hedge accounting

Derivative financial instruments are used to reduce or manage investment, interest rate and currency exposures, to facilitate efficient portfolio management and for investment purposes. The Group's policy is that amounts at risk through derivative transactions are covered by cash or by corresponding assets.

The Group may designate certain derivatives as hedges. This includes fair value hedges, cash flow hedges and hedges of net investments in foreign operations. If the criteria for hedge accounting are met then the following accounting treatments are applied from the date at which the designation is made and the accompanying requisite documentation is in place:

(i) Hedges of net investments in foreign operations – the effective portion of any change in fair value of derivatives or other financial instruments designated as net investment hedges are recognised in equity. The ineffective portion of changes in the fair value of the hedging instrument is recorded in the income statement. The gain or loss on the hedging instrument recognised directly in equity is recognised in the income statement on disposal of the foreign operation.

(ii) Fair value hedges – movements in the fair value of the hedged item attributable to the hedged risk are recognised in the income statement.

(iii) Cash flow hedges – the effective portion of changes in the fair value of derivatives designated as cash flow hedges are recognised in equity. Movements in fair value relating to the ineffective portion are booked in the income statement. Amounts recognised directly in equity are recorded in the income statement in the periods in which the hedged item affects profit or loss.

All derivatives that do not meet the relevant hedging criteria are carried at fair value with movements in fair value being recorded in the income statement.

Embedded derivatives

Embedded derivatives are held by various Group companies including JNL and Egg. They are embedded within other non-derivative host financial instruments to create hybrid instruments. Where economic characteristics and risks of the embedded derivatives are not closely related to the economic characteristics and risks of the host instrument, and where the hybrid instrument is not measured at fair value with the changes in fair value recognised in the income statement, depending on the classification of the host instrument, the host is then measured in accordance with the relevant requirements of IAS 39.

Securities lending including repurchase agreements

The Group is party to various securities lending agreements under which securities are loaned to third parties on a short-term basis. The loaned securities are not derecognised; rather, they continue to be recognised within the appropriate investment classification. The Group's policy is that collateral in excess of 100 per cent of the fair value of securities loaned is required from all securities borrowers and typically consists of cash, debt securities, equity securities or letters of credit.

In cases where the Group takes possession of the collateral under its securities lending programme, the collateral, and corresponding obligation to return such collateral are recognised in the consolidated balance sheet. To further minimise credit risk, the financial condition of counterparties is monitored on a regular basis.

Derecognition of financial assets and liabilities

The Group's policy is to derecognise financial assets when it is deemed that substantially all the risks and rewards of ownership have been transferred. The Group also derecognises a financial asset when the contractual rights to the cash flows from the financial asset expire. Where the Group neither transfers nor retains substantially all the risks and rewards of ownership, the Group will derecognise the financial asset where it is deemed that the Group has not retained control of the financial asset.

Where the transfer does not result in the Group transferring the right to receive the cash flows of the financial assets, but does result in the Group assuming a corresponding obligation to pay the cash flows to another recipient, the financial assets are also accordingly derecognised providing the following conditions are met:

- The Group has no obligation to pay amounts to the eventual recipients unless it collects the equivalent amounts from the original asset;
- the Group is prohibited by the terms of the transfer contract from selling or pledging the original asset; or
- the Group has no obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay.

The Group derecognises financial liabilities only when the obligation specified in the contract is discharged, cancelled or has expired.

Securitisation of assets

Egg has issued debt securities in order to finance certain portfolios of loan and investment assets. These obligations are secured on Egg's assets. The securitised assets and the related liabilities are presented gross within the relevant headings in the balance sheet under the 'gross presentation' method.

Borrowings

Although initially recognised at fair value, net of transaction costs, borrowings, excluding liabilities of consolidated collateralised debt obligations, are subsequently accounted for on an amortised cost basis using the effective interest method. Under the effective interest method, the difference between the redemption value of the borrowing and the initial proceeds (net of related issue costs) is amortised through the income statement to the date of maturity.

A4: Significant accounting policies continued

Financial liabilities designated at fair value through profit and loss

The Group has designated under IAS 39 classification, certain financial liabilities at fair value through profit and loss as these instruments are managed and their performance evaluated on a fair value basis. These instruments include liabilities related to consolidated collateralised debt obligations and net assets attributable to unit holders of consolidated unit trusts and similar funds.

(ii) Long-term business contracts

Income statement treatment

2004

Premiums and claims

Premium and annuity considerations for conventional with-profits policies and other protection type insurance polices are recognised when due. Premiums and annuity considerations for linked policies, unitised with-profits and other investment type policies are recognised when received or, in the case of unitised or unit-linked policies, when units are issued. These amounts exclude any taxes or duties assessed based on premiums.

Policy fees charged on linked and unitised with-profits policies for mortality, asset management and policy administration are recognised as revenue when related services are provided.

Claims paid include maturities, annuities, surrenders and deaths. Maturity claims are recorded on the policy maturity date. Annuity claims are recorded when the annuity becomes due for payment. Surrenders are recorded when paid, and death claims are recorded when notified.

Premiums and claims include receipts and payments on deposit style 'investment contracts' where the insurance risk in the contracts is insignificant.

Acquisition costs

Costs of acquiring new business, principally commissions, marketing and advertising costs and certain other costs associated with policy issuance and underwriting that are not reimbursed by policy charges are specifically identified and capitalised as deferred acquisition costs (DAC), which are included as an asset in the balance sheet. The DAC asset is amortised against margins in future revenues on the related insurance policies, to the extent that the amounts are recoverable out of the margins. Recoverability of the unamortised DAC asset is assessed at the time of policy issue, and reviewed if profit margins have declined.

2005

For 2005, the recognition basis in the income statement remains the same except for investment contracts which do not contain discretionary participating features, where the accounting reflects the deposit nature of the arrangement, with premium and claims reflected as deposits and withdrawals taken directly to the balance sheet.

Under IFRS, investment contracts (excluding those with discretionary participation features) are required to be accounted for as financial liabilities in accordance with IAS 39 and, where relevant, the provisions of IAS 18, in respect of the attaching investment management features of the contracts. The Group's investment contracts primarily comprise of certain unit-linked savings contracts in the UK and Asia and contracts with fixed and guaranteed terms in the US (such as guaranteed investment contracts and annuity-certains).

Incremental, directly attributable acquisition costs relating to the investment management element of these contracts are capitalised and amortised in line with the related revenue. If the contracts involve up-front charges, this income is also deferred and amortised through the income statement in line with contractual service provision.

UK regulated with-profits funds

2004

The UK GAAP basis applied in 2004 was the MSB, which closely reflected the Peak 1 regulatory basis of the UK FSA.

Prudential's long-term business written in the UK comprises predominantly life insurance policies under which the policyholders are entitled to participate in the returns of the funds supporting these policies. Business similar to this type is also written in certain of the Group's Asian operations and subject to local market and regulatory conditions. Such policies are called 'with-profits' policies. Prudential maintains with-profits funds within the Group's long-term business funds, which segregate the assets and liabilities and accumulate the returns related to that with-profits business. The amounts accumulated in these with-profits funds are available to provide for future policyholder benefit provisions and for bonuses to be distributed to with-profits policyholders. The bonuses, both annual and final, reflect the right of the with-profits policyholders to participate in the financial performance of the with-profits funds. Shareholders' profits with respect to bonuses declared on with-profits business correspond to the shareholders' share of the cost of bonuses as declared by the Board of directors. The shareholders' share currently represents one-ninth of the cost of bonuses declared for with-profits policies.

Annual bonuses are declared and credited each year to with-profits policies. The annual bonuses increase policy benefits and, once credited, become guaranteed. Annual bonuses are charged to the profit and loss account in the year declared. Final bonuses are declared each year and accrued for all policies scheduled to mature and death benefits expected to be paid during the next financial year. Final bonuses are not guaranteed and are only paid on policies that result from claims through the death of the policyholder or maturity of the policy within the period of declaration or by concession on surrender. No policyholder benefit provisions are recorded for future annual or final bonus declarations.

A4: Significant accounting policies continued

Conventional with-profits business

Future policyholder benefit provisions on conventional with-profits and other protection-type policies were calculated using the net premium valuation method. The net premium was calculated such that it would be sufficient at the outset of the policy to provide only for the discounted value of the original guaranteed death and maturity benefits on the chosen valuation assumptions. The provision was then calculated by subtracting the present value of future net premiums from the present value of future benefits (including vested bonuses) using a prudent discount rate.

Under the net premium valuation method, vested bonuses were included in the cash flows assessed but future allocations of bonuses are not included explicitly, although they were implicitly taken into account in the discount rate used, which was based on the return available on suitable investments. The detailed methodology for UK companies is included in regulations contained in the FSA rules. In particular, the returns available from equity and property assets are based on expected income and/or earnings and no allowance was made for potential future capital growth.

Accumulating with-profits business

For accumulating with-profits business, the calculation of the long-term business provision was based on a gross premium bonus reserve valuation. In general terms, a gross premium valuation basis is one in which the premiums brought into account are the full amounts receivable under the contract. The method included explicit estimates of premiums, expected claims, future regular bonuses, costs of maintaining contracts and future renewal expenses. Cash flows were discounted at the valuation rate of interest. The methodology for UK companies is included in the FSA rules. The discount rate was based on the expected return on the assets deemed to back the liabilities as prescribed by the FSA rules.

For PAC business, the calculation was based on a valuation under which future reversionary bonuses were added to the guaranteed liabilities existing at the valuation date. The provision was then calculated as the present value of future policyholder benefits plus the present value of future expenses, without assumption for withdrawals.

An addition was made in respect of future premiums if this produced a higher provision. The assumptions to which the estimation of the long-term business provision was particularly sensitive included the assumed future reversionary bonuses, the interest rate used to discount the provision, the assumed future per policy expenses and the assumed future mortality experience of policyholders.

For PAC business, the provision was taken as the lower of:

- The accumulated fund or the value at the bid price of the notional number of units allocated to policyholders, in both cases excluding final bonus; and
- the surrender or transfer value which, having regard to policyholders' reasonable expectations, would be payable at the valuation date, or, if greater, the value of the guaranteed liabilities excluding final bonus calculated on a gross premium bonus reserve method.

The amounts shown in the consolidated balance sheet for the year ended 31 December 2004, for with-profits contracts and unallocated surplus of the PAC with-profits fund have been determined in accordance with the MSB. With the exception of minor accounting adjustments, the technical provisions reflect the UK regulatory basis of reporting that has applied for many years, and which effectively constitutes the Peak 1 basis under the new FSA regime.

2005

For 2005, the basis described above has been replaced under a policy improvement to align with the UK accounting standard FRS 27, 'Life Assurance'.

FRS 27 is underpinned by the FSA's Peak 2 basis of reporting. This Peak 2 basis, which came into effect for the first time for 2004 regulatory reporting, requires the value of liabilities to be calculated as:

- A with-profits benefits reserve (WPBR); plus
- future policy related liabilities (FPRL); plus
- the realistic current liabilities of the fund.

The WPBR is primarily based on the retrospective calculation of accumulated asset shares but is adjusted to reflect future policyholder benefits and other outgoings. By contrast, the Peak 1 basis addresses, at least explicitly, only declared bonuses.

The FPRL must include a market consistent valuation of costs of guarantees, options and smoothing, less any related charges, and this amount is determined using either a stochastic approach, hedging costs or a series of deterministic projections with attributed probabilities. Under the Peak 1 basis there is an allowance on a deterministic basis for the intrinsic value of these costs.

The assumptions used in the stochastic models are calibrated to produce risk-free returns on each asset class. Volatilities of, and correlations between, investment returns from different asset classes are as determined by the Group's Portfolio Management Group but are also market consistent.

A4: Significant accounting policies continued

The cost of guarantees, options and smoothing is very sensitive to the bonus, market value reduction (MVR) and investment policy the Company employs and therefore the stochastic modelling incorporates a range of management actions that would help to protect the fund in adverse scenarios. Substantial flexibility has been included in the modelled management actions in order to reflect the discretion that the Company retains in adverse investment conditions, thereby avoiding the creation of unreasonable minimum capital requirements. The management actions assumed are consistent with management's policy for with-profits funds and the disclosures made in the publicly available Principles and Practices of Financial Management.

Under FRS 27, the main changes that are required for UK with-profits funds are:

- Derecognition of deferred acquisition costs and related deferred tax; and
- replacement of MSB liabilities for with-profits business with adjusted realistic basis liabilities.

Adjusted realistic basis liabilities represent the Peak 2 basis realistic liabilities for with-profits business included in Form 19 of the FSA regulatory returns, but after excluding the element for the shareholders' share of the future bonuses. This latter item is recognised as a liability for the purposes of regulatory returns but, for accounting purposes under FRS 27, consistent with the current basis of financial reporting, shareholder transfers are recognised only on declaration.

Unallocated surplus

The unallocated surplus represents the excess of assets over policyholder liabilities for the Group's with-profits funds. In 2005, as allowed under IFRS 4, the Group has opted to continue to record unallocated surplus of with-profits funds wholly as a liability. The annual excess (shortfall) of income over expenditure of the with-profits funds, after declaration and attribution of the cost of bonuses to policyholders and shareholders, is transferred to (from) the unallocated surplus each year through a charge (credit) to the income statement. The balance retained in the unallocated surplus represents cumulative income arising on the with-profits business that has not been allocated to policyholders or shareholders. The balance of the unallocated surplus is determined after full provision for deferred tax on unrealised appreciation on investments.

Other insurance contracts (contracts which contain significant insurance risk as defined under IFRS 4)

UK GAAP has been applied in both 2004 and 2005. UK GAAP for these contracts reflects the MSB. Under this basis the following approach applies.

UK insurance contracts

Other UK insurance contracts, including unit-linked contracts, that contain significant insurance risk, are accounted for consistently in 2004 and 2005. Segregated accounts are established for linked business for which policyholder benefits are wholly or partly determined by reference to specific investments or to an investment-related index. The interest rates used in establishing policyholder benefit provisions for pension annuities in the course of payment are adjusted each year. Mortality rates used in establishing policyholder benefit provisions were based on published mortality tables adjusted to reflect actual experience.

Overseas subsidiaries

Results of overseas subsidiaries are determined initially using local GAAP bases of accounting with subsequent adjustments where necessary to comply with the Group's accounting policies.

Jackson National Life

The future policyholder benefit provisions for JNL's conventional protection-type policies are determined using the net level premium method under US GAAP principles and assumptions as of the issue date as to mortality, interest, policy lapses and expenses plus provisions for adverse deviations. For non-conventional protection-type policies, the policyholder benefit provision included within policyholder liabilities in the consolidated balance sheet is the policyholder account balance.

For the business of JNL, the determination of the expected emergence of margins, against which the amortisation profile of the DAC asset is established, is dependent on certain key assumptions. For single premium deferred annuity business, the key assumption is the expected long-term spread between the earned rate and the rate credited to policyholders. For variable annuity business, the key assumption is the expected long-term level of equity market returns which, for 2005 and 2004, was 8.4 per cent per annum implemented using a mean reversion methodology. These returns affect the level of future expected profits through their effects on fee income and the required level of provision for guaranteed minimum death benefit claims.

In 2005, JNL accounts for the majority of its investment portfolio on an available-for-sale basis (see investment policies above) whereby unrealised gains and losses are recognised directly in equity. As permitted by IFRS 4, JNL has used shadow accounting. Under shadow accounting, to the extent that recognition of unrealised gains or losses on available-for-sale securities causes adjustments to the carrying value and amortisation patterns of deferred acquisition costs and deferred income, these adjustments are recognised directly in equity to be consistent with the treatment of the gains or losses on the securities.

A4: Significant accounting policies continued

Asian operations

The future policyholder benefit provisions for Asian businesses are determined in accordance with methods prescribed by local GAAP adjusted to comply, where necessary, with UK GAAP. For the Hong Kong business, which is a branch of the PAC, and the Singapore and Malaysian operations the valuation principles and sensitivities to changes of assumptions of conventional with-profits and other protection-type policies are similar to those described above for equivalent products written by the UK operations.

For Asian operations in countries where local GAAP is not well established and in which the business written is primarily non-participating and linked business, US GAAP is used as the most appropriate proxy to local GAAP. The future policyholder benefit provisions for non-linked business are determined using the net level premium method, with an allowance for surrenders, maintenance and claim expenses. Rates of interest used in establishing the policyholder benefit provisions vary by operation depending on the circumstances attaching to each block of business.

Although the basis of valuation of Prudential's overseas operations is in accordance with the requirements of the Companies Act 1985 and ABI SORP, the valuation of policyholder benefit provisions for these businesses may differ from that determined on a UK MSB for UK operations with the same features.

Liability adequacy

The Group performs liability adequacy testing on its insurance provisions to ensure that the carrying amounts of provisions (less related deferred acquisition costs and present value of in-force business – see policy on Business Acquisitions and Disposals) is sufficient to cover current estimates of future cash flows. When performing the liability adequacy test, the Group discounts all contractual cash flows and compares this amount to the carrying value of the liability. Any deficiency is immediately charged to the income statement.

Reinsurance

In the normal course of business, the Group seeks to reduce loss exposure by reinsuring certain levels of risk in various areas of exposure with other insurance companies or reinsurers. An asset or liability is recognised in the consolidated balance sheet representing premiums due to or payments due from reinsurers, and the share of losses recoverable from reinsurers. The measurement of reinsurance assets is consistent with the measurement of the underlying direct insurance contracts.

Gains arising on the purchase of reinsurance contracts by JNL are deferred and amortised over the contract duration. Any loss is recognised in the income statement immediately.

Investment contracts (contracts which do not contain significant insurance risk as defined under IFRS 4)

For investment contracts with discretionary participation features, the accounting basis in 2005 and 2004 is consistent with the accounting for similar with-profits insurance contracts. For investment contracts without discretionary participation features, UK GAAP has been applied for 2004. For 2005, investment contracts are accounted for on a basis that reflects the hybrid nature of the arrangements whereby part is accounted for as a financial instrument under IAS 39 and the investment management service component is accounted for under IAS 18 as described in note A6.

For those investment contracts in the US with fixed and guaranteed terms, the Group uses the amortised cost model to measure the liability. On contract inception the liability is measured at fair value less incremental, directly attributable, acquisition costs. Remeasurement at future reporting dates is on an amortised cost basis utilising an effective interest rate methodology whereby the interest rate utilised discounts to the net carrying amount of the financial liability.

Those investment contracts without fixed and guaranteed terms are designated at fair value through profit and loss. Fair value is based upon the fair value of the underlying assets of the fund. Where the contract includes a surrender option its carrying value is subject to a minimum carrying value equal to its surrender value.

(iii) Other assets, liabilities, income and expenditure

All other items are accounted for in both the 2004 and 2005 results and notes on the financial statements under the relevant IFRS standard.

Basis of consolidation

The Group consolidates those entities it is deemed to control. The degree of control is determined by the ability of the Group to govern the financial and operating policies of an entity in order to obtain benefits. Consideration is made of other factors such as potential voting rights.

The Group has consolidated some special purpose entities (SPE), such as funds holding collateralised debt obligations (CDO) where equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. These SPEs are consolidated because the Group is deemed to control them under IFRS.

Where the Group holds investments in Open-ended Investment Companies (OEICs) and unit trusts and the Group's ownership share falls marginally below 50 per cent due to the fluctuating nature of the internal and external participation in these vehicles, the Group will continue to consolidate the OEIC or unit trust when the fall in percentage ownership below 50 per cent is deemed to be temporary.

A4: Significant accounting policies continued

Where the Group exercises significant influence or has the power to exercise significant influence over an entity, generally through ownership of 20 per cent or more of the entity's voting rights, but does not control the entity then this is considered to be an investment in an associate. With the exception of those referred to below, the Group's investments in associates are recorded at the Group's share of the associate's net assets. The carrying value of investments in associates is adjusted each year for the Group's share of the entities' profit or loss. This does not apply to investments in associates held by the Group's insurance or investment funds including the venture capital business or mutual funds and unit trusts, which are carried at fair value through profit and loss.

The Group's investments in joint ventures are recognised using proportional consolidation whereby the Group's share of an entity's individual balances are combined line-by-line with similar items into the Group financial statements.

Other interests in entities, where significant influence is not exercised, are carried as investments at fair value through profit and loss.

The consolidated financial statements of the Group include the assets, liabilities and results of the Company and subsidiary undertakings in which Prudential has a controlling interest, using accounts drawn up to 31 December 2005 except where entities have non-coterminous year ends. In such cases, the information consolidated is based on the accounting period of these entities and is adjusted for material changes up to 31 December. Accordingly, the information consolidated is deemed to cover the same period for all entities throughout the Group. The results of subsidiaries are included in the financial statements from the date acquired to the effective date of disposal. All inter-company transactions are eliminated on consolidation. Results of investment management activities include those for managing internal funds.

Investment properties

Investments in tenant occupied leasehold and freehold properties are carried at fair value, with changes in fair value included in the income statement. Properties are valued annually either by the Group's qualified surveyors or professional external valuers using The Royal Institution of Chartered Surveyors (RICS) guidelines. The RICS guidelines apply separate assumptions to the value of the land, buildings, and tenancy associated with each property. Each property is externally valued at least once every three years. The cost of additions and renovations is capitalised and considered when estimating fair value.

Leases of investment property where the Group has substantially all the risks and rewards of ownership are classified as finance leases (leasehold property). Finance leases are capitalised at the lease's inception at the lower of the fair value of the leased property and the present value of the minimum lease payments. Where a lease has a contingent rent element, the rent is calculated in accordance with individual lease terms and charged as an expense as incurred.

Pension schemes

The Group operates a number of pension schemes around the world. The largest of these schemes is the PSPS, a defined benefit scheme. The Group also operates defined contribution schemes. Defined contribution schemes are schemes where the Company pays contributions into a fund and the Company has no legal or constructive obligation to pay further contributions should the assets of that fund be insufficient to pay the employee benefits relating to employee service in both current and prior periods. Defined benefit schemes are post-employment benefits plans that are not defined contribution schemes.

For the Group's defined benefit schemes, if the present value of the defined benefit obligation exceeds the fair vale of the schemes assets, then a liability is recorded in the Group's balance sheet. The Group utilises the projected unit credit method to calculate the defined benefit obligation. Estimated future cash flows are then discounted at a high-quality corporate bond rate to determine its present value. These calculations are performed by independent actuaries.

The plan assets of the Group's pension schemes exclude several insurance contracts that have been issued by the Group. These assets are excluded from plan assets in determining the pension obligation recognised in the consolidated balance sheet.

The aggregate of the actuarially determined service costs of the currently employed personnel and the unwind of discount on liabilities at the start of the period, less the expected investment return on scheme assets at the start of the period, is charged to the income statement. Actuarial gains and losses as a result of changes in assumptions or experience variances are also charged or credited to the income statement.

Contributions to the Group's defined contribution schemes are expensed when due. Once paid, the Group has no further payment obligations. Any prepayments are reflected as an asset on the balance sheet.

Share-based payments

The Group offers share award and option plans for certain key employees and a Save As You Earn plan (SAYE) plan for all UK and certain overseas employees. The arrangements for distribution to employees of shares held in trust relating to share award plans and for entitlement to dividends depend upon the particular terms of each plan. Shares held in trust relating to these plans are conditionally gifted to employees.

The compensation expense charged to the income statement is primarily based upon the fair value of the options granted, the vesting period and the vesting conditions. The Group revises its estimate of the number of options likely to be exercised at each balance sheet date and adjusts the charge to the income statement accordingly. Where the share-based payment depends upon vesting outcomes attaching to market-based performance conditions, additional modelling is required to take into account these conditions which effectively estimates the number of shares expected to vest. No subsequent adjustment is then made to the fair value charge for awards that do not vest on account of these performance conditions not being met.

A4: Significant accounting policies continued

The Company has established trusts to facilitate the delivery of Prudential plc shares under employee incentive plans and savings-related share option schemes. The cost to the Company of acquiring these treasury shares held in trusts is shown as a deduction from shareholders' equity.

Tax

The Group's UK subsidiaries each file separate tax returns. JNL and other foreign subsidiaries, where permitted, file consolidated income tax returns. In accordance with UK tax legislation, where one domestic UK company is a 75 per cent owned subsidiary of another UK company or both are 75 per cent owned subsidiaries of a common parent, the companies are considered to be within the same UK tax group. For companies within the same tax group, trading profits and losses arising in the same accounting period may be offset for purposes of determining current and deferred taxes.

Current tax expense is charged or credited to operations based upon amounts estimated to be payable or recoverable as a result of taxable operations for the current year. To the extent that losses of an individual UK company are not offset in any one year, they can be carried back for one year or carried forward indefinitely to be offset against profits arising from the same company.

Deferred taxes are provided under the liability method for all relevant temporary differences, being the difference between the carrying amount of an asset or liability in the balance sheet and its value for tax purposes. IAS 12, 'Income Taxes' does not require all temporary differences to be provided for, in particular, the Group does not provide for deferred tax on undistributed earnings of subsidiaries where the Group is able to control the timing of the distribution and the temporary difference created is not expected to reverse in the foreseeable future. The tax effects of losses available for carry forward are recognised as an asset. Deferred tax assets are only recognised when it is probable that future taxable profits will be available against which these losses can be utilised. Deferred tax related to charges or credits taken directly to equity is also credited or charged directly to equity and is subsequently recognised in the income statement together with the deferred gain or loss.

The tax charge for long-term business includes tax expense on with-profits funds attributable to both the policyholders and the shareholders. Different tax rules apply under UK law depending upon whether the business is life insurance or pension business. Tax on the life insurance business is based on investment returns less expenses attributable to that business. Tax on the pension business is based on the shareholders' profits or losses attributable to that business. The shareholders' portion of the long-term business is taxed at the shareholders' rate with the remaining portion taxed at rates applicable to the policyholders.

Property, plant and equipment

All property, plant and equipment such as owner occupied property, computer equipment and furniture and fixtures, are carried at depreciated cost. Costs including expenditure directly attributable to the acquisition of the assets are capitalised. Depreciation is calculated and charged on a straight-line basis over an asset's estimated useful life. The residual values and useful lives are reviewed at each balance sheet date. If the carrying amount of an asset is greater than its recoverable amount then its carrying value is written down to that recoverable amount.

Leasehold improvements to owner occupied property are depreciated over the life of the lease. Assets held under finance leases are capitalised at their fair value.

Business acquisitions and disposals

Business acquisitions are accounted for by applying the purchase method of accounting, which adjusts the net assets of the acquired company to fair value at the date of purchase. The excess of the costs of acquisition over the fair value of the acquired entity is recorded as goodwill. Should the fair value of the identifiable assets and liabilities of the entity exceed the cost of acquisition then this is recognised immediately in the income statement. Income and expenses of acquired entities are included in the income statement from the date of acquisition. Revenues and expenses of entities sold during the period are included in the income statement up to the date of disposal. The gain or loss on disposal is calculated as the difference between sale proceeds net of selling costs less the net assets of the entity at the date of disposal.

For life insurance company acquisitions, the adjusted net assets include an identifiable intangible asset for the present value of in-force business which represents the profits that are expected to emerge from the acquired insurance business. The present value of in-force business is calculated using best estimate actuarial assumptions for interest, mortality, persistency and expenses and is amortised over the anticipated lives of the related contracts in the portfolio. An intangible asset may also be recognised in respect of acquired investment management contracts representing the fair value of contractual rights acquired under these contracts.

The Company uses the economic entity method to purchase minority interests. Under the economic entity method any difference between consideration and the share of net assets acquired is recorded directly in equity.

Goodwill

Goodwill arising on acquisitions of subsidiaries and businesses is capitalised and carried on the Group balance sheet as an intangible asset at initial value less any accumulated impairment losses. Goodwill impairment testing is conducted annually and when there is an indication of impairment. For the purposes of impairment testing, goodwill is allocated to cash generating units. These cash generating units reflect the smallest group of assets that includes the goodwill and generates cash flows that are largely independent of the cash inflows from other groups of assets. If the carrying amount of the cash generating unit exceeds its recoverable amount then the goodwill is considered impaired. Impairment losses are recognised immediately in the income statement and may not be reversed in future periods.

A4: Significant accounting policies continued

Cash and cash equivalents

Cash and cash equivalents consist of cash at bank and in hand, deposits held at call with banks, treasury bills and other short-term highly liquid investments with less than 90 days maturity from the date of acquisition.

Rights of offset

Assets and liabilities in the consolidated financial statements are only reported on a net basis when there is a legally enforceable right to offset and there is an intention to settle on a net basis.

Segments

In accordance with IAS 14, 'Segment Reporting' the Group reports its results and certain other financial information by primary and secondary segments. The Group's primary segments are its business segments, namely, long-term business, banking and broker-dealer and fund management. The Group's secondary segments are its geographical segments, namely, UK, US and Asia.

Shareholders' dividends

Dividends to shareholders are recognised as a liability in the period in which they are declared. Where scrip dividends are issued, the value of such shares, measured as the amount of the cash dividend alternative, is credited to reserves and the amount in excess of the nominal value of the shares issued is transferred from the share premium account to retained earnings.

Share capital

Where there is no obligation to transfer assets, shares are classified as equity. The difference between the proceeds received on issue of the shares, net of share issue costs, and the nominal value of the shares issued, is credited to share premium. Where the Company purchases shares for the purposes of employee incentive plans, the consideration paid, net of issue costs, is deducted from retained earnings. Upon issue or sale any consideration received is credited to retained earnings net of related costs.

Foreign exchange

The Group's consolidated financial statements are presented in pound sterling, the Group's presentation currency. Accordingly, the results and financial position of foreign subsidiaries must be translated into the presentation currency of the Group from their functional currencies i.e. the currency of the primary economic environment in which the entity operates. All assets and liabilities of foreign subsidiaries are converted at year end exchange rates whilst all income and expenses are converted at average exchange rates where this is a reasonable approximation of the rates prevailing on transaction dates. The impact of these currency translations is recorded as a separate component of equity.

Foreign currency borrowings that have been used to provide a hedge against Group equity investments in overseas subsidiaries, are translated at year end exchange rates and taken directly to shareholders' equity. Other foreign currency monetary items are translated at year end exchange rates with changes recognised in the income statement. Foreign currency transactions are translated at the spot rate prevailing at the time.

(iv) Presentation of supplementary analysis of profit before tax attributable to shareholders

The Group provides supplementary analysis of profit before tax attributable to shareholders that distinguishes operating profit based on longer-term investment returns from other constituent elements of the total profit. As a result of the differences described above, in respect of adoption of the standards IAS 32, IAS 39 and IFRS 4 from 1 January 2005, the 2004 analysis is prepared on an inconsistent basis from that in 2005 and those intended to be presented in future years. The key area of difference relates to the valuation basis of derivatives and debt securities of JNL as described in section B1.

Operating profit based on longer-term investment returns

Previously under UK GAAP, the Group used operating profit based on longer-term investment returns before amortisation of goodwill as a supplemental measure of its results. For the purposes of measuring operating profit, investment returns on shareholder-financed business were based on the expected longer-term rates of return. For debt securities, the longer-term returns (including losses arising on the recognition of permanent diminutions in value) were averaged over five years for inclusion in operating profit.

Under IFRS, the Group continues to use operating profit based on longer-term investment returns as a supplemental measure of its results as explained in notes A3 and A6. For the purposes of measuring operating profit based on longer-term investment returns, investment returns on shareholder-financed business continue to be based on the expected longer-term rate of return. However, for debt securities, the five year averaging approach described above has been replaced with a basis that more closely reflects longer-term experience. The amounts included in operating results for longer-term capital returns for debt securities comprise two components. These are a risk margin reserve based charge for expected defaults, which is determined by reference to the credit quality of the portfolio, and amortisation of interest-related realised gains and losses to operating results based on longer-term investment returns to the date when sold bonds would have otherwise matured. This change has been applied following a comprehensive review of the Group's accounting policies and is unrelated to the requirements of IFRS. The change is of most importance to the determination of the operating result based on longer-term investment returns of JNL. Total profits are unaffected by the change of basis of determining longer-term investment returns.

A4: Significant accounting policies continued

Items excluded from operating profit based on longer-term investment returns

Items excluded from operating profit based on longer-term investment returns but included in profit before tax attributable to shareholders of continuing operations, include goodwill impairment charges, short-term fluctuations in investment returns (i.e. actual less longer-term returns), actuarial gains and losses on defined benefit pension schemes and exceptional items.

With the exception of derivatives used for managing equity exposure, value movements on derivatives held by JNL are included within short-term fluctuations. For the purposes of distinguishing actuarial gains and losses on defined benefit pension schemes in this analysis, plan assets include Prudential policies held by the schemes.

A5: Changes from previous accounting basis and reconciliation to previously published 2004 results on first-time adoption of IFRS

The changes of accounting policies from those applied for UK GAAP that arise on the conversion to IFRS basis reporting are numerous and extend to many elements of income, expenditure, assets and liabilities. The policy changes from the previously published 2004 UK GAAP audited financial statements which are of significance to reported results are detailed below. These changes affect the basis of preparation for the results for 2004, 2005 and, subject to policy changes, future accounting periods. In addition to these changes, significant additional policy changes arose in 2005. These additional changes are not required to be retrospectively applied to the 2004 results. The additional changes that affect the 2005 results are described in note A6.

Basis of preparation

Under UK GAAP, the Group's consolidated financial statements were previously prepared in accordance with applicable accounting standards under UK GAAP including being in accordance with the SORP issued in November 2003 by the ABI.

The date of adoption of IFRS is 1 January 2004. As at that date the Group has applied all International Accounting Standards Board (IASB) standards on a basis prescribed or permitted by those standards in the preparation of its consolidated financial statements.

In general, a Group is required to determine its IFRS accounting policies and apply those retrospectively to determine its opening balance sheet under IFRS. However, in accordance with IFRS 1, the Group has applied the mandatory exceptions and certain optional exemptions from full retrospective application of IFRS.

Significant exemptions from full retrospective application elected by the Group are as follows:

Business combinations

The Group has elected not to apply retrospectively the provisions of IFRS 3, 'Business Combinations' to business combinations that occurred prior to 1 January 2004. At the date of adoption, therefore, no adjustment was made between UK GAAP and IFRS shareholders' equity for any historical business combination. Consistent with this approach, goodwill recognised in the opening balance sheet at 1 January 2004 for acquired businesses that have previously been consolidated, is the same as previously shown under UK GAAP. Goodwill on newly consolidated entities, for example on venture subsidiaries of the PAC with-profits fund, is determined by reference to net identifiable assets at transition date.

Comparatives

The Group has taken advantage of the exemption within IFRS that allows comparative information presented in the first year of adoption of IFRS not to comply with the standards IAS 32, IAS 39 and IFRS 4.

Consolidation principles

Inter-company transactions

Previously, under UK GAAP, all inter-company transactions were eliminated on consolidation except for investment management fees charged by M&G and the Group's US and Asia fund management operations to long-term business funds.

Under IFRS, all inter-company transactions are eliminated on consolidation. Investment management fees charged by M&G, and the Group's US and Asia fund management operations to long-term business funds are recorded within inter-segment revenue and expenditure as set out in note D but eliminated on consolidation in the income statement.

Entities subject to consolidation

Previously, under UK GAAP, the assets and liabilities and results of entities were consolidated where Prudential had a controlling interest under the terms of Companies Act legislation, FRS 2, 'Accounting for Subsidiary Undertakings' and other relevant UK GAAP interpretations.

Entities are consolidated under IFRS if they fall within the scope of IAS 27, 'Consolidated and Separate Financial Statements' and the IFRIC interpretation, SIC 12, 'Consolidation – Special Purpose Entities', of the IASB. Under IFRS, certain investment vehicles are newly consolidated due to the requirements differing from UK GAAP.

A5: Changes from previous accounting basis and reconciliation to previously published 2004 results on first-time adoption of IFRS continued

Basis of presentation of tax charges

Historically, under Companies Act requirements, tax charges attributable to policyholders and unallocated surplus of with-profits funds and unit-linked policies were charged, together with tax charges attributable to the long-term business result attributable to shareholders, as an expense in the long-term business technical account of the profit and loss account. In the non-technical section (i.e. the summary profit and loss section attributable to shareholders) the post-tax balance transferred from the long-term business technical account was grossed up by attributable shareholder tax to derive the pre-shareholder tax long-term business result. Tax charges in the non-technical account reflected the aggregate of the shareholder tax on the long-term business result and on the Group's other results.

Under UK Listing Authority rules, profit before tax is required to be presented. This requirement, coupled with the fact that IFRS does not contemplate tax charges which are attributable to policyholders and unallocated surplus of with-profits funds and unit-linked policies, necessitates the reporting of total tax charges within the presented results. The result before all taxes i.e. 'profit before tax' as shown in the income statement represents income net of post-tax transfers to unallocated surplus of with-profits funds, before tax attributable to policyholders and unallocated surplus of with-profits funds, unit-linked policies and shareholders. Separately, within the income statement 'profit before tax attributable to shareholders' is shown after deduction of taxes attributable to policyholders and unallocated surplus of with-profits funds and unit-linked policies. Tax charges on this measure of profit reflect the tax charges attributable to shareholders. In determining the tax charges attributable to shareholders, the Group has applied a methodology consistent with that previously applied under UK GAAP reflecting the broad principles underlying the tax legislation of life assurance companies.

Pension costs

Under UK GAAP, the Group applied the provisions of SSAP 24, 'Pension Costs'. Consistent with the surplus financial position of the PSPS (which accounts for 90 per cent of the liabilities of the Group's defined benefit pension schemes) at 5 April 2002, which was at the time when the scheme was last subject to a full triennial actuarial valuation, and the scheme rules over minimum levels of funding, no SSAP 24 basis prepayment or provision has been reported in the Group's UK GAAP balance sheet. Additional disclosures were made in the notes to the Group's financial statements concerning the Group's UK defined benefit schemes, applying the methodology prescribed by FRS 17, 'Retirement Benefits'.

Under IAS 19, 'Employee Benefits', the impact of the surplus or deficit of defined benefit pension schemes on the consolidated net assets of the Group is determined by the difference between the fair value of assets held within the schemes and the net present value of projected future cash flows based on accrued liabilities. The net present value is determined by applying a discount rate based on the yield at the balance sheet date on high-quality corporate bonds.

The deficits on the Group's defined benefit pension schemes are apportioned between shareholders' equity and unallocated surplus of the PAC with-profits fund based on the weighted cumulative activity attaching to the contributions paid into the schemes in the past. For the PSPS scheme for 2004 it was estimated that 80 per cent of the deficit was attributable to the PAC with-profits sub-fund and 20 per cent to shareholder-backed operations. For 2005, following further detailed consideration of the sourcing of previous contributions by group companies and funds, the ratio has been altered to 70/30 for the allocation of the deficit between the PAC with-profits sub-fund and shareholder-backed operations.

The IFRS income statement charge for pension costs normally comprises two items, namely:

(a) The aggregate of the actuarially determined service cost of the currently employed personnel, the unwind of discount on liabilities at the start of the year, less the expected investment return on the scheme assets at the start of the reporting year; and

(b) Actuarial gains and losses. These gains and losses arise from changes in assumptions, the difference between actual and expected investment return on the scheme assets, and experience gains and losses on liabilities.

For 2005, additional gains and losses have been recognised as explained in note B1.

Goodwill

Under UK GAAP, with effect from 1 January 1998, goodwill arising from acquisitions was recognised as an asset on the balance sheet and amortised through the consolidated profit and loss account on a straight-line basis over its estimated useful life, not exceeding 20 years. Prior to 1 January 1998, goodwill relating to acquisitions was charged directly to shareholders' funds. As permitted under the transitional arrangements of FRS 10, 'Goodwill and Intangible Assets', amounts previously charged to shareholders' funds were not reinstated as assets in the UK GAAP balance sheet.

Under IFRS, subject to reassessment of previously recognised assets and liabilities in accordance with IFRS 1, the goodwill balance at 1 January 2004 reflects the carrying value of UK GAAP goodwill for previously consolidated entities at that date on the basis described above, as well as goodwill on certain newly consolidated entities. Under IFRS, goodwill is no longer amortised. However, impairment testing is required annually and on adoption. In addition, as prescribed by IFRS 1. Goodwill previously charged to shareholders' funds on transition is not transferred to the income statement upon disposal of the relevant entity. For 2005, an impairment charge in respect of goodwill attaching to the Japan life insurance business was required.

A5: Changes from previous accounting basis and reconciliation to previously published 2004 results on first-time adoption of IFRS continued

Share-based payments

The Group offers share awards and option plans for certain key employees and a SAYE plan for all UK and certain overseas employees. The arrangements for distribution to employees of shares held in trusts relating to share award plans and for entitlement to dividends depend upon the particular terms of each plan. Shares held in trusts relating to non-SAYE plans are conditionally gifted to employees. Previously, under UK GAAP, compensation for non-SAYE plans was recorded over the periods to which share awards or options were earned based on intrinsic value. No costs were required to be recorded for SAYE plans.

Under IFRS, share-based payments are accounted for on a fair value basis. The fair value is recognised in the income statement over the relevant vesting period and adjusted for lapses and forfeitures with the number of shares expected to lapse or be forfeited estimated at each balance sheet date prior to the vesting date. The only exception is where the share-based payment depends upon vesting outcomes attaching to market-based performance conditions such as in the case of the Restricted Share Plan (RSP). Under these circumstances additional modelling is required to take into account these market-based performance conditions which effectively estimate the number of shares expected to vest. No subsequent adjustment is then made to the fair value charge for shares that do not vest on account of these performance conditions not being met.

Shareholders' dividends

Previously, under UK GAAP, shareholders' dividends were accrued in the period to which they related regardless of when they were declared. Under IFRS, dividends declared after the balance sheet date in respect of the prior reporting period are treated as a non-adjusting event. The appropriation reflected in the statement of changes in equity, therefore, includes the final dividend in respect of the prior year.

A5: Changes from previous accounting basis and reconciliation to previously published 2004 results on first-time adoption of IFRS continued

Reconciliation of income statement for 2004

The following table reconciles the income statement for the year ended 31 December 2004 as previously published under UK GAAP to the IFRS basis income statement for that year as presented in the comparatives to the 2005 income statement.

Year ended 31 December 2004	UK GAAP (note i) £m	IFRS adjustments: Presentation of UK GAAP in IFRS format (note i) £m	IFRS adjustments: Recognition, measurement and other changes (notes ii and iii) £m	**IFRS basis £m**
Earned premiums, net of reinsurance	16,099	53		**16,152**
Investment income	13,917	2,082	(249)	**15,750**
UK fund management result	136	(136)		**0**
US broker-dealer and fund management result	(14)	14		**0**
Asia fund management result	19	(19)		**0**
UK banking result (continuing operations)	63	(63)		**0**
Other income		773	1,229	**2,002**
Total revenue	30,220	2,704	980	**33,904**
Benefits and claims and movement in unallocated surplus of with-profits funds	(26,598)	(83)	88	**(26,593)**
Acquisition costs and other operating expenditure	(2,069)	(2,434)	(1,060)	**(5,563)**
Finance costs: interest on core structural borrowings of shareholder-financed operations		(187)		**(187)**
Amortisation of goodwill (continuing operations)	(94)	0	94	**0**
Total charges	(28,761)	(2,704)	(878)	**(32,343)**
Profit before tax*	1,459		102	**1,561**
Tax attributable to policyholder's returns	(701)		(10)	**(711)**
Profit before tax attributable to shareholders	758		92	**850**
Tax expense	(947)		(4)	**(951)**
Less: tax attributable to policyholders' returns	701		10	**711**
Tax attributable to shareholders' profit	(246)		6	**(240)**
Profit from continuing operations after tax	512		98	**610**
Discontinued operations (net of tax)	(94)			**(94)**
Profit for the year	418		98	**516**
Attributable to:				
Equity holders of the Company	428		89	**517**
Minority interests	(10)		9	**(1)**
Profit for the year	418		98	**516**

*Profit before tax represents income net of post-tax transfers to unallocated surplus of with-profits funds, before tax attributable to policyholders and unallocated surplus of with-profits funds, unit-linked policies and shareholders' profits.

Notes

(i) UK GAAP results

The UK GAAP basis results shown above reflect those previously recorded in the technical accounts and non-technical account of the Group's profit and loss account under Companies Act requirements. These results are then reconfigured to be consistent with the format applied for reporting in the Group's 2005 financial statements under IFRS.

(ii) Recognition, measurement and other changes for results attributable to shareholders

Changes to profit from continuing operations (including actual investment returns) before and after tax attributable to shareholders, for 2004 reflect the effects of IFRS adoption. In summary the effects are for:

	2004 £m
Egg – primarily relates to charges for share-based payments in respect of Egg shares	(2)
Additional pension costs and share-based payments costs in respect of Prudential plc shares not allocated by business unit	(4)
Amortisation of goodwill not applied under IFRS	94
Actuarial gains and losses of defined benefit schemes recognised under IFRS	(7)
Value movements of US investment funds newly consolidated under IFRS	2
Share of profits of venture investment companies and property partnerships of the PAC with-profits fund, newly consolidated under IFRS, that is attributable to external investors	9
Total changes before tax	92
Related tax attributable to shareholders	6
Total changes after tax	98

(iii) Recognition, measurement and other changes for results attributable to the with-profits funds

Changes to revenue, charges, and related tax of the Group's with-profits funds principally relate to measurement differences on investments, consolidation criteria for venture fund and other investment subsidiaries, and pension cost accounting. These amounts have been reflected by changes of an equal and opposite amount to transfers to unallocated surplus with no net effect on shareholder results.

A5: Changes from previous accounting basis and reconciliation to previously published 2004 results on first-time adoption of IFRS continued

Reconciliations of equity and balance sheet

This table reconciles IFRS shareholders' equity at 1 January 2004, the IFRS transition date, from that previously published under UK GAAP.

At 1 January 2004	Shareholders' equity £m	Minority interests £m	Total equity £m
Changes on adoption of statutory IFRS basis			
Treasury shares adjustment for Prudential plc shares held by unit trusts newly consolidated under IFRS (note i)	(40)		(40)
Minority share of equity of consolidated venture investments companies and property partnerships of the PAC with-profits fund (note i)		32	32
Shareholders' share of deficits (net of tax) of UK defined benefit pension schemes (note ii)	(110)		(110)
Timing difference on recognition of dividend declared after balance sheet date (note iii)	214		214
Other items	(11)	(2)	(13)
Total	53	30	83
Equity at 1 January 2004			
As previously published under UK GAAP	3,240	107	3,347
As restated under IFRS	3,293	137	3,430

A5: Changes from previous accounting basis and reconciliation to previously published 2004 results on first-time adoption of IFRS continued

The following table provides a reconciliation of the summarised balance sheet at 31 December 2004 between previously published UK GAAP and the IFRS balance sheet included in the comparatives to the 2005 financial statements.

At 31 December 2004	UK GAAP £m	Effect of changes on implementation of IFRS recognition and measurement changes: Newly consolidated entities (note i) £m	Defined benefit pension schemes accounting (note ii) £m	Other recognition and measurement changes (note iii) £m	Grossing-up and other format changes £m	Total IFRS changes £m	**IFRS basis £m**
Assets							
Goodwill:							
Attributable to PAC with-profits fund		784				784	**784**
Attributable to shareholders	1,367			94		94	**1,461**
Investments: per IFRS balance sheet		1,963		35	162,388	164,386	**164,386**
Investments: per UK GAAP analysis (non-linked, linked and banking business assets)	129,468				(129,468)	(129,468)	**0**
Other items	43,741	1,477	102	50	(31,995)	(30,366)	**13,375**
Total assets	174,576	4,224	102	179	925	5,430	**180,006**
Equity and liabilities							
Equity							
Shareholders' equity	4,281	(30)	(117)	355		208	**4,489**
Minority interests	71	68		(2)		66	**137**
Total equity	4,352	38	(117)	353		274	**4,626**
Liabilities							
Banking customer accounts: per IFRS balance sheet					6,607	6,607	**6,607**
Banking business liabilities: per UK GAAP balance sheet	11,216				(11,216)	(11,216)	**0**
Policyholder liabilities and unallocated surplus of with-profits funds:							
Technical provisions	129,101		(125)	8	78	(39)	**129,062**
Unallocated surplus of with-profits funds	16,686	(31)	(472)	(34)		(537)	**16,149**
Borrowings: per IFRS balance sheet:							
Core structural borrowings of shareholder-financed operations					3,248	3,248	**3,248**
Operational borrowings attributable to shareholder-financed operations		972		9	5,440	6,421	**6,421**
Borrowings attributable to with-profits funds		1,888		105	144	2,137	**2,137**
Borrowings: per UK GAAP balance sheet (subordinated liabilities, debenture loans and other borrowings)	4,673				(4,673)	(4,673)	**0**
Dividend payable	253			(253)		(253)	**0**
Other non-insurance liabilities	8,295	1,357	816	(9)	1,297	3,461	**11,756**
Total liabilities	170,224	4,186	219	(174)	925	5,156	**175,380**
Total equity and liabilities	174,576	4,224	102	179	925	5,430	**180,006**

Notes

(i) Newly consolidated entities
Under IAS 27 and SIC 12, the Group is required to consolidate the assets and liabilities of certain entities which have previously not been consolidated. The principal change to shareholders' equity arises from an adjustment in respect of Prudential plc shares held by unit trusts that are newly consolidated. These shares are accounted for as treasury shares and the cost of purchase of £44 million and £29 million is deducted from shareholders' equity at 1 January 2004 and 31 December 2004 respectively. The change to the minority share of equity reflects external parties' interest in consolidated venture investment companies and property partnerships of the PAC with-profits fund. Measurement changes to the carrying value of these companies that are attributable to the PAC with-profits fund share are reflected in unallocated surplus.

(ii) Defined benefit pension schemes accounting
Provisions for deficits on the Group's defined benefit pension schemes are absorbed by the unallocated surplus of the PAC with-profits fund and shareholders' funds on a basis that reflects the weighted cumulative activity attaching to the contributions paid in the past, and after deduction of deferred tax. The M&G scheme held Prudential Group insurance policies as scheme assets amounting to £125 million at 31 December 2004. The asset and liability are eliminated on consolidation.

(iii) Other recognition and measurement changes
Under IFRS, dividends declared after the balance sheet date are not recognised as a liability. In addition, subject to required impairment testing, goodwill under IFRS is the carrying value at adoption date as discussed above. Adjustments in the table include the write-back of amortisation previously charged under UK GAAP from 1 January 2004.

Cash flow

Under IFRS, the cash flow statement includes a number of format and presentational differences to that under UK GAAP. The most significant difference relates to long-term business fund cash flows.

Previously, under UK GAAP, the Group's cash flow statement excluded the cash flows of long-term business funds, except for the transfer to shareholders' funds. Under IFRS the cash flow statement comprises consolidated cash flows for the Group as a whole, including those of long-term business funds.

A6: Changes of accounting policy in 2005

The accounting policy changes from those applied previously for UK GAAP consist of those described in note A5 and the additional changes described in this note.

Adoption of IAS 32, IAS 39 and IFRS 4

As previously noted, the Group has chosen to apply the exemption within IFRS that allows comparative information presented in the first year of adoption of IFRS not to comply with IAS 32, IAS 39 and IFRS 4. These standards have been formally adopted on 1 January 2005. The principal effects of adopting these standards arises in the Group's UK long-term business contracts, JNL's debt securities and derivative instruments, and Egg's banking assets, liabilities and derivatives positions.

Long-term business

On adoption of these standards, the measurement basis of assets and liabilities of long-term business contracts is dependent upon the classification of the contracts under IFRS 4 as either 'insurance' contracts, if the level of insurance risk in the contracts is significant, or 'investment' contracts, if the risk is insignificant. Insurance contracts are permitted to be accounted for under previously applied GAAP. The Group has chosen to apply this approach. However, as an improvement to accounting policy, permitted by IFRS 4, the Group has applied the requirements of the UK standard FRS 27 to its UK with-profits funds as explained in note A4. For those 'investment' contracts with discretionary participation features, IFRS 4 also permits the continued application of previously applied GAAP. The Group has chosen to apply this approach.

For those 'investment' contracts that do not contain discretionary participating features, IAS 39 and, where the contract includes an investment management element, IAS 18, apply measurement principles to the assets and liabilities attaching to the contract that may diverge from those previously applied under UK GAAP. The changes primarily arise in respect of deferred acquisition costs, deferred income reserves and provisions for future expenses commonly called 'sterling reserves'.

Under UK GAAP, acquisition expenses are deferred with amortisation on a basis commensurate with the anticipated emergence of margins under the contract. Under IFRS, incremental costs that are directly attributable to securing investment management contracts are recognised as an asset that represents the entity's contractual right to benefit from providing investment management services and is amortised as the entity recognises the related revenue. IAS 18 further reduces the costs potentially capable of deferral to incremental costs only. Deferred acquisition costs are amortised to the income statement in line with service provision.

Deferred income provisions for front-end fees and similar arrangements are required to be established for investment management contracts under IAS 18 with amortisation over the expected life of the contract in line with service provision. In contrast to UK GAAP, sterling reserves are not permitted to be recognised under IFRS. An additional feature is that investment contracts are closer in nature to a deposit style arrangement between the investors and the Company. Under IFRS, premiums and withdrawals for these contracts are recorded within the balance sheet directly as a movement on the investors liability. After making these and other consequential changes, the IFRS income statement reflects fee income on the contracts, expenses and taxation rather than the UK GAAP basis profit and loss account.

The investment contract classification applies primarily to certain unit-linked and similar contracts in the UK insurance operations and guaranteed investment contracts (GICs) of JNL. Significant differences between the timing of recognising profits under UK GAAP and IFRS bases are confined to the UK contracts only.

JNL debt securities and derivative instruments

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 all derivatives, are measured at fair value. To this extent IAS 39 is consistent with the basis of valuation applied under UK GAAP for most financial assets of the Group's UK and Asian insurance operations. On application of IAS 39, movements in the fair value of investments are recorded either in the income statement or directly in equity, depending upon the designation and the application of hedge accounting rules. Derivative instruments are carried at fair value with value movements being recorded in the income statement. Hedge accounting, whereby value movements on derivatives and hedged items are recorded together in the income statement, is permissible only if certain criteria are met regarding documentation and continued measurement of hedge effectiveness.

The changes from UK GAAP to the basis applied from 1 January 2005 arising from these valuation requirements are concentrated on the accounting for the investments and derivatives of JNL. Previously, the debt securities of JNL, unless impaired, were accounted for at amortised cost with derivatives similarly treated. On adoption of IAS 39, the Group has decided to account for JNL's debt securities on an available-for-sale basis whereby the debt securities are accounted for at fair value with movements in fair value being recorded in the statement of changes in equity i.e. directly to shareholders' reserves rather than the income statement. Value movements for JNL's derivatives are, however, recorded in the income statement as required by IAS 39.

The Group has decided not to seek to hedge account for the majority of JNL's derivatives under IAS 39. To do so would require a wholesale reconfiguration of JNL's derivative book into much smaller components than currently applied by JNL through its economic hedge programme, accompanied by an extra layer of hedging instruments beyond what is economically rational.

A6: Changes of accounting policy in 2005 continued

Egg

The changes of policy for Egg arising from the adoption of IAS 39 arise primarily in respect of determination of effective interest rates, impairment losses on loans and advances to customers, carrying values of wholesale financial instruments and equity savings products.

For credit card receivables, under UK GAAP, the carrying amount of credit card receivables with low or zero rate interest on balance transfers are carried at cost with interest being accrued at 0 per cent during the incentive period and then at the standard rate thereafter. Under IAS 39, these receivables are measured on an amortised cost basis.

For loans and advances to customers, specific and formulated provisions are raised against non-performing loans and a general provision against the balance. Under IAS 39, an impairment loss is only recognised when there is objective evidence that a debt is impaired.

Wholesale instruments, under UK GAAP, were previously accounted for on an amortised cost basis. Under IAS 39, certain wholesale financial instruments are required to be measured at fair value, and depending on whether they have been classified as fair value through the profit and loss or available-for-sale, the changes in fair value are recognised in the income statement or in equity respectively. The adjustments for wholesale financial instruments also include the impact of designating some of Egg's derivatives as cash flow hedges.

Certain equity savings products contain embedded derivatives. These contracts have been separated under IFRS with the host contract accounted for on an amortised cost basis and the embedded derivatives on a fair value basis.

The following table demonstrates the effects of adoption of IAS 32, IAS 39 and IFRS 4 on the IFRS balance sheet at 31 December 2004.

		Effect of adoption of IAS 32, IAS 39 and IFRS 4					
	At 31 Dec 2004 (note A5) £m	UK insurance operations (note i) £m	JNL (note ii) £m	Banking and non-insurance operations (note iii) £m	Grossing-up and other format changes £m	Total effect £m	**At 1 Jan 2005 £m**
Assets							
Goodwill	2,245						**2,245**
Other intangibles:							
PAC with-profits fund	798	(765)				(765)	**33**
Other operations	2,244	23	(456)			(433)	**1,811**
Total	3,042	(742)	(456)			(1,198)	**1,844**
Other non-investment and non-cash assets:							
Property, plant and equipment	967						**967**
Reinsurers' share of policyholder liabilities	1,018						**1,018**
Deferred tax assets	827	10	67	7		84	**911**
Current tax recoverable	159						**159**
Accrued investment income	1,733			(50)		(50)	**1,683**
Other debtors	1,188		(1)	(49)		(50)	**1,138**
Total	5,892	10	66	(92)		(16)	**5,876**
Investments of long-term business, banking and other operations:							
Investment properties	13,303						**13,303**
Investments accounted for using the equity method	5						**5**
Financial investments:							
Loans and receivables	12,430	(55)		58		3	**12,433**
Equity securities and portfolio holdings in unit trusts	54,466	(21)				(21)	**54,445**
Debt securities	76,374	(76)	1,023	(2)		945	**77,319**
Other investments	2,537	1	234	89	95	419	**2,956**
Deposits	5,271	6	5		(27)	(16)	**5,255**
Total investments	164,386	(145)	1,262	145	68	1,330	**165,716**
Held for sale assets	100					0	**100**
Cash and cash equivalents	4,341					0	**4,341**
Total assets	180,006	(877)	872	53	68	116	**180,122**

A6: Changes of accounting policy in 2005 continued

	At 31 Dec 2004 (note A5) £m	Effect of adoption of IAS 32, IAS 39 and IFRS 4: UK insurance operations (note i) £m	JNL (note ii) £m	Banking and non-insurance operations (note iii) £m	Grossing-up and other format changes £m	Total effect £m	**At 1 Jan 2005 £m**
Equity and liabilities							
Equity							
Shareholders' equity	4,489	(22)	273	(25)		226	**4,715**
Minority interests	137			(3)		(3)	**134**
Total equity	4,626	(22)	273	(28)		223	**4,849**
Liabilities							
Banking customer accounts	6,607			84		84	**6,691**
Policyholder liabilities and unallocated surplus:							
Insurance contract liabilities					103,582	103,582	**103,582**
Investment contract liabilities with discretionary participation features					22,661	22,661	**22,661**
Unallocated surplus of the with-profits funds:							
Reflecting application of 'realistic' basis provisions for UK regulated with-profits funds					8,342	8,342	**8,342**
Reflecting previous UK GAAP basis of provisioning	16,149	(7,807)			(8,342)	(16,149)	
Investment contract liabilities without discretionary participation features					9,788	9,788	**9,788**
Technical provisions in respect of non-linked business	104,996	7,020	(51)		(111,965)	(104,996)	
Technical provisions for linked liabilities	24,066				(24,066)	(24,066)	
Total policyholder liabilities	145,211	(787)	(51)		0	(838)	**144,373**
Core structural borrowings of shareholder-financed operations:							
Subordinated debt (other than Egg)	1,429				5	5	**1,434**
Other	1,368						**1,368**
	2,797				5	5	**2,802**
Egg subordinated debt	451						**451**
Total	3,248				5	5	**3,253**
Operational borrowings attributable to shareholder-financed operations	6,421		207	62	(13)	256	**6,677**
Borrowings attributable to with-profits funds	2,137						**2,137**
Other non-insurance liabilities:							
Obligations under funding, securities lending and sale and repurchase agreements	3,819						**3,819**
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	808						**808**
Current tax liabilities	1,018		(4)			(4)	**1,014**
Deferred tax liabilities	2,279	(91)	218	(6)		121	**2,400**
Accruals and deferred income	655			(88)		(88)	**567**
Other creditors	996	8		(54)		(46)	**950**
Provisions	1,006						**1,006**
Other liabilities	1,175	15	229	83	76	403	**1,578**
Total other non-insurance liabilities	11,756	(68)	443	(65)	76	386	**12,142**
Total liabilities	175,380	(855)	599	81	68	(107)	**175,273**
Total equity and liabilities	180,006	(877)	872	53	68	116	**180,122**

Notes
The changes shown above include the impact of remeasurement for:
(i) UK insurance operations
(a) The reduction in shareholders' equity of £22 million includes £20 million relating to certain unit-linked and similar contracts that do not contain significant insurance risk and are therefore categorised as investment contracts under IFRS 4.

A6: Changes of accounting policy in 2005 continued

(b) Changes to insurance assets and liabilities of the PAC with-profits fund following the improvement of accounting policy applied on adoption of IFRS 4. The changes correspond to those applicable if the Group had adopted FRS 27 under UK GAAP. As a result of the policy improvement, liabilities, deferred acquisition costs, deferred tax and unallocated surplus of UK regulated with-profits funds are remeasured as described in note A4. At 1 January 2005, the unallocated surplus is subject to a transition adjustment of £(7.8) billion. Shareholders' equity is not affected by this change.

The unallocated surplus of £8.3 billion at 1 January 2005 post IAS 39 and IFRS 4 adoption, comprises £8.0 billion for the PAC with-profits fund and £0.3 billion for Asian subsidiaries. The £8.0 billion for the PAC with-profits fund represents:

	£bn
Regulatory basis realistic surplus of with-profits sub-fund and SAIF	6.0
Add back: regulatory basis provision for future shareholder transfers	2.9
Less: other adjustments to align with accounting basis	(0.9)
Accounts basis	8.0

(ii) Jackson National Life
Under IAS 39, JNL's debt securities and derivative financial instruments are remeasured to fair value from the lower of amortised cost and, if relevant, impaired value. Fair value movements on debt securities, net of 'shadow' changes to deferred acquisition costs and related deferred tax are recorded directly to equity. Fair value movements on derivatives are recorded in the income statement.

(iii) Banking and non-insurance operations
Under IAS 39, for Egg, changes to opening equity at 1 January 2005 arise from altered policies for effective interest rate on credit card receivables, impairment losses on loans and advances, fair value adjustments on wholesale financial instruments and embedded derivatives in equity savings products. The net effect on shareholders' equity of these changes, after tax, is a deduction of £15 million. A further £10 million reduction in equity arises on fair valuation of certain centrally held financial instruments and derivatives.

Supplemental earnings information and discretionary non-IFRS change of policy for longer-term investment returns

As indicated above, under UK GAAP, the Group used operating profit based on longer-term investment returns before amortisation of goodwill as a supplemental measure of its results. For the purposes of measuring operating profit, investment returns on shareholder-financed business were based on the expected longer-term rates of return. For debt securities, the longer-term returns (including losses arising on the recognition of permanent diminutions in value) were averaged over five years for inclusion in operating profit.

Under IFRS, the Group continues to use operating profit based on longer-term investment returns as a supplemental measure of its results, as explained in notes A3 and A4. For the purposes of measuring operating profit based on longer-term investment returns, investment returns on shareholder-financed business continue to be based on the expected longer-term rate of return. However, for debt securities, the five year averaging approach previously applied under UK GAAP has been replaced with a basis that more closely reflects longer-term experience. The amounts included in operating results for longer-term capital returns comprises two components. These are a risk margin reserve based charge for expected defaults, which is determined by reference to the credit quality of the portfolio, and amortisation of interest-related realised gains and losses to operating results based on longer-term investment returns to the date when sold bonds would have otherwise matured. This change has been applied following a comprehensive review of the Group's accounting policies and is unrelated to the requirements of IFRS. The change is of most importance to the determination of the operating results based on longer-term investment returns of JNL. Total profits are unaffected by the change of basis in determining longer-term investment returns.

Items excluded from operating profit, but included in total pre-tax profit of continuing operations, include goodwill impairment charges, short-term fluctuations in investment returns (i.e. actual less longer-term returns), actuarial gains and losses on defined benefit pension schemes and exceptional items. For the purposes of distinguishing actuarial gains and losses on defined benefit pension schemes in this analysis, plan assets include Prudential policies held by the scheme. Total profits are unaffected by the change of basis of determining longer-term investment returns.

The supplemental earnings information in the statutory basis financial statements is presented in note B1. The 2004 and 2005 analyses are not comparable because the comparative 2004 results do not incorporate the effects of adoption of IAS 32, IAS 39 and IFRS 4 and are thus inconsistent with the basis of preparation for the 2005 results. A comparison of supplemental earnings information based on the IFRS basis results for 2005 and pro forma IFRS results for 2004, which reflect the estimated effects of adoption of these three standards on the 2004 results of the Group's insurance operations, is included in the supplementary IFRS results within the Group's annual report.

A7: New accounting pronouncements

The following standards, interpretations and amendments have been issued but are not yet effective. This is not intended to be a complete list as only those standards, interpretations and amendments that are anticipated to have a future impact upon Prudential's financial statements have been discussed.

IFRS 7, 'Financial Instruments: Disclosures'

IFRS 7 replaces IAS 30, 'Disclosures in the Financial Statements of Banks and Similar Financial Institutions', which dealt with disclosures for banking operations, and the disclosure requirements of IAS 32, 'Financial Instruments: Disclosure and Presentation'. The latter therefore becomes a standard dealing wholly with presentation of financial instruments. IFRS 7 is intended to complement the principles for recognising, measuring and presenting financial assets and financial liabilities in IAS 32 and IAS 39, 'Financial Instruments: Recognition and Measurement'. The objective of IFRS 7 is to require entities to provide disclosures in their financial statements to enable the users of financial statements to evaluate the significance of financial instruments for the entity's financial position and performance and the nature and extent of risks arising from financial instruments to which the entity is exposed, and how the entity manages those risks. Consequential amendments have been made to other standards as a result of the release of IFRS 7, notably IAS 1, 'Presentation of Financial Statements' and IFRS 4, 'Insurance Contracts'.

IFRS 7 was issued on 18 August 2005 and is effective for annual periods beginning on or after 1 January 2007.

Revised IFRS 4, 'Implementation Guidance'

Revised IFRS 4 'Implementation Guidance' was issued in December 2005 and is effective in conjunction with the adoption of IFRS 7 as discussed above. The revisions relate to disclosures around insurance contracts.

Amendment to IAS 1, 'Capital Disclosures'

As a result of the issue of IFRS 7, IAS 1 was amended in August 2005 to include a requirement to disclose information on the entity's objectives, policies and processes for managing capital. This amendment will become effective for annual periods beginning on or after 1 January 2007.

Amendment to IAS 39, 'Cash Flow Hedge Accounting of Forecast Intra-group Transactions'

Amendments in respect of cash flow hedge accounting of forecast intra-group transactions were issued in April 2005 to clarify the accounting treatment of certain foreign currency cash flow hedges. The amendments are effective for annual periods beginning on or after 1 January 2006.

Amendment to IAS 39 and IFRS 4, 'Financial Guarantee Contracts'

Issued in August 2005, the amendments to IAS 39 and IFRS 4 in respect of financial guarantee contracts are effective for annual periods beginning on or after 1 January 2006. These amendments define a financial guarantee contract and address initial and subsequent measurement issues. These amendments apply even if the contract meets the definition of an insurance contract under IFRS 4 although they allow continuation of accounting under IFRS 4 if the contracts were considered to be insurance contracts and documented as such.

The Group is currently assessing the impact of the aforementioned standards, revisions and amendments on its financial statements. The Group has not early-adopted any of the above noted items.

B: Summary of results

B1: Supplementary analysis of profit before tax attributable to shareholders

This information is provided as supplementary information under the Group's accounting policies. It is not required by IFRS standards.

	2005 £m	2004 (note i) £m
UK operations		
UK insurance operations (note iii)	**400**	305
M&G	**163**	136
Egg	**44**	61
Total	**607**	502
US operations		
Jackson National Life (note iii)	**348**	296
Broker-dealer and fund management (including Curian losses of £10m (2004: £29m))	**14**	(14)
Total	**362**	282
Asian operations		
Long-term business (note iii)	**195**	117
Fund management (note iv)	**12**	19
Development expenses	**(20)**	(15)
Total	**187**	121
Other income and expenditure		
Investment return and other income	**87**	44
Interest payable on core structural borrowings	**(175)**	(154)
Corporate expenditure:		
Group Head Office	**(70)**	(51)
Asia Regional Head Office	**(30)**	(29)
Charge for share-based payments for Prudential schemes	**(11)**	(7)
Total	**(199)**	(197)
Operating profit from continuing operations based on longer-term investment returns (note ii)	**957**	708
Goodwill impairment charge (note v)	**(120)**	–
Short-term fluctuations in investment returns on shareholder-backed business (note vi)	**211**	149
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes (note vii)	**(50)**	(7)
Profit from continuing operations before tax attributable to shareholders	**998**	850

Notes

(i) Basis of preparation
Except in respect of three IFRS standards the 2005 and 2004 results in the table above have been prepared consistently. However, as permitted by the IFRS transition rules, and consistent with the approach of groups with significant banking operations where retrospective application is complex and onerous, the results include the effects of the adoption of the standards IAS 32, IAS 39 and IFRS 4 from 1 January 2005 rather than 1 January 2004. The 2004 comparative results are therefore prepared on an inconsistent basis from those for 2005. Pro forma basis comparative results for 2004, as if these standards had been applied by the Group's insurance operations from 1 January 2004, are provided as supplementary information to this report. The pro forma results for 2004 are not audited and do not form part of these financial statements either directly or by cross reference. The principal area of inconsistency between the bases of measurement applied in 2004 and 2005 as it affects profits is related to the valuation of derivatives of Jackson National Life (JNL). The value movements on these derivatives are recorded in the income statement for 2005. In the analysis shown above, the movements are included in short-term fluctuations in investment returns (see note (vi) below). For 2004, the derivatives were recorded at amortised cost so value movements do not feature. Other smaller valuation differences for investment contracts measured under IAS 39 also slightly affect the comparison of operating profits.

(ii) Operating profit based on longer-term investment returns
Operating profit based on longer-term investment returns is a supplemental measure of results. For the purposes of measuring operating profit, investment returns on shareholder-financed business are based on expected long-term rates of return. The expected long-term rates of return are intended to reflect historical real rates of return and, where appropriate, current inflation expectations adjusted for consensus economic and investment forecasts. The significant operations that require adjustment for the difference between actual and long-term investment returns are JNL and certain businesses of the Group's Asian operations. The amounts included in operating results for long-term capital returns for debt securities comprise two components. These are a risk margin reserve based charge for expected defaults, which is determined by reference to the credit quality of the portfolio, and amortisation of interest-related gains and losses for operating results based on longer-term results to the date when sold bonds would otherwise have matured.

(iii) Effect of changes to assumptions and bases of determining life assurance liabilities
The results of the Group's long-term business operations are affected by changes of assumptions and bases of preparation. These are described in notes D2(f), D3(f) and D4(f).

(iv) Asian fund management business
Operating profit for the Asian fund management business was £12 million for 2005. The decrease from the results for 2004 reflects the exceptional cost of £16 million incurred in Taiwan due to bond fund restructuring required as a result of industry-wide regulatory change.

(v) Goodwill impairment charge
The charge for goodwill impairment of £120 million relates to the Japan life business. Further details of the Group's goodwill are shown in note H1.

(vi) Short-term fluctuations in investment returns on shareholder-backed business
The fluctuations arise as follows:

	2005 £m	2004 £m
US operations:		
Movements in market value of derivatives used for economic hedging purposes (2004 not applicable as described in note (i) above)	**122**	–
Actual less longer-term investment returns for other items	**56**	61
Asian operations	**32**	37
Other operations (including £6m (2004: nil) on sale of partial stake in Indian subsidiary – see note H8)	**1**	51
	211	149

B1: Supplementary analysis of profit before tax attributable to shareholders continued

Notes continued

(vii) Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes

	2005 £m	2004 £m
Actuarial losses		
Actual less expected returns on scheme assets	**544**	115
Experience gains (losses) on liabilities	**1**	(17)
Losses on changes of assumptions for plan liabilities (based on long-term inflation of 2.8%)	**(489)**	(141)
	56	(43)
Less: amount attributable to the PAC with-profits fund	**(58)**	36
	(2)	(7)
Non-recurrent credit (charge)		
Shareholders' share of credit arising from reduction in level of assumed future discretionary increases for Prudential Staff Pension Scheme (PSPS) for pensions in payment to 2.5%	**35**	–
Losses on re-estimation of shareholders' share of deficits arising from the PSPS (a)	**(63)**	–
Strengthening in actuarial provisions for increase in ongoing contributions for future service of active scheme members (b)	**(20)**	–
	(48)	–
Total	**(50)**	(7)

(a) Up to 31 December 2004, the deficits arising on the PSPS had been assessed as being 80 per cent attributable to the PAC with-profits fund and 20 per cent to shareholder operations. In 2005, following additional analysis this apportionment has been altered to a ratio of 70/30.

(b) As a result of the April 2005 scheme valuation and subsequent discussions, the contribution levels for future ongoing service of active members will approximately double. The charge of £20 million reflects the actuarial provision for this increase in expenses for certain insurance contracts.

Further details on the Group's defined benefit pension schemes are shown in note I1.

B2: Earnings per share

Basic earnings per share is calculated by dividing the earnings attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the year, excluding those held in employee share trusts, which are treated as cancelled.

For diluted earnings per share, the weighted average number of shares in issue is adjusted to assume conversion of all dilutive potential ordinary shares. The Group's only class of dilutive potential ordinary shares are those share options granted to employees where the exercise price is less than the average market price of the Company's ordinary shares during the year.

2005	**Before tax (note B1) £m**	**Tax (note F5) £m**	**Minority interests £m**	**Net of tax and minority interests £m**	**Basic earnings per share Pence**	**Diluted earnings per share Pence**
Based on operating profit based on longer-term investment returns	**957**	**(186)**	**(10)**	**761**	**32.2p**	**32.2p**
Adjustments arising from:						
Goodwill impairment charge	**(120)**	**–**	**–**	**(120)**	**(5.1)p**	**(5.1)p**
Short-term fluctuations in investment returns on shareholder-backed business	**211**	**(70)**	**(2)**	**139**	**5.9p**	**5.9p**
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	**(50)**	**15**	**0**	**(35)**	**(1.5)p**	**(1.5)p**
Based on profit for the year from continuing operations	**998**	**(241)**	**(12)**	**745**	**31.5p**	**31.5p**
Adjustment for post-tax results of discontinued operations	**3**	**0**	**0**	**3**	**0.1p**	**0.1p**
Based on profit for the year	**1,001**	**(241)**	**(12)**	**748**	**31.6p**	**31.6p**

2004	Before tax (note B1) £m	Tax (note F5) £m	Minority interests £m	Net of tax and minority interests £m	Basic earnings per share Pence	Diluted earnings per share Pence
Based on operating profit based on longer-term investment returns	708	(210)	(8)	490	23.1p	23.1p
Adjustments arising from:						
Short-term fluctuations in investment returns on shareholder-backed business	149	(32)	(18)	99	4.6p	4.6p
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	(7)	2	0	(5)	(0.2)p	(0.2)p
Based on profit for the year from continuing operations	850	(240)	(26)	584	27.5p	27.5p
Adjustment for post-tax results and profits on business disposals of discontinued operations	(108)	14	27	(67)	(3.1)p	(3.1)p
Based on profit for the year	742	(226)	1	517	24.4p	24.4p

B2: Earnings per share continued

Number of shares

A reconciliation of the weighted average number of ordinary shares used for calculating basic and diluted earnings per share is set out as below:

	2005 (millions)	2004 (millions)
Weighted average shares for calculation of basic earnings per share	**2,365**	2,121
Shares under option at end of year	**13**	13
Number of shares that would have been issued at fair value on assumed option exercise	**(9)**	(10)
Weighted average shares for calculation of diluted earnings per share	**2,369**	2,124

B3: Dividends

	2005 £m	2004 £m
Dividends declared and paid in reporting period		
Parent company:		
Interim dividend (2005: 5.30p, 2004: 5.19p per share)	**126**	109
Final dividend for prior period (2004: 10.65p, 2003: 10.29p per share)	**252**	214
Subsidiary company payment to minority interests	**2**	–
Total	**380**	323
Parent company dividends relating to reporting period:		
Interim dividend (2005: 5.30p, 2004: 5.19p per share)	**126**	109
Final dividend (2005: 11.02p, 2004: 10.65p per share)	**267**	252
Total	**393**	361

A final dividend of 11.02 pence per share was proposed on 15 March 2006. The dividend will be paid on 26 May 2006 to shareholders on the register at the close of business on 24 March 2006. The dividend will absorb an estimated £267 million of shareholders' funds. A scrip dividend alternative will be offered to shareholders.

B4: New business

Insurance products and investment products*

	Insurance products gross premiums		Investment products gross inflows		Total	
	2005 £m	2004 £m	2005 £m	2004 £m	2005 £m	2004 £m
UK operations	**7,276**	6,538	**7,916**	5,845	**15,192**	12,383
US operations	**5,023**	4,420	**414**	418	**5,437**	4,838
Asian operations	**1,485**	1,172	**18,457**	19,068	**19,942**	20,240
Group total	**13,784**	12,130	**26,787**	25,331	**40,571**	37,461

*The format of the tables shown above is consistent with the distinction between insurance and investment products as applied for previous financial reporting periods. With the exception of some US institutional business, products categorised as 'insurance' refer to those classified as contracts of long-term insurance business for regulatory reporting purposes, i.e. falling within one of the classes of insurance specified in part II of Schedule 1 to the Regulated Activities Order under FSA regulations.

B4: New business continued

Insurance products – new business premiums and contributions*

	Single		Regular		Annual premium equivalents	
	2005 £m	2004 £m	**2005 £m**	2004 £m	**2005 £m**	2004 £m
UK insurance operations						
Direct to customer						
Individual annuities	**720**	630	**–**	–	**72**	63
Individual pensions and life	**29**	19	**11**	10	**14**	12
Department of Work and Pensions rebate business	**244**	265	**–**	–	**24**	27
Total	**993**	914	**11**	10	**110**	102
Business to business						
Corporate pensions	**242**	153	**146**	137	**170**	152
Individual annuities	**212**	229	**–**	–	**21**	23
Bulk annuities	**511**	474	**–**	–	**51**	47
Total	**965**	856	**146**	137	**242**	222
Intermediated distribution						
Life	**1,112**	1,001	**6**	5	**118**	105
Individual annuities	**995**	1,180	**–**	–	**100**	118
Individual and corporate pensions	**108**	189	**25**	25	**36**	44
Department of Work and Pensions rebate business	**83**	89	**–**	–	**8**	9
Total	**2,298**	2,459	**31**	30	**262**	276
Partnerships						
Life	**814**	790	**3**	2	**84**	81
Individual and bulk annuities	**1,814**	1,249	**–**	–	**182**	125
Total	**2,628**	2,039	**3**	2	**266**	206
Europe						
Life	**201**	89	**–**	2	**20**	11
Total UK insurance operations	**7,085**	6,357	**191**	181	**900**	817
US operations						
Fixed annuities	**788**	1,130	**–**	–	**79**	113
Fixed index annuities	**616**	429	**–**	–	**62**	43
Variable annuities	**2,605**	1,981	**–**	–	**261**	198
Life	**11**	16	**14**	12	**15**	14
Guaranteed investment contracts	**355**	180	**–**	–	**35**	18
GIC – Medium Term Notes	**634**	672	**–**	–	**63**	67
Total US operations	**5,009**	4,408	**14**	12	**515**	453
Asian operations						
China	**17**	9	**23**	16	**25**	17
Hong Kong	**289**	255	**83**	78	**112**	103
India (Group's 26% interest)	**4**	5	**57**	33	**57**	33
Indonesia	**42**	38	**42**	28	**46**	32
Japan	**30**	17	**4**	7	**7**	9
Korea	**29**	36	**132**	60	**135**	64
Malaysia	**9**	7	**66**	61	**67**	62
Singapore	**284**	199	**58**	47	**86**	67
Taiwan	**124**	88	**150**	143	**162**	151
Other	**9**	8	**33**	37	**34**	38
Total Asian operations	**837**	662	**648**	510	**731**	576
Group total	**12,931**	11,427	**853**	703	**2,146**	1,846

*The format of the tables shown above is consistent with the distinction between insurance and investment products as applied for previous financial reporting periods. With the exception of some US institutional business, products categorised as 'insurance' refer to those classified as contracts of long-term insurance business for regulatory reporting purposes, i.e. falling within one of the classes of insurance specified in part II of Schedule 1 to the Regulated Activities Order under FSA regulations.

Annual premium and contribution equivalents are calculated as the aggregate of regular new business amounts and one-tenth of single new business amounts.

B4: New business continued

Investment products – funds under management*

	1 Jan 2005 £m	Gross inflows £m	Redemptions £m	Market and other movements £m	**31 Dec 2005 £m**
UK operations	28,705	7,916	(4,054)	3,629	**36,196**
US operations	550	414	(116)	125	**973**
Asian operations	8,538	18,457	(17,130)	267	**10,132**
Group total	37,793	26,787	(21,300)	4,021	**47,301**

*The format of the tables shown above is consistent with the distinction between insurance and investment products as applied for previous financial reporting periods. With the exception of some US institutional business, products categorised as 'insurance' refer to those classified as contracts of long-term insurance business for regulatory reporting purposes, i.e. falling within one of the classes of insurance specified in part II of Schedule 1 to the Regulated Activities Order under FSA regulations.

The details shown above for insurance products include contributions for contracts that are classified under IFRS 4, 'Insurance Contracts' as not containing significant insurance risk. These products are described as investment contracts or other financial instruments under IFRS. Contracts included in this category are primarily certain unit-linked and similar contracts written in UK insurance operations, and GICs and similar funding agreements written in US operations.

UK and Asian investment products referred to in the tables above are unit trust, mutual funds and similar types of retail fund management arrangements. US investment products relate to assets under administration in Curian. These are unrelated to insurance products that are classified as 'investment contracts' under IFRS 4, as described above, although similar IFRS recognition principles apply to the acquisition costs and fees attaching to this type of business.

B5: Group balance sheet

The Group's primary reporting segments are long-term business, banking, and broker-dealer and fund management. The Group's secondary reporting segments are geographical namely UK, US, and Asia. Details of disclosures in accordance with the requirements of IAS 14 for segment assets and liabilities are shown below.

Details of the primary reporting segments are as follows:

Long-term business

This segment comprises long-term products that contain both a significant and insignificant element of insurance risk. The products are managed together and not classified in this way other than for accounting purposes. This segment also includes activity of the PAC with-profits funds' venture investments managed by PPM Capital and other investment subsidiaries held for the purpose of supporting the Group's long-term business operations.

Banking

This segment consists of products provided by the Group's online banking subsidiary, Egg. The 2004 comparatives also include amounts from Jackson Federal Bank that was sold in October 2004. The nature of these products and the managing of the business differ from the risks inherent in the other business segments, and the regulatory environment of the banking industry differs from that of the other business segments.

B5: Group balance sheet continued

Broker-dealer and fund management

The investment management segment is comprised of both internal and third-party asset management services, inclusive of portfolio and mutual fund management, where the Group acts as an advisor, and broker-dealer activities. The nature of the products and the managing of the business differ from the risks inherent in the other business segments, and the regulatory environment of the investment management industry differs from that of the other business segments.

2005	**Long-term business £m**	**Banking £m**	**Broker-dealer and fund management £m**	**Unallocated to a segment £m**	**Intra-group eliminations £m**	**Total £m**
Consolidated total assets	**192,885**	**10,752**	**3,208**	**2,768**	**(2,236)**	**207,377**
Consolidated total liabilities	**(187,603)**	**(10,374)**	**(1,597)**	**(4,673)**	**2,236**	**(202,011)**

Segment assets by geographical segment	
UK	**154,841**
US	**41,700**
Asia	**13,072**
Intra-group eliminations	**(2,236)**
Total assets per balance sheet	**207,377**

2004	Long-term business £m	Banking £m	Broker-dealer and fund management £m	Unallocated to a segment £m	Intra-group eliminations £m	Total £m
Consolidated total assets	161,907	12,048	2,834	4,688	(1,471)	180,006
Consolidated total liabilities	(157,672)	(11,708)	(1,193)	(6,278)	1,471	(175,380)

Segment assets by geographical segment	
UK	138,904
US	32,697
Asia	9,876
Intra-group eliminations	(1,471)
Total assets per balance sheet	180,006

To explain more comprehensively the assets, liabilities and capital of the Group's businesses it is appropriate to provide an analysis of the Group's balance sheet by a mixture of primary and secondary segments.

This analysis is shown below for the Group balance sheet at 31 December 2005.

B5: Group balance sheet continued

	UK insurance operations (note D2) £m	M&G £m	Egg (note E) £m	Total UK operations £m	US operations (note D3) £m	Asian operations (note D4) £m	Unallocated to a segment £m	Intra-group eliminations £m	Group total £m
Assets									
Goodwill:									
Attributable to PAC with-profits fund	607	–	–	607	–	–	–	–	607
Attributable to shareholders	–	1,153	–	1,153	16	172	–	–	1,341
Total (note H1)	607	1,153	–	1,760	16	172	–	–	1,948
Other intangible assets (primarily deferred acquisition costs):									
PAC with-profits fund	35	–	–	35	–	–	–	–	35
Other operations	199	6	–	205	1,634	566	–	–	2,405
Total (note H2)	234	6	–	240	1,634	566	–	–	2,440
Other non-investment and non-cash assets (notes G1 and H3 to H6)	4,470	256	280	5,006	1,888	566	1,059	(2,236)	6,283
Investments of long-term business, banking and other operations (note G1)	131,263	1,383	9,747	142,393	37,960	11,264	775	–	192,392
Held for sale assets (note H9)	728	–	–	728	–	–	–	–	728
Cash and cash equivalents	1,195	26	725	1,946	202	504	934	–	3,586
Total assets	**138,497**	**2,824**	**10,752**	**152,073**	**41,700**	**13,072**	**2,768**	**(2,236)**	**207,377**
Equity and liabilities									
Equity									
Shareholders' equity (note H11)	1,141	1,398	303	2,842	2,969	1,288	(1,905)	–	5,194
Minority interests	95	–	75	170	2	–	–	–	172
Total equity	1,236	1,398	378	3,012	2,971	1,288	(1,905)	–	5,366
Liabilities									
Banking customer accounts (note G1)	–	–	5,830	5,830	–	–	–	–	5,830
Policyholder liabilities and unallocated surplus of with-profits funds:									
Insurance contract liabilities (note H12)	79,231	–	–	79,231	30,479	10,726	–	–	120,436
Investment contract liabilities with discretionary participation features (note G1)	26,443	–	–	26,443	–	80	–	–	26,523
Investment contract liabilities without discretionary participation features (note G1)	10,502	–	–	10,502	1,502	22	–	–	12,026
Unallocated surplus of with-profits funds (reflecting application of 'realistic' basis provisions for UK regulated with-profits funds – see notes D2(d)(ii) and H12)	11,272	–	–	11,272	–	85	–	–	11,357
Total policyholder liabilities and unallocated surplus of with-profits funds	127,448	–	–	127,448	31,981	10,913	–	–	170,342
Core structural borrowings of shareholder-financed operations (note H13):									
Subordinated debt (other than Egg)	–	–	–	–	–	–	1,646	–	1,646
Other	–	–	–	–	145	–	948	–	1,093
	–	–	–	–	145	–	2,594	–	2,739
Egg subordinated debt (note H13)	–	–	452	452	–	–	–	–	452
Total	–	–	452	452	145	–	2,594	–	3,191
Operational borrowings attributable to shareholder-financed operations (notes G1 and H13)	17	2	3,856	3,875	1,085	–	1,472	–	6,432
Borrowings attributable to with-profits funds (notes G1 and H13)	1,898	–	–	1,898	–	–	–	–	1,898
Other non-insurance liabilities (notes G1, H4, H9 and H15)	7,898	1,424	236	9,558	5,518	871	607	(2,236)	14,318
Total liabilities	137,261	1,426	10,374	149,061	38,729	11,784	4,673	(2,236)	202,011
Total equity and liabilities	**138,497**	**2,824**	**10,752**	**152,073**	**41,700**	**13,072**	**2,768**	**(2,236)**	**207,377**

C: Group risk management

(i) Overview

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 Risk Framework requires that all of the Group's businesses and functions establish processes for identifying, evaluating and managing the key risks faced by the Group. During the year, the risk management of the Group was given additional focus by the establishment of a newly created role of Group Chief Risk Officer (CRO). The CRO oversees all aspects of the Group's risk management, including Financial Risk, Operational Risk, Compliance, and for management purposes, Internal Audit. Additional information on the the Group's risk framework, including the Group and business unit level risk committees, is included in the corporate governance section of the Group's Annual Report.

As a provider of financial services, including insurance, the Group's business is the managed acceptance of risk. The system of internal control is an essential and integral part of the risk management process. As part of the annual preparation of its business plan, all of the Group's businesses and functions are required to carry out a review of risks. This involves an assessment of the impact and likelihood of key risks and of the effectiveness of the controls in place to manage them. The assessment is reviewed regularly throughout the year. In addition, business units review opportunities and risks to business objectives regularly with the Group Chief Executive, Group Finance Director and the Group Chief Risk Officer.

Businesses are required to confirm annually that they have undertaken risk management during the year as required by the Group Risk Framework and that they have reviewed the effectiveness of the system of internal control. The results of this review were reported to and reviewed by the Audit Committee, and confirmed that the processes described above and required by the Group Risk Framework were in place throughout the period covered by this report, and complied with Internal Control: Guidance on the Combined Code (the Turnbull guidance). In addition, Internal Audit executes a comprehensive risk-based audit plan throughout the Group, from which all significant issues are reported to the Group Audit Committee.

The Group's internal control framework includes detailed procedures laid down in financial and actuarial procedure manuals. The Group prepares an annual business plan with three-year projections. Executive management and the Board receive monthly reports on the Group's actual performance against plan, together with updated forecasts.

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

(ii) Major risks

The Group publishes separately within its Group Annual Report a section on key risk factors, which discuss inherent risks in the business and trading environment.

(iii) Financial risks

(a) Foreign exchange risk

Prudential faces foreign exchange risk, primarily because its presentation currency is pounds sterling, whereas approximately 55 per cent of Prudential's operating profit from continuing operations based on longer-term investment returns, as described in note B1, for the year ended 31 December 2005 came from Prudential's US and Asian operations. The exposure relating to the translation of reported earnings is not separately managed although its impact is reduced by interest payments on foreign currency borrowings and by the adoption of average exchange rates for the translation of foreign currency revenues.

Approximately 82 per cent of the Group's IFRS basis shareholders' funds at 31 December 2005 arose in Prudential's US and Asian operations. To mitigate the exposure of the US component there are US$1.55 billion of borrowings held centrally. The Group also has entered into a US$2 billion net investment hedge (see note G3). Net of the currency position arising from these instruments some 46 per cent of the Group's shareholders' funds is represented by net assets in currencies other than sterling.

(b) Liquidity risk

Liquidity risk is the risk that Prudential may be unable to meet payment of obligations in a timely manner at a reasonable cost or the risk of unexpected increases in the cost of funding the portfolio at appropriate maturities or rates. Liquidity management in each business seeks to ensure that, even under adverse conditions, Prudential has access to the funds necessary to cover surrenders, withdrawals and maturing liabilities.

In practice, most of Prudential's invested assets are marketable securities. This, combined with the fact that a large proportion of the liabilities contain discretionary surrender values or surrenders charges, reduces the liquidity risk. The Group maintains committed borrowing and securities lending facilities.

C: Group risk management continued

(c) Credit risk

Credit risk is the risk that a counterparty or an issuer of securities, which Prudential holds in its asset portfolio, defaults or another party fails to perform according to the terms of the contract. Some of Prudential's businesses, in particular JNL, Egg, the PAC with-profits fund and Prudential's UK pension annuity business, hold large amounts of interest-sensitive investments that contain credit risk on which a certain level of defaults is expected. These expected losses are considered when Prudential determines the crediting rates, deposit rates and premium rates for the products that will be supported by these assets. The key shareholder businesses exposed to credit risks are JNL and Egg. Certain over-the-counter derivatives contain a credit risk element that is controlled through evaluation of collateral agreements and master netting agreements on interest rate and currency swaps. Prudential is also exposed to credit-related losses in the event of non-performance by counterparties.

Further analysis of the credit risks for JNL is shown in note D3 and for Egg in note E7.

(iv) Operational, compliance and fiscal risk

Operational risk can result from a variety of factors, including failure to obtain proper internal authorisations or maintain internal controls, failure to document transactions properly, failure of operational and information security procedures or other procedural failures, computer system or software failures, other equipment failures, fraud, inadequate training or errors by employees. Compliance with internal rules and procedures designed to manage these risks is monitored by Prudential's local management boards.

Internal compliance managers who report to the local management boards monitor adherence to local regulatory requirements. The head of Prudential's Group Compliance function reports directly to the Group Chief Risk Officer who submits regular reports to the Board of Directors.

Compliance risk includes the possibility that transactions may not be enforceable under applicable law or regulation as well as the cost of rectification and fines, and also the possibility that changes in law or regulation could adversely affect Prudential's position. Prudential seeks to minimise compliance risk by seeking to ensure that transactions are properly authorised and by submitting new or unusual transactions to legal advisers for review.

Prudential is exposed to certain fiscal risks arising from changes in tax laws and enforcement policies and in reviews by taxation authorities of tax positions Prudential has taken in recent years. Prudential manages this risk and risks associated with changes in other legislation and regulation through ongoing review by relevant departments of proposed changes to legislation and by membership of relevant trade and professional committees involved in commenting on draft proposals in these areas.

(v) Market risk

Market risk is the risk that future changes in market prices may make a financial instrument less valuable. The primary market risks Prudential faces are equity risk and interest rate risk because most of its assets are investments that are either equity type investments and subject to equity price risk, or bonds, mortgages or cash deposits, the values of which are subject to interest rate risk. The amount of risk borne by Prudential's shareholders depends on the extent to which its customers share the investment risk through the structure of Prudential's products.

The split of Prudential's investments between equity investments and interest-sensitive instruments depends principally on the type of liabilities supported by those investments and the amount of capital Prudential has available. This mix of liabilities allows Prudential to invest a substantial portion of its investment funds in equity and property investments that Prudential believes produce greater returns over the long term. On the other hand Prudential has some liabilities that contain guaranteed returns and allow instant access (for example, interest-sensitive fixed annuities, immediate annuities and fixed rate customer bank deposits), which generally will be supported by fixed income investments.

To reduce investment, interest rate and foreign exchange exposures, and to facilitate efficient investment management, Prudential uses derivative instruments. Prudential's policy is that cash or corresponding assets cover amounts at risk through derivative contracts.

(vi) Asset/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 offered by Prudential 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 Group's insurance operations 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, UK and Asian regulators.

A stochastic approach models the inter-relationship between asset and liability movements, taking into account asset correlation and policyholder behaviour, under a large number of possible scenarios. These scenarios are projected forward over a period of time, typically 25 years or longer, and the liabilities and solvency position of the fund are calculated in each scenario in each future year. This allows the identification of which extreme scenarios will have the most adverse effects and what the best estimate outcome may be. The fund's policy on management actions, including bonus and investment policy, are then set in order that they are consistent with the available capital and the targeted risk of default. This differs from a deterministic model, which would only consider the results from one carefully selected scenario.

C: Group risk management continued

For businesses that are most sensitive to interest rate changes, such as immediate annuity business, Prudential uses cash flow analysis to create a portfolio of fixed income securities whose value changes in line with the value of liabilities when interest rates change. This type of analysis helps protect profits from changing interest rates. In the UK, the cash flow analysis is used in Prudential's annuity and banking business while, in the US, it is used for its interest-sensitive and fixed index annuities and stable value products such as Guaranteed Investments Contracts (GICs). Perfect matching is not possible for interest-sensitive and fixed index annuities because of the nature of the liabilities (which include guaranteed surrender values) and options for prepayment contained in the assets. The US supervisory authorities require JNL to calculate projections to test JNL's ability to run off its liabilities with assets equal to statutory reserves in a number of specified future economic scenarios. If JNL is unable to satisfy all of these tests, which are carried out at least annually, then it may be required to establish additional statutory reserves.

For businesses that are most sensitive to equity price changes, Prudential uses stochastic modelling and scenario testing to look at the expected future returns on its investments under different scenarios that best reflect the large diversity in returns that equities can produce. This allows Prudential to devise an investment and with-profits policyholder bonus strategy that, on the model assumptions, allows it to optimise returns to its policyholders and shareholders over time while maintaining appropriate financial strength. Prudential uses this method extensively in connection with its UK with-profits business.

When presenting regulatory returns to the UK supervisory authorities, the calculation of the statutory liabilities for solvency purposes on the FSA's Peak 1 basis is required to incorporate a 'resilience' reserve that is sufficient to ensure that assets equal to the statutory reserves (including the resilience reserve) remain equal to statutory reserves in the event of certain prescribed changes in equity and real estate prices combined with prescribed rises and falls in interest yields.

All of Prudential's investments are held either for risk management or investment purposes. This is because almost all of the investments support policyholder or customer liabilities of one form or another. Any assets that Prudential holds centrally that are not supporting customer liabilities are predominantly invested in short-term fixed income and fixed maturity securities.

(vii) Use of derivatives

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, Prudential uses derivatives to reduce interest rate risk, to facilitate efficient portfolio management and to match liabilities under fixed index annuities policies.

Details of the Group's use of derivatives are explained in note G3.

It is Prudential's policy that cash or corresponding assets cover amounts at risk through derivative transactions. Derivative financial instruments used to facilitate efficient portfolio management and for investment purposes are carried at fair value with changes in fair value included in long-term investment returns.

D: Life assurance business

D1: Group overview

(a) Products and classification for IFRS reporting

For 2004, the IFRS results included in these financial statements continue to reflect UK GAAP requirements in relation to long-term business contracts.

Under IFRS, from 1 January 2005 when the Group adopts IFRS 4, the measurement basis of assets and liabilities of long-term business contracts is dependent upon the classification of the contracts under IFRS. Under IFRS 4, contracts are initially classified as being either 'insurance' contracts, if the level of insurance risk in the contracts is significant, or 'investment' contracts, if the risk is insignificant.

'Insurance' contracts are permitted to be accounted for under previously applied GAAP. The Group has chosen to adopt this approach. However, as an improvement to accounting policy, permitted by IFRS 4, the Group has applied the measurement principles and disclosures of the UK Standard FRS 27 for 2005 reporting. An explanation of the changes under FRS 27 is provided in note D2. 2004 comparatives are not required to be restated.

'Investment' contracts are further delineated under IFRS 4 between those with and without discretionary participation features. For those contracts with discretionary participation features, IFRS 4 also permits the continued application of previously applied GAAP. The Group has adopted this approach, again subject to the FRS 27 improvement.

For 'investment' contracts that do not contain discretionary participation features, IAS 39 and, where the contract includes an investment management element, IAS 18, apply measurement principles to assets and liabilities attaching to the contract that may diverge from those previously applied. Details of the impact for Prudential are described below.

As indicated above, insurance contracts, as defined under IFRS 4 are those contracts that contain significant insurance risk and these contracts may continue to be accounted for using previously applied GAAP. Under UK GAAP, the assets and liabilities of contracts are prepared in accordance with the MSB of reporting as set out in the revised SORP issued by the ABI in November 2003.

D1: Group overview continued

The insurance contracts of the Group's shareholder-backed business fall broadly into the following categories:

- UK insurance operations – bulk and individual annuity business, written by Prudential Retirement Income Limited, Prudential Pensions Limited, and other categories of non-participating UK business;
- Jackson National Life – fixed and variable annuity business and life insurance; and
- Prudential Corporation Asia – non-participating term, whole life, and unit-linked policies, together with accident and health policies.

The assets and liabilities of contracts with insignificant insurance risk previously were accounted for under UK GAAP under the provisions of the ABI SORP, as described in note A4. Under IFRS 4, the assets and liabilities of these contracts with insignificant insurance risk and no discretionary participation features are required to be accounted for in accordance with IAS 39 and, where relevant, the provisions of IAS 18, in respect of attaching investment management features of the contracts. Contracts of the Group whose assets and liabilities are required to be remeasured from 1 January 2005 under these two standards can be summarised as:

- UK – certain unit-linked savings and similar contracts;
- Jackson National Life – GICs
  – minor amounts of 'annuity certain' contracts; and
- Prudential Corporation Asia – minor amounts for a number of small categories of business.

The impact on the contracts of UK insurance operations and JNL's GICs are considered in turn below:

(i) Certain UK unit-linked savings and similar contracts

Change is required for the following contract assets and liabilities.

Deferred acquisition costs

Under UK GAAP, acquisition expenses are deferred with amortisation on a basis commensurate with the anticipated emergence of margins under the contract. Under IFRS, acquisition costs are deferred to the extent that it is appropriate to recognise an asset that represents the entity's contractual right to benefit from providing investment management services and are amortised as the entity recognises the related revenue. IAS 18 further reduces the costs potentially capable of deferral to incremental costs only. Deferred acquisition costs are amortised to the income statement in line with service provision.

Deferred income reserves

These are required to be established under IAS 18 with amortisation over the expected life of the contract. The majority of the relevant UK contracts are single premium with the initial deferred income reflecting the 'front end load' i.e. the difference between the premium paid and the amount credited to the unit fund. Deferred income is amortised to the income statement in line with service provision.

Sterling reserves

Under UK GAAP, reflecting the regulatory approach in the UK, prudent provisions are established for possible future expenses not covered by future margins at a policy level. Under IFRS, such provisions are no longer permitted.

(ii) Jackson National Life – GICs

Previously, under UK GAAP, the assets and liabilities of JNL's insurance contracts, including GICs, have been measured by the application of US GAAP principles with contract liabilities accounted for on an amortised cost basis. Under a traditional GIC, the policyholder makes a lump sum deposit. The interest rate paid is fixed and established when the contract is issued. Funding agreements are of a similar nature but the interest rate may be floating, based on a rate linked to an external index. The US GAAP accounting requirements for such contracts are very similar to those under IFRS on the amortised cost model for liability measurement.

(b) Concentration of risk

(i) Business accepted

The Group has a broadly based exposure to life assurance risk. This is achieved through the geographical spread of the Group's operations and, within those operations, through a broad mix of product types. In addition, looking beyond pure insurance risk, the Group considers itself well developed in its approach to assessment of diversification benefits through its 'economic capital' project that is used for internal business management. The economic capital project seeks to apply a single yardstick to assess and quantify all risks attaching to the Group's insurance business and associated capital requirements.

On 2 June 2005, the Group published details of the framework and results to that point of its economic capital project. Under the framework, cash flows and capital requirements for each of the main business units in the UK, US and Asia are projected over many internally consistent stochastically generated simulations. The process, using a group solvency model, captures 80 per cent of the business, the other 20 per cent being modelled on a stand-alone basis and aggregated with the main results using a correlation matrix approach. This is a standard method of aggregation used by banks and other financial institutions.

Using an iterative modelling process, economic capital is calculated as the amount required at the calculation date such that the cumulative number of projected defaults is less than a predetermined rate reflecting Prudential's internal target solvency level. Prudential's internal target solvency level has been set as equivalent to the historic default rate on AA-rated bond (equivalent to a cumulative probability of default of 44 out of 1,000 simulations over 25 years). The economic capital framework thus assesses the capital required to meet Prudential's obligations with at least this level of confidence taking into account extreme events. Prudential's economic capital model covers all material risks in each business, including (where relevant) financial risks and insurance and business risks.

D1: Group overview continued

The 2 June announcement made reference to unaudited economic capital requirements at 31 December 2004. These results remain unaudited in these statements except to the extent of being an accurate representation of the information reported at that time.

As at 31 December 2004, Prudential reported that it required £1.8 billion of capital for the Group to cover the risks to its existing contractual and discretionary insurance liabilities, on an economic basis and its internal target solvency level. This number is after allowance for diversification across risks and geographies and the capturing of future shareholders' transfers from the business units. This compares to available capital of £3.4 billion on an equivalent basis (i.e. GAAP based shareholders' equity after adjusting to eliminate goodwill, to include subordinated debt capital and valuation differences). This requirement has been analysed into its contributory parts by risk type as follows: asset liability matching 28 per cent, credit risk 47 per cent, underwriting (mortality, longevity and morbidity) 10 per cent, persistency 2 per cent, and operational 13 per cent. The largest risk exposure on a diversified basis, credit risk, reflects the relative size of the exposure to JNL, Prudential UK shareholder annuities business, and Egg.

An example of the diversification benefits for Prudential is that adverse scenarios do not affect all business units in the same way, providing natural hedges within the Group. For example, the Group's US business is sensitive towards increasing interest rates, whereas, in contrast, several business units in Asia benefit from increasing rates. Conversely, these Asian business units are sensitive towards low interest rates, whereas the US benefits from falling interest rates. The economic capital project also takes into account situations where factors are correlated, for example the extent of correlation between Asian and US economies.

(ii) Ceded business

The Group cedes certain business to other insurance companies. Although the ceding of insurance does not relieve the Group of liability to its policyholders, the Group participates in such agreements for the purpose of managing its loss exposure. The Group evaluates the financial condition of its reinsurers and monitors concentration of credit risk from similar geographic regions, activities or economic characteristics of the reinsurers to minimise its exposure from reinsurer insolvencies. There are no significant concentrations of reinsurance risk.

(c) Guarantees

Notes D2(b), D3(b) and D4(b) and (h) provide details of guarantee features of the Group's life assurance products. In the UK guarantees of the with-profits products are valued for accounting purposes on a market consistent basis for 2005 as described in section D2(d)(ii). The UK business also has products with guaranteed annuity option features, mostly within SAIF, as described in section D2(b). There is little exposure to financial options and guarantees in the shareholder-backed business of the UK operations. The US business annuity products have a variety of option and guarantee features as described in section D3(b). JNL's derivative programme seeks to manage the exposures as described in section D3(c). The most significant exposure for the Group arises on Taiwan whole of life policies as described in section D4(h).

(d) Amount, timing and uncertainty of future cash flows from insurance contracts

The factors that affect the amount, timing and uncertainty of future cash flows from insurance contracts depend upon the businesses concerned as described in subsequent sections. In general terms, the Group is managed by reference to a combination of measures. These measures include IFRS basis earnings, net shareholder cash flow to or from business units from or to central funds, and movements in the value of discounted future expected cash flows of in-force long-term insurance business. The latter item is commonly referred to as Embedded Value.

The Group prepares and publishes supplementary information in accordance with the European Embedded Value (EEV) principles issued by the CFO Forum of European Insurance Companies in May 2004 and expanded by the addition of Additional Guidance on EEV Disclosures published in October 2005. Key elements of the EEV principles are the approach applied to allowing for risk and the best estimate assumptions of future cash flows arising from the contracts.

The business covered for determining EEV basis results includes investment contracts (i.e. contracts with insignificant insurance risk as defined under IFRS 4) as well as insurance contracts (i.e. those that contain significant insurance risk). Investment contracts form a relatively small part of the Group's long-term business as demonstrated by the carrying values of policyholder liabilities shown in the Group balance sheet.

The cash flows subject to valuation are those expected under the contracts such as those arising from premiums, claims, expenses after appropriate estimation of future lapse behaviour and mortality and morbidity experience. The cash flows also include the expected future cash flows on assets covering liabilities and encumbered capital.

Encumbered capital is based on Prudential's internal target for economic capital subject to it being at least the local statutory minimum requirements. Economic capital is assessed using internal models but does not take credit for the significant diversification benefits that exist within the Group.

Valuation of the future cash flows also takes account of the 'time value' of option and guarantee features of the Group's long-term business contracts. The time value reflects the variability of economic outcomes in the future. Where appropriate, a full stochastic valuation is undertaken to determine the value of the in-force business. Common principles are adopted across the Group for the stochastic asset model classes, for example, separate modelling of individual asset classes but with allowance for correlation between the various asset classes. In deriving the time value of financial options and guarantees, management actions in response to emerging investment and fund solvency conditions are modelled. In all instances, the modelled actions are in accordance with approved local practice and therefore reflect the options actually available to management. For the PAC with-profits sub-fund, the actions are consistent with those set out in the Principles and Practices of Financial Management.

D1: Group overview continued

The present value of the future cash flows is calculated using a risk discount rate which reflects both the time value of money and the risks associated with the cash flows that are not otherwise allowed for. The risk allowance covers market and non-market risks.

Under Capital Asset Pricing Methodology (CAPM), the discount rate is determined as the aggregate of the risk-free rate and the risk margin for market risk. The latter is calculated as the 'beta' times the equity risk premium. Under CAPM, the beta of a portfolio or product measures its relative market risk. The risk discount rates reflect the market risk inherent in each product group and hence the volatility of product cash flows. They are determined by considering how the profits from each product are impacted by changes in expected returns on various asset classes, and by converting this into a relative rate of return it is possible to derive a product specific beta.

CAPM does not include any allowance for non-market risks since they are assumed to be fully diversifiable. For EEV purposes, however, a risk margin is added for non-diversifiable non-market risks and to cover Group level risks.

Product specific discount rates are used in order to reflect the risk profile of each major territory and product group. No allowance is required for non-market risks where these are assumed to be fully diversifiable. The majority of non-market risks are considered to be diversifiable. Finance theory cannot be used to determine the appropriate component of beta for non-diversifiable non-market risks since there is no observable risk premium associated with it that is akin to the equity risk premium. Recognising this, a pragmatic approach has been used. A constant 50 basis points has been added to the risk margin for market risk to cover the non-diversifiable non-market risks associated with the business.

Product level betas are calculated each year. They are combined with the most recent product mix to produce appropriate beta and risk discount rates for each major product grouping.

Details of the key assumptions and sensitivity of the EEV value of in-force business are shown in the sections for each geographic segment that follow in this note. The sensitivity of the present value of the discounted future cash flows under the EEV methodology is of particular interest. The sensitivity provides an indication of the movement in the net value ascribable to potential variations in the amounts and timing of future cash flows to shareholders and the uncertainty attached to those cash flows.

(e) Sensitivity of IFRS basis profit or loss and equity to changes that have a material effect

The factors that may significantly affect IFRS results due to changes of experience or assumptions vary significantly between business units. The most significant items are summarised below.

UK insurance operations

- With-profits business – investment performance subject to smoothing through declared bonuses;
- unit-linked business – investment performance through fund management fees; and
- annuity business – mortality experience and assumptions, and credit risk.

Jackson National Life

- Variable annuity business – fund management performance and incidence of guarantee features of the contracts;
- fixed annuity business – spread differential between earned rate and rate credited to policyholder; and
- fixed index annuity business – spread differential between earned rate and rate credited to policyholder and incidence of equity index participation features.

Asian operations

- With-profits business – as for UK Insurance operations;
- unit-linked business – as for UK Insurance operations; and
- non-participating business – return on assets covering the Taiwan whole of life policies.

Where appropriate these issues are discussed in notes D2, D3 and D4.

Lapse risk is not mentioned above and has variable impacts. In the UK, adverse persistency experience has led to losses in embedded value in 2004 and 2005 reflecting a reduced level of projected statutory transfers from the PAC with-profits fund. However, in any given year the statutory transfer recognised in IFRS profits is only marginally affected by altered persistency trends.

JNL is sensitive to lapse risk. However, JNL has swaption derivatives in place to ameliorate the effect of a sharp rise in interest rates, which would be the most likely cause of a sudden change in policyholder behaviour.

(f) Duration of liabilities

Under the terms of the Group's contracts, as for life assurance contracts generally, the contractual maturity date is the earlier of the end of the contract term, death or surrender. The Group has therefore chosen to provide details of liability duration that reflect the actuarially determined best estimate of the likely incidence of these three factors on contract duration. Details are shown in sections D2(i), D3(i) and D4(i). Effective interest rates, as defined in IAS 32, are not applicable to the Group's insurance contracts and investment contracts with discretionary participation features.

In the years 2001 to 2005 claims paid on the Group's life assurance contracts including those now classified as investment contracts under IFRS 4 ranged from £11.8 billion to £13.8 billion. Indicatively it is to be expected that of the Group's policyholder liabilities (excluding unallocated surplus) at 31 December 2005 of £159 billion, the amounts likely to be paid in 2006 will be of a similar magnitude.

D2: UK insurance operations

(a) Summary balance sheet at 31 December 2005

In order to explain the different types of UK business and fund structure, the balance sheet of the UK insurance operations may be analysed by the assets and liabilities of the Scottish Amicable Insurance Fund, the PAC with-profits sub-fund, annuity business, unit-linked and other business. The assets and liabilities of these funds and subsidiaries are shown in the table below.

		PAC with-profits sub-fund (note i)			Other funds and subsidiaries			
	Scottish Amicable Insurance Fund (note ii) £m	Excluding Prudential Annuities Limited £m	Prudential Annuities Limited (note iii) £m	Total (note iv) £m	Prudential Retirement Income Limited £m	Other non-profit unit-linked and other business (note v) £m	Total £m	UK insurance operations Total £m
Assets								
Goodwill attributable to PAC with-profits fund	–	607	–	607	–	–	–	607
Other intangibles:								
PAC with-profit fund	6	29	–	29	–	–	–	35
Other operations	–	–	–	–	–	199	199	199
Total	6	29	–	29	–	199	199	234
Other non-investment and non-cash assets	314	2,263	273	2,536	236	1,384	1,620	4,470
Investments of long-term business, banking and other operations:								
Investment properties	1,586	9,569	401	9,970	214	900	1,114	12,670
Financial investments:								
Loans and receivables	213	653	211	864	44	9	53	1,130
Equity securities and portfolio holdings in unit trusts	7,515	39,797	369	40,166	6	10,839	10,845	58,526
Debt securities	4,710	15,373	14,331	29,704	8,695	6,343	15,038	49,452
Other investments	237	2,231	181	2,412	28	11	39	2,688
Deposits	723	3,615	391	4,006	442	1,626	2,068	6,797
Total investments	14,984	71,238	15,884	87,122	9,429	19,728	29,157	131,263
Held for sale assets	–	728	–	728	–	–	–	728
Cash and cash equivalents	101	721	75	796	13	285	298	1,195
Total assets	**15,405**	**75,586**	**16,232**	**91,818**	**9,678**	**21,596**	**31,274**	**138,497**
Equity and liabilities								
Equity								
Shareholders' equity	–	–	–	–	782	359	1,141	1,141
Minority interests	21	74	–	74	–	–	–	95
Total equity	21	74	–	74	782	359	1,141	1,236
Liabilities								
Policyholder liabilities and unallocated surplus of with-profits funds:								
Insurance contract liabilities	14,011	33,424	14,068	47,492	8,324	9,404	17,728	79,231
Investment contract liabilities with discretionary participation features	751	25,692	–	25,692	–	–	–	26,443
Investment contract liabilities without discretionary participation features	–	–	–	–	–	10,502	10,502	10,502
Unallocated surplus of with-profit funds (reflecting application of 'realistic' provisions for UK regulated with-profits funds)	–	9,683	1,589	11,272	–	–	–	11,272
Total	14,762	68,799	15,657	84,456	8,324	19,906	28,230	127,448
Operational borrowings attributable to shareholder-financed operations	–	–	–	–	–	17	17	17
Borrowings attributable to with-profit funds	118	1,780	–	1,780	–	–	–	1,898
Other non-insurance liabilities	504	4,933	575	5,508	572	1,314	1,886	7,898
Total liabilities	15,384	75,512	16,232	91,744	8,896	21,237	30,133	137,261
Total equity and liabilities	**15,405**	**75,586**	**16,232**	**91,818**	**9,678**	**21,596**	**31,274**	**138,497**

Notes

(i) For the purposes of this table and subsequent explanation, references to the WPSF also include, for convenience, the amounts attaching to the Defined Charges Participating Sub-fund.

(ii) Scottish Amicable Insurance Fund (SAIF) is a separate sub-fund within the PAC long-term business fund.

(iii) Wholly-owned subsidiary of the PAC WPSF that writes annuity business.

(iv) Excluding policyholder liabilities of the Hong Kong branch of PAC.

(v) Within policyholder liabilities of £19,906 million for the non-profit unit-linked and other business is £16,639 million for unit-linked business.

D2: UK insurance operations continued

(b) Products and guarantees

Prudential's long-term products in the UK consist of life insurance, pension products and pension annuities.

These products are written primarily in:

- One of three separate sub-funds of the PAC long-term fund, namely the with-profits sub-fund, the SAIF, and the non-profit sub-fund;
- Prudential Annuities Limited, which is owned by the PAC with-profits sub-fund;
- Prudential Retirement Income Limited, a shareholder-owned subsidiary; or
- other shareholder-backed subsidiaries writing mainly non-profit unit-linked business.

(i) With-profits products and PAC with-profits sub-fund

Within the balance sheet of UK insurance operations, there are policyholder liabilities of £73.2 billion and unallocated surplus of £11.3 billion that relate to the WPSF. The WPSF mainly contains with-profits business but it also contains some non-profit business (unit-linked, term assurances and annuities). The WPSF's profits are apportioned 90 per cent to its policyholders and 10 per cent to shareholders as surplus for distribution is determined via the annual actuarial valuation.

With-profits products provide returns to policyholders through bonuses that are 'smoothed'. There are two types of bonuses: 'annual' and 'final'. Annual bonuses are declared once a year, and once credited, are guaranteed in accordance with the terms of the particular product. Unlike annual bonuses, final bonuses are guaranteed only until the next bonus declaration.

When determining policy payouts, including final bonuses, Prudential considers policyholders' reasonable expectations, the need to smooth claim values and payments from year to year and competitive considerations, together with 'asset shares' for specimen policies. Asset shares broadly reflect the value of premiums paid plus the investment return on the assets notionally attributed to the policy, less the other items to be charged such as expenses and the cost of the life insurance cover.

For many years, UK with-profits product providers, such as Prudential, have been required by law and regulation to consider the reasonable expectations of policyholders in setting bonus levels. This concept is established by statute but is not defined. However, it is defined within the regulatory framework, which also more recently contains an explicit requirement to treat customers fairly.

The WPSF held a provision of £52 million at 31 December 2005 (2004: £49 million) to honour guarantees on a small amount of guaranteed annuity products. SAIF's exposure to guaranteed annuities is described below.

Beyond the generic guarantees described above, there are very few explicit options or guarantees such as of minimum investment returns, surrender values or annuity at retirement and any granted have generally been at very low levels.

(ii) Annuity business

Prudential's conventional annuities include level, fixed increase and retail price index (RPI) annuities. They are mainly written within the subsidiaries PAL, PRIL, Prudential Pensions Limited and the PAC with-profits sub-fund, but there are some annuity liabilities in the WPSF and SAIF.

Prudential's fixed-increase annuities incorporate automatic increases in annuity payments by fixed amounts over the policyholder's life. The RPI annuities that Prudential offers provide for a regular annuity payment to which an additional amount is added periodically based on the increase in the UK RPI. Prudential's with-profits annuities, which are written in the WPSF, combine the income features of annuity products with the investment smoothing features of with-profits products and enable policyholders to obtain exposure to investment return on the WPSF's equity shares, property and other investment categories over time.

Policyholders select an 'anticipated bonus' from the specific range Prudential offers for the particular product. The amount of the annuity payment each year depends upon the relationship between the anticipated bonus rate selected by the policyholder when the product is purchased and the bonus rates Prudential subsequently declares each year during the term of the product. If the total bonus rates fall below the anticipated rate, then the annuity income falls.

At 31 December 2005, £25.3 billion of investments relate to annuity business of PAL and PRIL. These investments are predominantly in debt securities (including retail price index-linked bonds to match retail price index-linked annuities), loans and deposits and are duration matched with the estimated duration of the liabilities they support.

(iii) SAIF

SAIF is a ring-fenced sub-fund of the PAC long-term fund and was formed following the acquisition of the mutually owned Scottish Amicable Life Assurance Society in 1997. No new business may be written in SAIF, although regular premiums are still being paid on policies in force at the time of the acquisition and incremental premiums are permitted on these policies.

The fund is solely for the benefit of policyholders of SAIF. Shareholders have no interest in the profits of this fund although they are entitled to investment management fees on this business.

The process for determining policyholder bonuses of SAIF with-profits policies, which constitute the vast majority of obligations of the funds, is similar to that for the with-profit policies of the WPSF. However, in addition, the surplus assets in SAIF are allocated to policies in an orderly and equitable distribution over time as enhancements to policyholder benefits i.e. in excess of those based on asset share.

D2: UK insurance operations continued

Provision is made for the risks attaching to some SAIF unitised with-profits policies that have MVR – free dates and for those SAIF products which have a guaranteed minimum benefit on death or maturity of premiums accumulated at 4 per cent per annum.

The Group's main exposure to guaranteed annuities in the UK is through SAIF and a provision of £619 million was held in SAIF at 31 December 2005 (2004: £648 million) to honour the guarantees. As SAIF is a separate sub-fund solely for the benefit of policyholders of SAIF this provision has no impact on the financial position of the Group's shareholders' funds.

(iv) Unit-linked (non-annuity) and other non-profit business

Prudential UK insurance operations also have an extensive book of unit-linked policies of varying types and provide a range of other non-profit business such as stakeholder, credit life and non-life long-term contracts. These contracts do not contain significant financial guarantees.

There are no guaranteed maturity values or guaranteed annuity options on unit-linked policies except for minor amounts for certain policies linked to cash units within SAIF.

(c) Exposure to market risk

(i) Non-linked life and pension business

For with-profits business, the absence of guaranteed surrender values and the flexibility given by the operation of the bonus system means that the majority of the investments backing the with-profits business are in equities and real estate with the balance in debt securities, deposits and loans.

The investments supporting the protection business are small in value and tend to be fixed maturities reflecting the guaranteed nature of the liabilities.

(ii) Pension annuity business

Prudential's UK annuity business employs fixed income investments (including UK retail price index-linked assets) because the liabilities consist of guaranteed payments for as long as each annuitant is alive. Retail price index-linked assets are used to back pension annuities where the payments are linked to the RPI.

(iii) Unit-linked business

Except through the second order effect on investment management fees, the unit-linked business of the UK insurance operations is not exposed to market risk. The lack of exposure arises from the contract nature whereby policyholder benefits reflect asset value movements of the unit-linked funds.

(d) Process for setting assumptions and determining liabilities

(i) Overview

Calculation of the contract liabilities involves the setting of assumptions for future experience. This is done following detailed review of the relevant experience including, in particular, mortality, expenses, tax and economic assumptions. For with-profits business written in the WPSF or SAIF from 2005, for IFRS accounting purposes, a market consistent valuation is performed (as described in section (ii) below). Additional assumptions required are persistency and the management actions under which the fund is managed. Assumptions used for market consistent valuation typically do not contain margins, whereas those used for the valuation of other classes of business do.

Mortality assumptions are set based on the results of the most recent experience analysis looking at the experience over recent years of the relevant business. For non-profit business, a margin for adverse deviation is added. Different assumptions are applied for different product groups. For annuitant mortality, assumptions for current mortality rates are based on recent experience investigations and expected future improvements in mortality. The expected future improvements are based on recent experience and projections of the business and industry generally.

Maintenance and, for some classes of business, termination expense assumptions are expressed as per policy amounts. They are set based on the expenses incurred during the year, including an allowance for ongoing investment expenditure and allocated between entities and product groups in accordance with the operation's internal cost allocation model. For non-profit business a margin for adverse deviation is added to this amount. Expense inflation assumptions are set consistent with the economic basis and based on the difference between nominal gilts and index-linked gilts; unit expenses are assumed not to increase in future years at a faster rate than this difference.

The actual renewal expenses charged to SAIF will continue to be based on the tariff arrangement specified in the Scottish Amicable Life Assurance Society Scheme until 31 December 2007, when the tariff arrangement terminates. This provides an additional margin in SAIF as the unit costs derived from actual expenses (and used to derive the recommended assumptions) are generally significantly greater than the tariff costs.

The assumptions for investment management expenses are based on the charges specified in agreements with the Group's investment management operations, plus a margin for adverse deviation for non-profit business.

Tax assumptions are set equal to current rates of taxation.

For non-profit business excluding unit-linked business, the valuation interest rates used to discount the liabilities are based on the yields as at the valuation date on the assets backing the technical provisions. For fixed interest securities the gross redemption yield is used, for property it is the rental yield, and for equities it is the greater of the dividend yield and the average of the dividend yield and the earnings yield. An adjustment is made to the yield on non risk-free fixed interest securities and property to reflect credit risk. To calculate the non-unit reserves for linked business, assumptions have been set for the gross unit growth rate and the rate of inflation of maintenance expenses, as well as for the valuation interest rate as described above.

D2: UK insurance operations continued

(ii) WPSF and SAIF

The policyholder liabilities reported for the WPSF are primarily for two broad types of business. These are accumulating and conventional with-profits contracts.

2005

The provisions at 31 December 2005 have been determined on a basis consistent with the detailed methodology included in regulations contained in the FSA's rules for the determination of regulatory reporting reserves on the FSA's 'realistic' Peak 2 basis. In aggregate, the regime has the effect of placing a value on the liabilities of UK with-profits contracts, which reflects the amounts expected to be paid based on the current value of investments held by the with-profits funds and current circumstances. These contracts are a combination of insurance and investment contracts with discretionary participation features, as defined by IFRS 4.

The FSA's Peak 2 calculation under the new realistic regime, which came fully into effect for the first time for 2004 regulatory reporting requires the value of liabilities to be calculated as:

- The with-profits benefits reserve (WPBR); plus
- future policy related liabilities (FPRL); plus
- the realistic current liabilities of the fund.

The WPBR is primarily based on the retrospective calculation of accumulated asset shares but is adjusted to reflect future expected policyholder benefits and other outgoings. By contrast, the Peak 1 basis addresses, at least explicitly, only declared bonuses.

Asset shares are calculated as the accumulation of all items of income and outgo that are relevant to each policy type. Income comprises credits for premiums, investment returns (including unrealised gains), and miscellaneous profits. Outgo comprises charges for tax (including an allowance for tax on unrealised gains), guarantees and smoothing, mortality and morbidity, shareholders' profit transfers, miscellaneous losses, and expenses and commission (net of any tax relief).

The FPRL must include a market consistent valuation of costs of guarantees, options and smoothing, less any related charges, and this amount must be determined using either a stochastic approach, hedging costs or a series of deterministic projections with attributed probabilities.

The assumptions used in the stochastic models are calibrated to produce risk-free returns on each asset class. Volatilities of, and correlations between, investment returns from different asset classes are as determined by the Group's Portfolio Management Group but aim to be market consistent.

The cost of guarantees, options and smoothing is very sensitive to the bonus, market value reduction (MVR), and investment policy the Company employs and therefore the stochastic modelling incorporates a range of management actions that would help to protect the fund in adverse investment scenarios. Substantial flexibility has been included in the modelled management actions in order to reflect the discretion that the Company retains in adverse investment conditions, thereby avoiding the creation of unreasonable minimum capital requirements. The management actions assumed are consistent with our management policy for with-profit funds and our disclosures in the publicly available Principles and Practices of Financial Management.

The contract liabilities for with-profits business also required assumptions for persistency. These are set based on the results of the Company's recent experience analysis.

2004

The amounts shown in the consolidated balance sheet at 31 December 2004 for technical provisions and unallocated surplus (fund for future appropriations) for with-profit business of the WPSF and SAIF have been determined in accordance with the MSB of accounting applicable at that time. With the exception of minor accounting adjustments, the technical provisions reflect the UK regulatory basis of reporting that has applied for many years, and which effectively constitutes the Peak 1 basis under the new FSA regime.

Under this basis of accounting, the future policyholder benefit provisions on conventional with-profit policies was calculated using the net premium valuation method, such that they would be sufficient at the outset of the policy to provide only for the discounted value of the original guaranteed death and maturity benefits on the chosen valuation assumptions. The provisions were then calculated by subtracting the present value of future net premiums from the present value of future benefits (including vested bonuses) using a prudent discount rate.

Under the net premium valuation method, vested bonuses are included in the cash flows assessed but future allocations of bonuses are not included explicitly, although they may be implicitly taken into account in the discount rate used, which is based on the return available on suitable investments. The detailed methodology for UK companies is included in the regulations contained in the FSA rules. In particular, the returns available from equity and property assets are based on expected income and/or earnings and no allowance is made for future capital growth.

The assumptions to which the estimate of the technical provisions for conventional with-profit contracts at 31 December 2004 were particularly sensitive were the interest rates used to discount the provision and the future mortality experience of policyholders. The net premium reserves were calculated using assumptions for interest, mortality, morbidity, and expense but without assumptions for withdrawals. The assumptions were determined as prudent best estimates at the date of valuation. Interest rates used in establishing policyholder benefit provisions at 31 December 2004 range from 3 per cent to 5 per cent.

D2: UK insurance operations continued

For accumulating with-profit business, the calculation of technical provisions at 31 December 2004 was based on a gross premium bonus reserve valuation. In general terms, a gross premium valuation basis is one in which the premiums brought into account are the full amounts receivable under the contract. The method includes explicit estimates of premiums, expected claims, future regular bonuses, costs of maintaining contracts and future renewal expenses. Cash flows are discounted at the valuation rate of interest. The methodology for UK companies is included in the FSA rules. The discount rate is based on the expected return on the assets deemed to back the liabilities as prescribed by the FSA rules.

For PAC business the calculation was based on a valuation under which future reversionary bonuses are added to the guaranteed liabilities existing at the valuation date. The assumptions to which the estimation of the technical provisions were particularly sensitive were the assumed future reversionary bonuses, the interest rate used to discount the provisions, the assumed future per policy expenses and the assumed future mortality experience of policyholders.

For the purposes of calculating the liabilities using the bonus reserve method the assumed interest rates ranged from 2.5 per cent to 5.0 per cent at 31 December 2004, while future reversionary bonuses were assumed to fall immediately from then current levels to zero.

(iii) Annuity business

The contract liabilities for PAL and PRIL are based on the FSA regulatory solvency basis. The valuation is then modified for MSB reporting purposes to remove certain of the margins for prudence within the assumptions, and contingency reserves, both of which are required under the solvency basis applied for regulatory purposes, but not for financial accounting.

The contract liabilities are the discounted value of future claim payments, adjusted for investment expenses and future administration costs. The interest rate used for discounting claim payments is derived from the yield on the assets held with an allowance for default and mismatching risk. At 31 December 2005, the interest rates applied ranged from 1.0 per cent to 4.6 per cent (2004: 1.5 per cent to 5.0 per cent).

The mortality assumptions are set in light of recent population and internal experience. The assumptions used are percentages of standard actuarial mortality tables with an allowance for future mortality improvements. Where annuities have been sold on an enhanced basis to impaired lives an additional age adjustment is made. The percentages of the standard table used are selected according to the source of business. The range of percentages used is set out in the following tables:

PAL

	2005		2004	
	Males	**Females**	Males	Females
In payment	93% – 100% PMA92 (C = 2004) with medium cohort improvement table with a minimum annual improvement of 1.25%	84% – 105% PFA92 (C = 2004) with 75% of medium cohort improvement table with a minimum annual improvement of 0.75%	97% – 111% PMA92 (C = 2004) with medium cohort improvement table with a minimum annual improvement of 1.25%	92% – 105% PFA92 (C = 2004) with 75% of medium cohort improvement table with a minimum annual improvement of 0.75%
In deferment	AM92 minus 4 years	AF92 minus 4 years	AM92 minus 4 years	AF92 minus 4 years

PRIL

	2005		2004	
	Males	**Females**	Males	Females
In payment	88% – 100% PMA92 (C = 2004) with medium cohort improvement table with a minimum annual improvement of 1.25%	84% – 102% PFA92 (C = 2004) with 75% of medium cohort improvement table with a minimum annual improvement of 0.75%	90% – 113% PMA92 (C = 2004) with medium cohort improvement table with a minimum annual improvement of 1.25%	85% – 104% PFA92 (C = 2004) with 75% of medium cohort improvement table with a minimum annual improvement of 0.75%
In deferment	AM92 minus 4 years	AF92 minus 4 years	AM92 minus 4 years	AF92 minus 4 years

(iv) Unit-linked (non-annuity) and other non-profit business

The majority of other long-term business written in the UK insurance operations is unit-linked business or other business with similar features. For these contracts the attaching liability reflects the unit value obligation and provision for mortality risk. The latter component is determined by applying mortality assumptions on a basis that is appropriate for the policyholder profile.

For unit-linked business, the assets covering unit liabilities are exposed to market risk, but the residual risk when considering the unit-linked liabilities and assets together is limited to the effect on fund-based charges.

For those contracts where the level of insurance risk is insignificant the assets and liabilities arising under the contracts are distinguished between those that relate to the financial instrument liability and acquisition costs and deferred income that relate to the component of the contract that relates to investment management. Acquisition costs and deferred income are recognised consistent with the level of service provision in line with the requirements of IAS 18.

D2: UK insurance operations continued

(e) Reinsurance

The Group's UK insurance business cedes only minor amounts of business outside the Group. During 2005, reinsurance premiums for externally ceded business were £82 million and reinsurance recoverable insurance assets were £750 million in aggregate. The gains and losses recognised in profit and loss for these contracts were immaterial.

(f) Effect of changes in assumptions used to measure insurance assets and liabilities

For with-profits business the only change of note is an altered basis of recognising liabilities and unallocated surplus for SAIF. This is to comply with actuarial guidance GN 45, which requires that for a closed fund where the fund will be distributed fully that the working capital is shown as zero, with the future enhancements to asset shares being increased by the free capital. Without the adjustment the unallocated surplus would have been approximately £700 million. Shareholder results and equity are not altered by this change.

The change of mortality table for PAL explained in section D2(d) increased liabilities by £144 million. As PAL is owned by the WPSF this change had no affect on shareholder profit.

For shareholder-backed non-participating business a number of changes of assumptions were made in 2005. Taken together these changes had the effect of reducing operating profit based on longer-term investment returns before shareholder tax by £36 million with consequent increase in liabilities. The reduction arose from a charge of £69 million for strengthened mortality assumptions, being partially offset by a net credit of £29 million in respect of a reduced level of expected defaults for debt securities, and a credit of £4 million for other changes.

As described in section A4, the Group provides supplementary analysis of its profit before shareholder tax, distinguishing operating profit based on longer-term investment returns from short-term fluctuations in investment returns, actuarial gains and losses on defined benefit pension schemes, and exceptional items. In addition to the £36 million charge described above, an additional £20 million charge for the effect of change of assumption for renewal expenses, which relates to an increase in ongoing future pensions scheme contributions as described in section B1, has been recorded as part of actuarial and other gains and losses excluded from operating profit but included in total profit before shareholder tax.

The net charge of £36 million comprises amounts in respect of PAC (£35 million charge), Prudential Holborn Life (£2 million credit), and PRIL (£3 million charge).

(g) Amount, timing and uncertainty of future cash flows from insurance contracts

At 31 December 2005, the EEV basis value of the in-force business of the UK insurance operations, after taking account of the cost of encumbered capital and the cost of the time value of financial options and guarantees, was £4,274 million. This value has been determined after applying the principles of valuation described in note D1 and the following key assumptions.

	%
Risk discount rate for in-force business at the start of the year	7.7
Pre-tax expected long-term nominal rates of investment return:	
UK equities	8.1
Overseas equities	8.1 to 8.75
Property	6.4
Gilts	4.1
Corporate bonds	4.9
Expected long-term rate of inflation	2.9
Post-tax expected long-term nominal rate of return	7.1
Pensions business (where no tax applies)	6.3
Life business	

The sensitivity of this value to changes in key assumptions is as follows:

	£m
Economic assumptions:	
Discount rates – 1% increase	(432)
Interest rates (including consequential changes for assumed investment returns for all asset classes, market values of debt securities, and all risk discount rates):	
– 1% increase	108
– 1% decrease	(142)
Equity/property yields – 1% rise	297
Equity/property market values – 10% fall	(480)
Non-economic assumptions:	
Maintenance expenses – 10% decrease	33
Lapse rates – 10% decrease	68
Mortality and morbidity – 5% decrease in base rates (i.e. increased longevity)	(62)

D2: UK insurance operations continued

(h) Sensitivity of IFRS basis profit or loss and equity to changes that have a material effect

The primary sensitivities that have a material effect on the IFRS basis results of the UK insurance operations relate to asset-liability matching and mortality experience for shareholder-backed annuity business. Further details are described below.

(i) With-profits business

SAIF

Shareholders have no interest in the profits of SAIF but are entitled to the investment management fees paid on the business.

With-profits sub-fund business

For with-profits business (including non-participating business of PAL which is owned by the WPSF) adjustments to liabilities and any related tax effects are recognised in the income statement. However, except for any impact on the annual declaration of bonuses, shareholders' profit for with-profits business is unaffected. This is because IFRS basis profits for with-profits business, which are determined on the same basis as on preceding UK GAAP, solely reflect one-ninth of the cost of bonuses declared for the year.

The main factors that influence the determination of bonus rates are the return on the investments of the fund, the effect of inflation, taxation, the expenses of the fund chargeable to policyholders and the degree to which investment returns are smoothed. Mortality and other insurance risk represent a relatively small component of the factors.

Unallocated surplus represents the excess of assets over policyholder liabilities of the fund. As unallocated surplus of the WPSF is recorded as a liability, movements in its value do not affect shareholders' profits or equity.

The level of unallocated surplus is particularly sensitive to the level of investment returns on the portion of the life fund assets that represent the surplus. The effects for 2005 and 2004 are demonstrated in note D5.

(ii) Shareholder-backed annuity business

Profits from shareholder-backed annuity business are most sensitive to:

- The extent to which the duration of the assets held closely match the expected duration of the liabilities under the contracts, assuming close matching, the impact of short-term asset value movements for interest rate movements will broadly offset changes in the values of liabilities caused by movements in valuation rates of interest;
- actual versus expected default rates on assets held;
- the difference between long-term rates of return on corporate bonds and risk-free rates;
- the variance between actual and expected mortality experience; and
- the extent to which expected future mortality experience gives rise to changes in the measurement of liabilities.

A decrease in assumed mortality rates of 1 per cent would decrease gross profits by approximately £33 million. A decrease in credit default assumptions of five basis points would increase gross profits by £65 million. A decrease in renewal expenses (excluding investment management expenses) of 5 per cent would increase gross profits by £12 million. The effect on profits would be approximately symmetrical for changes in assumption that are directionally opposite to those explained above.

(iii) Unit-linked and other business

Unit-linked and other business represents a comparatively small proportion of the in-force business of the UK insurance operations.

Profits from unit-linked and similar contracts primarily arise from the excess of charges to policyholders, for management of assets under the Company's stewardship, over expenses incurred. The former is most sensitive to the net accretion of funds under management as a function of new business and lapse and mortality experience. The accounting impact of the latter is dependent upon the amortisation of acquisition costs in line with the emergence of margins (for insurance contracts) and amortisation in line with service provision (for the investment management component of investment contracts). By virtue of the design features of most of the contracts which provide low levels of mortality cover the profits are relatively insensitive to changes in mortality experience.

(iv) Exposure to interest rate risk

By virtue of the fund structure, product features and basis of accounting described in note D2(b) and (d), the policyholder liabilities of the UK insurance operations are, except for pension annuity business, not generally exposed to interest rate risk. For pension annuity, business liabilities are exposed to fair value interest rate risk. However, the net exposure to the PAC WPSF (for PAL) and shareholders (for liabilities of PRIL) is very substantially ameliorated by virtue of the close matching of assets with appropriate duration.

(i) Duration of liabilities

With the exception of most unitised with-profit bonds and other whole of life contracts the majority of the contracts of the UK insurance operations have a contract term. However, in effect, the maturity term of contracts reflects the earlier of death, maturity, or lapsation. In addition, with-profit contract liabilities as noted in note D2(d) above include projected future bonuses based on current investment values. The actual amounts payable will vary with future investment performance of SAIF and the WPSF. To ascribe particular amounts payable to these contracts in future years does not provide appropriate information.

D2: UK insurance operations continued

The Group uses cash flow projections of expected benefit payments as part of the determination of the value of in-force business when preparing EEV basis results. The maturity profile of the cash flows used for 2005 for that purpose for insurance contracts, as defined by IFRS, i.e. those containing significant insurance risk, and investment contracts, which do not, is as follows:

	Insurance contracts				Investment contracts	
	With-profits %	PAL %	PRIL %	Other %	With-profits %	Unit-linked and similar %
Expected maturity:						
0 to 5 years	48	32	29	33	25	45
5 to 10 years	29	24	22	25	24	24
10 to 15 years	13	17	17	18	18	14
15 to 20 years	6	12	12	14	14	8
20 to 25 years	3	7	8	6	11	5
Over 25 years	1	8	12	4	8	4

D3: US operations

(a) Summary balance sheet at 31 December 2005

	Long-term business				
	Variable annuity separate account assets and liabilities* £m	Fixed annuity, GIC and other business* £m	Total £m	Broker-dealer and fund management £m	US operations total £m
Assets					
Goodwill	–	–	–	16	16
Other intangibles	–	1,634	1,634	–	1,634
Other non-investment and non-cash assets	–	1,799	1,799	89	1,888
Investments:					
Investment properties	–	41	41	–	41
Financial investments:					
Loans and receivables	–	3,577	3,577	–	3,577
Equity securities and portfolio holdings in unit trusts	8,574	273	8,847	–	8,847
Debt securities	–	24,290	24,290	–	24,290
Other investments	–	794	794	31	825
Deposits	–	374	374	6	380
Total investments	8,574	29,349	37,923	37	37,960
Cash and cash equivalents	–	154	154	48	202
Total assets	**8,574**	**32,936**	**41,510**	**190**	**41,700**
Equity and liabilities					
Equity					
Shareholders' equity	–	2,899	2,899	70	2,969
Minority interests	–	2	2	–	2
Total equity	–	2,901	2,901	70	2,971
Liabilities					
Policyholder liabilities:					
Insurance contract liabilities	8,574	21,905	30,479	–	30,479
Investment contract liabilities without discretionary participation features (GIC and annuity certain)	–	1,502	1,502	–	1,502
Total	8,574	23,407	31,981	–	31,981
Core structural borrowings of shareholder-financed operations	–	145	145	–	145
Operational borrowings attributable to shareholder-financed operations	–	1,085	1,085	–	1,085
Other non-insurance liabilities	–	5,398	5,398	120	5,518
Total liabilities	8,574	30,035	38,609	120	38,729
Total equity and liabilities	**8,574**	**32,936**	**41,510**	**190**	**41,700**

*Assets and liabilities attaching to variable annuity business that are not held in the separate account are shown within those of other business.

D3: US operations continued

Summary policyholder liabilities (net of reinsurance) and reserves at 31 December 2005

The policyholder liabilities, net of reinsurers' share of £520 million reflect balances in respect of the following:

	2005 £m
Policy reserves and liabilities on non-linked business:	
Reserves for future policyholder benefits and claims payable	**971**
Deposits on investment contracts (as defined under US GAAP)	**20,702**
Guaranteed investment contracts	**1,214**
Unit-linked (variable annuity (VA)) business	**8,574**
	31,461

In addition to the policyholder liabilities above, JNL has entered into a programme of funding arrangements under contracts which, in substance, are almost identical to GICs. The liabilities under these funding arrangements totalled £3,267 million and are included in 'other non-insurance liabilities' in the balance sheet above.

(b) Products and guarantees

JNL provides long-term savings and retirement products to retail and institutional customers throughout the US. JNL offers individual fixed annuities, fixed index annuities, immediate annuities, variable annuities, individual and variable life insurance and institutional products.

(i) Fixed annuities

Interest-sensitive annuities

In 2005, interest-sensitive fixed annuities accounted for 36 per cent (2004: 41 per cent) of policy and contract liabilities of JNL. Interest-sensitive fixed annuities are primarily deferred annuity products that are used for retirement planning and for providing income in retirement. They permit tax-deferred accumulation of funds and flexible payout options.

The policyholder of an interest-sensitive fixed annuity pays JNL a premium, which is credited to the policyholder's account. Periodically, interest is credited to the policyholder's account and in some cases administrative charges are deducted from the policyholder's account. JNL makes benefit payments at a future date as specified in the policy based on the value of the policyholder's account at that date.

The policy provides that at JNL's discretion it may reset the interest rate, subject to a guaranteed minimum. The minimum guarantee varies from 1.5 per cent to 5.5 per cent (2004: 1.5 per cent to 5.5 per cent) depending on the jurisdiction of issue and the date of issue, with 73 per cent (2004: 73 per cent) of the fund at 3 per cent or less. The average guarantee rate is 3.3 per cent (2004: 3.3 per cent).

Approximately 29 per cent (2004: 22 per cent) of the interest-sensitive fixed annuities JNL wrote in 2005 provide for a market value adjustment, that could be positive or negative, on surrenders in the surrender period of the policy. This formula-based adjustment approximates the change in value that assets supporting the product would realise as interest rates move up or down. The minimum guaranteed rate is not affected by this adjustment.

Fixed index annuities

Fixed index annuities account for 7 per cent (2004: 6 per cent) of JNL's policy and contract liabilities at 31 December 2005. Fixed indexed annuities vary in structure, but generally are deferred annuities that enable policyholders to obtain a portion of an equity-linked return but provide a guaranteed minimum return. These guaranteed minimum rates are generally set at 3 per cent.

JNL hedges the equity return risk on fixed index products using futures and options linked to the relevant index. The cost of these hedges is taken into account in setting index participation rates and caps. JNL bears the investment and surrender risk on these products.

Immediate annuities

At 31 December 2005, immediate annuities accounted for 2 per cent (2004: 2 per cent) of JNL's policy and contract liabilities. Immediate annuities guarantee a series of payments beginning within a year of purchase and continuing over either a fixed period of years and/or the life of the policyholder. If the term is for the life of the policyholder, then JNL's primary risk is mortality risk. The implicit interest rate on these products is based on the market conditions that exist at the time the policy is issued and is guaranteed for the term of the annuity.

(ii) Variable annuities

At 31 December 2005, VAs accounted for 32 per cent (2004: 26 per cent) of JNL's policy and contract liabilities. VAs are deferred annuities that have the same tax advantages and payout options as interest-sensitive and fixed index annuities.

The primary difference between VAs and interest-sensitive or fixed index annuities are investment risk and return. If a policyholder chooses a VA, the rate of return depends upon the performance of the selected fund portfolio. Policyholders may allocate their investment to either the fixed or variable account. Investment risk on the variable account is borne by the policyholder, while investment risk in the fixed account is borne by JNL through guaranteed minimum fixed rates of return. At 31 December 2005, approximately 19 per cent (2004: 26 per cent) of VA funds were in fixed accounts.

D3: US operations continued

JNL issues VA contracts where it contractually guarantees to the contract holder either a) return of no less than total deposits made to the contract adjusted for any partial withdrawals, b) total deposits made to the contract adjusted for any partial withdrawals plus a minimum return, or c) the highest contract value on a specified anniversary date adjusted for any withdrawals following the contract anniversary. These guarantees include benefits that are payable in the event of death (guaranteed minimum death benefit (GMDB)), annuitisation (guaranteed minimum income benefit (GMIB)), or at specified dates during the accumulation period (guaranteed minimum withdrawal benefit (GMWB)). JNL hedges these risks using equity options and futures contracts as described in note D3(c).

(iii) Life insurance

JNL's life insurance products accounted for 9 per cent (2004: 10 per cent) of JNL's policy and contract liabilities at 31 December 2005. The products offered include variable life insurance, term life insurance and interest-sensitive life insurance.

(iv) Institutional products

JNL's institutional products consist of GICs, funding agreements (including agreements issued in conjunction with JNL's participation in the US Federal Home Loan Bank programme) and medium-term note funding agreements. At 31 December 2005, institutional products accounted for 14 per cent of JNL's policyholder reserves (2004: 15 per cent). Under a traditional GIC, the policyholder makes a lump sum deposit. The interest rate paid is fixed and established when the contract is issued. If deposited funds are withdrawn earlier than the specified term of the contract, an adjustment is made that approximates a market value adjustment.

Under a funding agreement, the policyholder either makes a lump sum deposit or makes specified periodic deposits. JNL agree to pay a rate of interest, which may be fixed but which is usually a floating short-term interest rate linked to an external index. The average term of the funding arrangements is one to two years. Funding agreements terminable by the policyholder with less than 90 days notice account for less than 1 per cent (2004: 2 per cent) of JNL total policyholder reserves.

Medium-term note funding agreements are generally issued to support trust instruments issued on non-US exchanges or to qualified investors (as defined by SEC rule 144A). Through the funding agreements, JNL agrees to pay a rate of interest, which may be fixed or floating, to the holders of the trust instruments.

(c) Risk management

JNL's main exposure to market risk is through its exposure to interest rate risk because approximately 88 per cent (2004: 88 per cent) of its general account investments support interest-sensitive and fixed index annuities, life business and surplus and 12 per cent (2004: 12 per cent) support institutional business. All of these types of business contain considerable interest rate guarantee features and, consequently, require that the assets that support them are primarily fixed income or fixed maturity.

Prudential is exposed primarily to the following risks in the US arising from fluctuations in interest rates:

- The risk of loss related to meeting guaranteed rates of accumulation following a sharp and sustained fall in interest rates;
- the risk of loss related to policyholder withdrawals following a sharp and sustained increase in interest rates; and
- the risk of mismatch between the expected duration of certain annuity liabilities and prepayment risk and extension risk inherent in mortgage-backed securities.

JNL enters into financial derivative transactions, including swaps, forwards, put-swaptions, futures and options to reduce and manage business risks. These transactions manage the risk of a change in the value, yield, price, cash flows, or quantity of, or a degree of exposure with respect to assets, liabilities or future cash flows, which JNL has acquired or incurred.

JNL generally uses free-standing derivative instruments for hedging purposes. Additionally, certain liabilities, primarily trust instruments supported by funding agreements, fixed index annuities and GMWB and reinsurance GMIB features of variable annuities, issued by JNL contain embedded derivatives as defined by IAS 39, 'Financial Instruments: Recognition and Measurement'. JNL does not account for such derivatives as either fair value or cash flow hedges as might be permitted if specific hedge documentation requirements of IAS 39 were followed. Financial derivatives, including derivatives embedded in certain host liabilities that have been separated for accounting and financial reporting purposes are carried at fair value.

Value movements on the derivatives are reported within the income statement. Under the Group's accounting policies supplementary analysis of the profit before taxes attributable to shareholders is provided as shown in note B1. In preparing this analysis value movements on JNL derivative contracts, other than for certain equity-based product management activities, are included within short-term fluctuations in investment returns and excluded from operating results based on longer-term investment returns. Value movements on derivative instruments used for certain equity-based product management activities are included within operating results based on longer-term investment returns as the value movements broadly offset the economic impact of changed levels of benefit payments and reserves as equity markets fluctuate. The types of derivative used by JNL and their purpose are as follows:

- Interest rate swaps agreements generally involve the exchange of fixed and floating payments over the life of the agreement without an exchange of the underlying principal amount. These agreements are used for hedging purposes;
- forwards consist of interest spreadlock agreements, in which JNL locks in the forward interest rate differential between a swap and the corresponding US Treasury security. The forwards are held for investment purposes;
- put-swaption contracts provide the purchaser with the right, but not the obligation, to require the writer to pay the present value of a long-duration interest rate swap at future exercise dates. JNL purchases and writes put-swaptions with maturities up to 10 years. On a net basis, put-swaptions hedge against significant upward movements in interest rates;

D3: US operations continued

- equity index futures contracts and equity index call and put options are used to hedge JNL's obligations associated with its issuance of fixed index immediate and deferred annuities and certain VA guarantees. These annuities and guarantees contain embedded options which are fair valued for accounting and financial reporting purposes;
- total return swaps in which JNL receives equity returns or returns based on reference pools of assets in exchange for short-term floating rate payments based on notional amounts, are held for both hedging and investment purposes; and
- cross-currency swaps, which embody spot and forward currency swaps and additionally, in some cases, interest rate swaps and equity index swaps, are entered into for the purpose of hedging JNL's foreign currency denominated funding agreements supporting trust instrument obligations.

As noted above, JNL is exposed to equity risk through the options embedded in JNL's fixed indexed liabilities and guarantees included in certain VA benefits including GMDB and GMWB. This risk is managed using a comprehensive equity hedging programme to minimise the risk of a significant economic impact as a result of increases or decreases in equity market levels while taking advantage of naturally offsetting exposures in JNL's operations. JNL purchases external futures and options that hedge the risks inherent in these products, while also considering the impact of rising and falling separate account fees. As a result of this hedging programme, if the equity markets were to increase by 10 per cent, JNL's free-standing derivatives would decrease in value by approximately £22 million net of related changes to amortisation of deferred acquisition costs. This would be substantially offset by the positive impact of increased separate account fees and reserve decreases of approximately £14 million, net of related changes to amortisation of deferred acquisition costs, resulting in a net loss of approximately £8 million.

For risk management purposes, the US general account portfolio is divided substantially into assets that support the interest-sensitive life and fixed annuity business, the institutional business and the fixed index business. Prudential hedges the equity return risk on fixed index products by purchasing futures and options on the relevant index.

Information on credit risk of debt securities and mortgage-backed securities

For statutory reporting in the US, debt securities are classified into six quality categories specified by the Securities Valuation Office of the National Association of Insurance Commissioners (NAIC). The categories range from Class 1 (the highest) to Class 6 (the lowest). Performing securities are designated as Classes 1 to 5. Securities in or near default are designated Class 6. Securities designated as Class 3, 4, 5 and 6 are non-investment grade securities. Generally, securities rated AAA to A by nationally recognised statistical ratings organisations are reflected in Class 1, BBB in Class 2, BB in Class 3 and B and below in Classes 4 to 6. If a designation is not currently available from the NAIC, JNL's investment advisor, PPM America, provided the designation for the purposes of disclosure below.

The following table shows the quality of publicly traded and SEC Rule 144A traded debt securities held by the US operations as at 31 December 2005:

	Carrying value £m	% of total
NAIC designation:		
1	**5,852**	**39.0**
2	**7,622**	**50.8**
3	**1,183**	**7.9**
4	**320**	**2.1**
5	**30**	**0.2**
6	**–**	**0.0**
	15,007	**100.0**

The following table shows the quality of the non-SEC Rule 144A traded private placement portfolio:

	Carrying value £m	% of total
NAIC designation:		
1	**1,368**	**42.8**
2	**1,471**	**46.0**
3	**299**	**9.3**
4	**51**	**1.6**
5	**–**	**–**
6	**11**	**0.3**
	3,200	**100.0**

Of the residential mortgage-backed securities, 86.9 per cent were rated AAA or the equivalent by a nationally recognised statistical ratings organisation (including Standard & Poor's, Moody's and Fitch) and 99.9 per cent were rated NAIC 1.

Of the commercial mortgage-backed securities, 100 per cent were rated by a nationally recognised statistical ratings organisation (including Standard & Poor's, Moody's and Fitch) and 98.5 per cent were rated investment grade.

D3: US operations continued

(d) Process for setting assumptions and determining liabilities

Under the MSB of reporting applied under IFRS 4 for insurance contracts, providing the requirements of the Companies Act, UK GAAP standards and the ABI SORP are met, it is permissible to reflect the local basis of provisioning. In the case of JNL, except for adjustments for certain items, the carrying values of insurance assets and liabilities are consolidated into the Group accounts based on US GAAP. The exceptions are for IFRS accounting in 2004 for fixed index annuities, which include embedded derivatives that are supported by equity call options and VA GMWB benefits, and VA GMIB benefits. For 2004, before the adoption of IAS 39, the call options were valued at amortised cost whilst the VA benefits were recognised as a portion of accumulated assessments related to expected excess benefits under MSB. For 2005, in line with US GAAP, these are carried at fair value following the adoption of IAS 39 using the Black-Scholes option valuation methodology.

Under US GAAP, investment contracts (as defined for US GAAP purposes) are accounted for by applying in the first instance a retrospective deposit method to determine the liability for policyholder benefits. This is then augmented by potentially three additional amounts. These amounts are for:

- Any amounts that have been assessed to compensate the insurer for services to be performed over future periods (i.e. deferred income);
- any amounts previously assessed against policyholders that are refundable on termination of the contract; and
- any probable future loss on the contract (i.e. premium deficiency).

Capitalised acquisition costs and deferred income for these contracts are amortised over the life of the book of contracts. The present value of the estimated gross profits is computed using the rate of interest that accrues to policyholder balances (sometimes referred to as the contract rate). Estimated gross profits include estimates of the following elements, each of which will be determined based on the best estimate of amounts of the following individual elements over the life of the book of contracts without provision for adverse deviation for:

- Amounts expected to be assessed for mortality less benefit claims in excess of related policyholder balances;
- amounts expected to be assessed for contract administration less costs incurred for contract administration;
- amounts expected to be earned from the investment of policyholder balances less interest credited to policyholder balances;
- amounts expected to be assessed against policyholder balances upon termination of contracts (sometimes referred to as surrender charges); and
- other expected assessments and credits.

VA contracts written by JNL may, as described above, provide for GMDB, GMIB and GMWB features. In general terms, liabilities for these benefits are accounted for under US GAAP by using estimates of future benefits and fees under best estimate persistency assumptions.

The GMDB liability is determined each period end by estimating the expected value of death benefits in excess of the projected account balance and recognising the excess rateably over the accumulation period based on total expected assessments. At 31 December 2005, the GMDB liability was valued using a series of deterministic investment performance scenarios, a mean investment return of 8.4 per cent (2004: 8.4 per cent) and assumptions for lapse, mortality and expense that are the same as those used in amortisation of capitalised acquisition costs.

The direct GMIB liability is determined by estimating the expected value of the annuitisation benefits in excess of the projected account balance at the date of annuitisation and recognising the excess rateably over the accumulation period based on total expected assessments.

The assumptions used for calculating the direct GMIB liability at 31 December 2005 and 2004 are consistent with those used for calculating the GMDB liability.

JNL regularly evaluates estimates used and adjusts the additional GMDB and GMIB liability balances, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised.

GMIB benefits are essentially fully reinsured, subject to annual claim limits. As this reinsurance benefit is net settled, it is considered to be a derivative under IAS 39 and is, therefore, recognised at fair value with the change in fair value included as a component of short-term derivative fluctuations.

Most GMWB features are considered to be embedded derivatives under IAS 39. Therefore, provisions for these benefits are recognised at fair value, with the change in fair value included in operating profit based on longer-term investment returns. Certain GMWB features guarantee payments over a lifetime and, therefore, include mortality risk. Provisions for these GMWB amounts, which are not significant, are valued consistent with the GMDB valuation method discussed above.

D3: US operations continued

The fair values of the GMWB and GMIB reinsurance derivatives are calculated based on actuarial assumptions related to the projected cash flows, including benefits and related contract charges, over the expected lives of the contracts, incorporating expectations regarding policyholder behaviour in varying economic conditions. As the nature of these cash flows can be quite varied, stochastic techniques are used to generate a variety of market return scenarios for evaluation. The generation of these scenarios and the assumptions as to policyholder behaviour involve numerous estimates and subjective judgements, including those regarding expected market volatility, correlations of market returns and discount rates, utilisation of the benefit by policyholders under varying conditions, and policyholder lapsation. At each valuation date, JNL assumes expected returns based on risk-free rates as represented by the LIBOR forward curve rates as of that date and market volatility as determined with reference to implied volatility data and evaluations of historical volatilities for various indices. The risk-free spot rates as represented by the LIBOR spot curve as of the valuation date are used to determine the present value of expected future cash flows produced in the stochastic process.

With the exception of the GMDB, GMIB and GMWB features of VA contracts, the financial guarantee features of JNL's contracts are in most circumstances not explicitly valued under the standard US GAAP basis of calculation, but the impact of any interest guarantees would be reflected as they are earned in the current account value (i.e. the US GAAP liability).

For traditional life insurance contracts, provisions for future policy benefits are determined under US GAAP standard FAS 60, 'Accounting and Reporting by Insurance Enterprises' using the net level premium method and assumptions as of the issue date as to mortality, interest, policy lapses and expenses plus provisions for adverse deviation.

Institutional products are accounted for as investment contracts under IFRS with the liability classified as being in respect of financial instruments rather than insurance contracts, as defined by IFRS 4. In practice, there is no material difference between the IFRS and US GAAP basis of recognition and measurement for these contracts.

Certain institutional products representing obligations issued in currencies other than US dollars have been hedged for changes in exchange rates using cross-currency swaps. The fair value of derivatives embedded in funding agreements, as well as foreign currency transaction gains and losses, are included in the carrying value of the trust instruments supported by funding agreements.

(e) Reinsurance

The principal reinsurance ceded by JNL outside the Group is on term life insurance, direct and assumed accident and health business and certain annuity guarantees. In 2005, the premiums for such ceded business amounted to £78 million. Net commissions received on ceded business and claims incurred ceded to external reinsurers totalled £13 million and £54 million, respectively, during 2005. There were no deferred gains or losses on reinsurance contracts in either 2005 or 2004. The reinsurance asset for business ceded outside the Group was £520 million.

(f) Effect of changes in assumptions used to measure insurance assets and liabilities

The operating profit based on longer-term investment returns of £362 million for US operations for 2005 has been determined after taking account of material changes of assumptions during the year. Several assumptions were modified in 2005 to conform to more recent experience. The most significant changes included a DAC write-down of £21 million for Single Premium Deferred Annuities partial withdrawal changes and a Universal Life SOP 03-1, 'Accounting and Reporting by Insurance Enterprises for Certain Non-traditional Long Duration Contracts and Separate Accounts' reserve increase of £13 million due to increasing the mortality assumption. Several smaller changes relating to Single Premium Whole Life surrenders and annuity mortality and annuitisation rates, resulted in a £19 million benefit on adjusting amortisation of deferred acquisition costs. Combined with other minor modifications, the resulting net impact of all changes during the year was a decrease to pre-tax profits of £7 million.

(g) Amount, timing and uncertainty of future cash flows from insurance contracts

At 31 December 2005, the EEV basis value of in-force business of the US operations, after taking account of the cost of encumbered capital, and the cost of the time value of financial options and guarantees was £1,251 million. This value has been determined after applying the principles of valuation described in section (d) of this note. The key assumptions in these projections are the risk discount rates, which are 8.0 per cent for VA business and 5.2 per cent for other business, and the expected long-term spread between the earned rate and the rate credited to policyholders for single premium deferred annuity business of 1.75 per cent.

The sensitivity of this value to changes in key assumptions is as follows:

	£m
Economic assumptions:	
Discount rates – 1% increase	(133)
Interest rates (including consequential changes for assumed investment returns for all asset classes, market values of debt securities, and all risk discount rates):	
– 1% increase	(144)
– 1% decrease	55
Equity/Property yields – 1% rise	42
Equity/Property market values – 10% fall	(85)
Non-economic assumptions:	
Maintenance expenses – 10% decrease	36
Lapse rates – 10% decrease	90
Mortality and morbidity – 5% decrease in base rates (i.e. increased longevity):	
Life	83
Annuity (relating to VA business)	7

D3: US operations continued

(h) Sensitivity of IFRS basis profit or loss and equity to changes that have a material effect

(i) Currency fluctuations

Consistent with the Group's accounting policies the profits of the Group's US operations are translated at average exchange rates and shareholders' equity at the closing rate for the reporting period. For 2005, the rates were US$1.82 and US$1.72 to £1 sterling respectively. A 10 per cent increase in these rates would reduce reported profit before tax attributable to shareholders and shareholders' equity attributable to US insurance operations by £48 million and £270 million respectively.

(ii) Other sensitivities

The principal determinants of variations in operating profit based on longer-term returns are:

- Growth in the size of assets under management covering the liabilities for the contracts in force; and

- spread returns for the difference between investment returns and rates credited to policyholders.

For the purpose of determining longer-term returns, adjustment is necessary for the normalisation of investment returns to remove the effects of short-term volatility in investment returns.

- Amortisation of deferred acquisition costs.

For term business, acquisition costs are deferred and amortised in line with expected premiums. For annuity business, acquisition costs are deferred and amortised in line with expected gross profits on the relevant contracts. For interest-sensitive business, the key assumption is the expected long-term spread between the earned rate and the rate credited to policyholders, which is based on an annual spread analysis. In addition, expected gross profits depend on mortality assumptions, assumed unit costs and terminations other than deaths (including the related charges) all of which are based on a combination of actual experience of the JNL companies, industry experience and future expectations. A detailed analysis of actual experience is measured by the internally developed mortality studies. For VA business, the key assumption is the expected long-term level of equity market returns which for 2005 and 2004, was 8.4 per cent per annum implemented using a mean reversion methodology. These returns affect the level of future expected profits through their effects on the fee income and the required level of provision for guaranteed minimum death benefit claims.

- Variations in fees and other income, offset by variations in market value adjustment payments and, where necessary, strengthening of liabilities.

Except to the extent of mortality experience, which primarily affects profits through variations in claim payments and GMDB reserves, the profits of JNL are relatively insensitive to changes in insurance risk.

(iii) Exposure to interest rate risk

Notwithstanding the market risk exposure described in section D3(c), except in the circumstances of interest rate scenarios where the guarantee rates included in contract terms are higher than crediting rates that can be supported from assets held to cover liabilities, the accounting measurement of liabilities of JNL products is not generally sensitive to interest rate risk. This position derives from the nature of the products and the US GAAP basis of measurement described in sections D3(b) and D3(d).

(i) Duration of liabilities

The Group uses cash flow projections of expected benefit payments as part of the determination of the value of in-force business when preparing EEV basis results. The maturity profile of the cash flows used for that purpose for 2005 is as follows:

	Fixed annuity and other business (including GICs and similar contracts) %	Variable annuity %
Expected maturity:		
0 to 5 years	34	34
5 to 10 years	29	31
10 to 15 years	17	19
15 to 20 years	10	10
20 to 25 years	5	4
Over 25 years	5	2

D4: Asian operations

(a) Summary balance sheet at 31 December 2005

	With-profit business £m	Unit-linked assets and liabilities £m	Other £m	Total £m
Assets				
Goodwill attributable to shareholders	–	–	172	172
Other intangibles (primarily deferred acquisition costs)	–	–	566	566
Total	–	–	738	738
Other non-investment and non-cash assets	104	11	451	566
Investments of long-term business, banking and other operations:				
Investment properties	24	–	15	39
Financial investments:				
Loans and receivables	382	–	723	1,105
Equity securities and portfolio holdings in unit trusts	2,444	1,889	626	4,959
Debt securities	1,901	704	2,137	4,742
Other investments	15	3	27	45
Deposits	102	67	205	374
Total investments	4,868	2,663	3,733	11,264
Cash and cash equivalents	114	24	366	504
Total assets	**5,086**	**2,698**	**5,288**	**13,072**
Equity and liabilities				
Equity				
Shareholders' equity	–	–	1,288	1,288
Liabilities				
Policyholder liabilities and unallocated surplus of with-profits funds:				
Insurance contract liabilities	4,545	2,698	3,483	10,726
Investment contract liabilities with discretionary participation features	80	–	–	80
Investment contract liabilities without discretionary participation features	22	–	–	22
Unallocated surplus of with-profits funds	85	–	–	85
Total	4,732	2,698	3,483	10,913
Other non-insurance liabilities	354	–	517	871
Total liabilities	5,086	2,698	4,000	11,784
Total equity and liabilities	**5,086**	**2,698**	**5,288**	**13,072**

Summary policyholder liabilities (net of reinsurance) and unallocated surplus at 31 December 2005

The policyholder liabilities (net of reinsurance of £8 million) and unallocated surplus shown in the table above reflect the following balances:

	2005 £m
With-profits and other non-linked business	**8,122**
Unallocated surplus of Asian operations	**85**
Unit-linked business	**2,698**
	10,905

At 31 December 2005 the policyholder liabilities (net of reinsurance) and unallocated surplus for Asian operations of £10.9 billion (2004: £7.9 billion) comprised the following:

	2005 £m
Singapore	**3,938**
Hong Kong	**2,156**
Taiwan	**2,050**
Japan	**631**
Malaysia	**763**
Other countries	**1,367**
Total Asian operations	**10,905**

This amount covers a range of with-profit, unit-linked and non-participating contracts.

D4: Asian operations continued

(b) Products and guarantees

The life insurance products offered by the Group's Asian operations include a range of with-profits and non-participating term, whole life, endowment and unit-linked policies. The Group's Asian operation also offers health, disability, critical illness, and accident coverage to supplement its core life products.

The terms and conditions of the contracts written in the Asian operations and, in particular, the products' options and guarantees, vary from territory to territory depending upon local market circumstances.

In general terms, the Group's Asian participating products provide savings and 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 insurers. The Asian operations' non-participating term, whole life and products offer savings with protection where the benefits are guaranteed or determined by a set of defined market related parameters. Unit-linked products combine savings with protection, the cash value of the policy depends on the value of the underlying unitised funds. Accident and Health (A&H) policies provide mortality or morbidity benefits and include health, disability, critical illness and accident coverage. A&H products are commonly offered as supplements to main life policies but can be sold separately.

Subject to local market circumstances and regulatory requirements, the guarantee features described above in respect of UK business broadly apply to similar types of participating contracts written in the PAC Hong Kong branch, Singapore and Malaysia. Participating products have both guaranteed and non-guaranteed elements.

Non-participating long-term products are the only ones where the insurer is contractually obliged to provide guarantees on all benefits. Investment-linked products have the lowest level of guarantee if indeed they have any.

Product guarantees in Asia can be broadly classified into four main categories; namely premium rate, cash value and interest guarantees, policy renewability and convertibility options.

The risks on death coverage through premium rate guarantees are low due to appropriate product pricing.

Cash value and interest rate guarantees are of three types:

- Maturity values
  Maturity values are guaranteed for non-participating products and on the guaranteed portion of participating products. Declared annual bonuses are also guaranteed once vested. Future bonus rates and cash dividends are not guaranteed in participating products.
- Surrender values
  Surrender values are guaranteed for non-participating products and on the guaranteed portion of participating products. The surrender value of declared reversionary bonuses are also guaranteed once vested.

  Market value adjustments and surrender penalties are used where the law permits such adjustments in cash values.
- Interest rate guarantees
  It is common in Asia for regulations or market driven demand and competition to provide some form of capital value protection and minimum crediting interest rate guarantees. This would be reflected within the guaranteed maturity and surrender values.

The guarantees are borne by shareholders for non-participating and investment-linked (non-investment guarantees only) products. Participating product guarantees are predominantly supported by the segregated life fund and its estate.

The most significant book of non-participating business in the Group's Asian operations is Taiwan's whole of life contracts. For these contracts there are floor levels of policyholder benefits that accrue at rates set at inception which are set by reference to minimum terms established by local regulation also at the time of inception. These rates do not vary subsequently with market conditions.

Under these contracts, the cost of premiums are also fixed at inception based on a number of assumptions at that time, including long-term interest rates, mortality assumptions and expenses. The guaranteed maturity and surrender values reflect the pricing basis. The main variable that determines the amounts payable under the contracts is the duration of the contracts, which is determined by death or surrender. The sensitivity of the IFRS result for these contracts is shown in section (h) below.

Whole life contracts with floor levels of policyholder benefits that accrue at rates set at inception are also written in the Korean life operations, though to a much less significant extent than in Taiwan. The Korean business has non-linked liabilities and linked liabilities at 31 December 2005 of £193 million and £91 million respectively. The business is much less sensitive to returns than Taiwan with the higher proportion of linked and health business.

The other area of note in respect of guarantees is the Japan business where pricing rates are higher than current bond yields. Lapse risk is a feature in that policyholders could potentially surrender their policies on guaranteed terms if interest rates significantly increased leaving the potential for losses if bond values had depreciated significantly. However, the business is matched to a relatively short realistic liability duration.

The method for determining liabilities of insurance contracts for UK GAAP, and hence IFRS, purposes for some Asian operations is based on US GAAP principles and this method applies to contracts with cash value and interest rate guarantees. Following standard US GAAP procedure, premium deficiency reserve calculations are performed each year to establish whether the carrying values of the liabilities are insufficient.

D4: Asian operations continued

On the US GAAP basis the calculations are deterministic, that is to say based off a single set of projections, and expected long-term rates of return are applied.

(c) Exposure to market risk

In Asia, Prudential sells with-profits and unit-linked policies and, although the with-profits business generally has a lower terminal bonus element than in the UK, the investment portfolio still contains a proportion of equities and, to a lesser extent, property. Non-participating business is largely backed by debt securities or deposits. With the principal exception of Taiwan's whole of life policy book, as described in section (h) below, the exposure to market risk of the Group arising from its Asian operations is at modest levels. This arises from the fact that the Group's Asian operations have a balanced portfolio of with-profits, unit-linked and other types of business.

(d) Process for setting assumptions and determining liabilities

The future policyholder benefit provisions for Asian businesses in the Group's IFRS accounts and previously under the MSB, are determined in accordance with methods prescribed by local GAAP adjusted to comply, where necessary, with UK GAAP.

For Asian operations in countries where local GAAP is not well established and in which the business written is primarily non-participating and linked business, US GAAP is used as the most appropriate reporting basis. Of the more significant Asia operations this basis is applied in Taiwan, Japan and Vietnam. The future policyholder benefit provisions for non-linked business are determined under FAS 60 using the net level premium method, with an allowance for surrenders, maintenance and claims expenses. Rates of interest used in establishing the policyholder benefit provisions vary by operation depending on the circumstances attaching to each block of business.

For the traditional business in Taiwan, the economic scenarios used to calculate the IFRS results reflect the assumption of a phased progression of bond yields from current rates to long-term expected rates. The projections assume that the current bond yields of around 2 per cent (3 per cent) trend towards 5.5 per cent (5.5 per cent) at 31 December 2012 (2010).

(e) Reinsurance

The Group's Asian businesses cede only minor amounts of business outside the Group with immaterial effects on reported profit. During 2005, reinsurance premiums for externally ceded business were £37 million and reinsurance recoverable insurance assets were £8 million in aggregate.

(f) Effect of changes in bases and assumptions used to measure insurance assets and liabilities

The 2005 results for Asian operations are affected in two significant ways for changes of basis or assumption.

For the Singapore life business, under the basis applied previously, 2004 liabilities of non-participating business were determined on a net premium basis using prescribed interest rates such that a very high degree of prudence resulted. This basis has been replaced under the Singapore risk-based capital framework, with one that, although still including provisions for adverse deviation, more accurately estimates the liability. This has resulted in a change of estimate and reduction in the liability of £73 million.

The second item reflects the application of liability adequacy testing for the Taiwan life business which has resulted in a write-off of deferred acquisition costs of £21 million in 2005. The assumptions for future investment returns for Taiwan are described in section (d) above. The loss reflects the reduction in 2005 in the expected yields over the trending period to the assumed long-term rate of 5.5 per cent for Taiwanese government bonds.

There were no other changes of assumptions that had a material impact on the 2005 results of Asian operations.

(g) Amount, timing and uncertainty of future cash flows from insurance contracts

At 31 December 2005, the EEV basis value of in-force business of the Group's Asian operations, after taking account of the cost of encumbered capital, and the cost of the time value of financial options and guarantees was £1,226 million. The most significant businesses in Asia are in Hong Kong, Malaysia, Singapore and Taiwan. These businesses account for 77 per cent of the total value of business in force for Prudential's Asian operations. These EEV basis in-force values for the Asian operations have been determined after applying the principles of valuation described in section D1 and the following key assumptions for the four most significant businesses.

	Risk discount rate (in-force business) %	Expected long-term rate of inflation %	Government bond yield %
Hong Kong*	6.15	2.25	4.8
Malaysia	9.0	3.0	7.5
Singapore	6.8	1.75	4.5
Taiwan	9.4	2.25	5.5

*Hong Kong business is predominantly US dollar denominated.

The most significant equity holdings in Asian operations are in Hong Kong, Singapore and Malaysia. The arithmetic average equity return assumptions for these three territories at 31 December 2005 were 8.6 per cent, 9.3 per cent and 12.8 per cent respectively (2004: 7.3 per cent, 9.75 per cent, and 12.25 per cent respectively).

For Taiwan the same assumptions are applied as under IFRS (see section (d) above).

D4: Asian operations continued

The sensitivity of this value to changes in key assumptions is as follows:

	£m
Economic assumptions:	
Discount rates – 1% increase	(236)
Interest rates (including consequential changes for assumed investment returns for all assets classes, market values of debt securities, and all risk discount rates):	
– 1% increase	49
– 1% decrease	(126)
Equity/Property yields – 1% rise	136
Equity/Property market values – 10% fall	(75)
Non-economic assumptions:	
Maintenance expenses – 10% decrease	45
Lapse rates – 10% decrease	87
Mortality and morbidity – 5% decrease in base rates (i.e. increased longevity)	69

In addition to these disclosures, for Asian operations as a whole it should be noted that the cash flows of the Taiwan life business are particularly sensitive to projected rates of investment return.

(h) Sensitivity of IFRS basis profit or loss and equity to changes that have a material effect

(i) Currency translation

Consistent with the Group's accounting policies, the profits of the Group's Asian operations are translated at average exchange rates and shareholders' equity at the closing rate for the reporting period. For 2005, the rates for the most significant operations are given in note I9.

A 10 per cent increase in these rates and those of other Asian operations would have reduced reported profit before tax attributable to shareholders and shareholders' equity, excluding goodwill attributable to Asian operations, by £23 million and £101 million respectively.

(ii) Other sensitivities

With-profits business

Similar principles to those explained for UK with-profits business apply to profit emergence for the Group's Asian with-profit business. Correspondingly the profit emergence reflects bonus declaration and is relatively insensitive to period by period fluctuations in insurance risk or interest rate movements.

Unit-linked business

As for the UK insurance operations, the profits and shareholders' equity related to the Group's Asian operations is primarily driven by charges related to invested funds. For the Group's Asian operations substantially all of the contracts are classified as insurance contracts under IFRS 4, i.e. containing significant insurance risk. The sensitivity of profits and equity to changes in insurance risk is minor, and to interest rate risk, not material.

Other non-participating business

The principal other non-participating business of Asian operations is the traditional whole life business written in Taiwan.

The in-force business of Taiwan life operation includes traditional whole of life policies where the premium rates have been set by the regulator at different points for the industry as a whole. Premium rates were set to give a guaranteed minimum sum assured on death and a guaranteed surrender value on early surrender based on prevailing interest rates at the time of policy issue. Premium rates also included allowance for mortality and expenses. The required rates of guarantee have fallen over time as interest rates have reduced from a high of 8 per cent to current levels of around 2 per cent. The current low level of bond rates in Taiwan gives rise to a negative spread against the majority of these policies. The current cash costs of funding in-force negative spread in Taiwan is around £30 million a year.

The profits attaching to these contracts are particularly affected by the rates of return earned, and estimated to be earned, on the assets held to cover liabilities and on future investment income and contract cash flows. Under IFRS, the insurance contract liabilities of the Taiwan business are determined on the US GAAP basis as applied previously under UK GAAP. Under this basis the policy liabilities are calculated on sets of assumptions, which are locked in at the point of policy inception, and a deferred acquisition cost is held in the balance sheet.

The adequacy of the insurance contract liabilities is tested by reference to best estimates of expected investment returns on policy cash flows and reinvested income. The assumed earned rates are used to discount the future cash flows. The assumed earned rates consist of a long-term best estimate determined by consideration of long-term market conditions, and rates assumed to be earned in the trending in period. As previously noted in section (d), for 2005, it has been projected that rates of return for Taiwanese bond yields will trend from the current levels of some 2 per cent to 5.5 per cent by 31 December 2012.

D4: Asian operations continued

The liability adequacy test results are sensitive to the attainment of the trended rates during the trending period. Based on the current asset mix, margins in other contracts that are used in the assessment of the liability adequacy tests, and currently assumed future rates of return, if interest rates were to remain at current levels in 2006 the premium reserve, net of deferred acquisition costs, would be broadly sufficient. If interest rates were to remain at current levels in 2007 then some level of write-off of deferred acquisition costs may be necessary. However, the amount of the charge, currently estimated at £50-70 million is sensitive for the previously mentioned variables.

The adequacy of the liability is also sensitive to the level of the projected long-term rate. The current long-term assumption of 5.5 per cent has been determined on a prudent best estimate basis by reference to detailed assessments of the financial dynamics of the Taiwanese economy. In the event that the rate applied was reduced or increased the carrying value of the liabilities would be affected.

In broad terms, if the assumed long-term rate applied was to fall by 0.25 per cent from 5.5 per cent to 5.25 per cent the impact on IFRS basis results would be a charge of some £120-130 million. If the rate was to further reduce the incremental increase in liabilities would be of a similarly commensurate size. The effects of changes in any one year reflect the combination of the short-term and long-term factors described above.

For the Korean and Japan life business exposures described in section (b) above, the results are comparatively unaffected by changes of assumption. The accounts basis value of liabilities for both operations are of a similar order of magnitude to those that apply for the purposes of Group solvency calculations under the Financial Conglomerates Directive (FCD).

(i) Duration of liabilities

The Group uses cash flow projections of expected benefit payments as part of the determination of the value of in-force business when preparing EEV basis results. The maturity profile of the cash flows, taking account of expected future premiums and investment returns, is as follows:

	Asia total %
Expected maturity:	
0 to 5 years	23
5 to 10 years	25
10 to 15 years	19
15 to 20 years	12
20 to 25 years	8
Over 25 years	13

D5: Capital position statement for life assurance businesses

(a) Summary statement

The Group's capital position for life assurance businesses with reconciliations to shareholders' funds is shown below. Available capital for each fund or group of companies is determined by reference to local regulation at 31 December 2004 and 2005.

31 December 2005	SAIF £m	WPSF (note i) £m	Total PAC with-profits fund £m	Other UK subsidiaries and funds (note ii) £m	JNL £m	Asian life assurance subsidiaries £m	Total life assurance operations £m	M&G £m	Egg £m	Parent company and shareholders' equity of other subsidiaries and funds £m	Group £m
Group shareholders' equity											
Held outside long-term funds:											
Net assets	0	0	0	640	2,899	1,034	4,573	245	303	(1,826)	3,295
Goodwill	0	0	0	0	–	111	111	1,153	–	77	1,341
Total	0	0	0	640	2,899	1,145	4,684	1,398	303	(1,749)	4,636
Held in long-term funds (note iii)	0	0	0	558	–	–	558	–	–	–	558
Total Group shareholders' equity	0	0	0	1,198	2,899	1,145	5,242	1,398	303	(1,749)	5,194
Adjustments to regulatory basis											
Unallocated surplus of with-profits funds (note v)	0	11,272	11,272	–	–	85	11,357				
Shareholders' share in realistic liabilities	–	(3,473)	(3,473)	–	–	–	(3,473)				
Deferred acquisition costs of non-participating business and goodwill not recognised for regulatory reporting purposes	(6)	(29)	(35)	(168)	(1,624)	(619)	(2,446)				
JNL surplus notes (note iv)	–	–	–	–	145	–	145				
Part of IAS 19 basis deficit attributable to WPSF not recognised for regulatory purposes	–	211	211	–	–	–	211				
Other adjustments to restate these amounts to a regulatory basis (with SAIF and the WPSF on a Peak 2 realistic basis) (note v)	6	(2)	4	(271)	837	(41)	529				
Total adjustments	0	7,979	7,979	(439)	(642)	(575)	6,323				
Total available capital resources of life assurance businesses on local regulatory bases	0	7,979	7,979	759	2,257	570	11,565				

Policyholder liabilities	SAIF £bn	WPSF (i) £bn	Other UK subsidiaries and funds (ii) £bn	JNL £bn	Asian life operations £bn	Total life assurance operations £bn
With-profits liabilities of UK regulated with-profits funds:						
Insurance contracts	13,043	32,557	–	–	2,053	47,653
Investment contracts (with discretionary participating features)	751	25,692	–	–	80	26,523
Total	13,794	58,249	–	–	2,133	74,176
Other liabilities:						
Insurance contracts:						
With-profit liabilities of non-UK regulated funds	–	–	–	–	2,492	2,492
Unit-linked, including variable annuity	–	2,125	7,629	8,574	2,698	21,026
Other life assurance business	968	12,810	10,099	21,905	3,483	49,265
Investment contracts without discretionary participation features (principally unit-linked and similar contracts in the UK and GIC liabilities of JNL) (note vi)	–	–	10,502	1,502	22	12,026
	968	14,935	28,230	31,981	8,695	84,809
Total policyholder liabilities shown in the consolidated balance sheet	14,762	73,184	28,230	31,981	10,828	158,985

D5: Capital position statement for life assurance businesses continued

31 December 2004	SAIF £m	WPSF (note i) £m	Total PAC with-profits fund £m	Other UK subsidiaries and non-profit funds of PAC (note ii) £m	JNL £m	Asian life assurance subsidiaries £m	Total life assurance operations £m	M&G £m	Egg £m	Parent company and shareholders' equity of other subsidiaries and funds £m	Group £m
Group shareholders' equity											
Held outside long-term funds:											
Net assets	0	0	0	308	2,295	750	3,353	300	273	(1,413)	2,513
Goodwill	0	0	0	0	–	231	231	1,153	–	77	1,461
Total	0	0	0	308	2,295	981	3,584	1,453	273	(1,336)	3,974
Held in long-term funds (note iii)	0	0	0	515	–	–	515	–	–	–	515
Total Group shareholders' equity	0	0	0	823	2,295	981	4,099	1,453	273	(1,336)	4,489
Adjustments to regulatory basis											
Unallocated surplus of with-profits funds (note v):											
Reflecting previous GAAP basis of measuring liabilities for with-profit contracts for UK regulated with-profits funds	1,836	13,928	15,764	–	–	385	16,149				
Transition adjustment on application of FRS 27 and IAS 39	(1,305)	(6,502)	(7,807)	–	–	–	(7,807)				
Reflecting FSA realistic basis of measuring liabilities for with-profit contracts for UK regulated with-profits funds	531	7,426	7,957	0	0	385	8,342				
Shareholders' share in realistic liabilities	0	(2,904)	(2,904)	–	–	–	(2,904)				
Deferred acquisition costs of non-participating business and goodwill not recognised for regulatory reporting purposes	0	(31)	(31)	(115)	(1,528)	(690)	(2,364)				
JNL surplus notes (note iv)	–	–	–	–	130	–	130				
IAS 19 basis deficit attributable to WPSF not recognised for regulatory purposes	–	525	525	–	–	–	525				
Other adjustments to restate these amounts to a regulatory basis (with SAIF and the WPSF on a Peak 2 realistic basis) (note v)	146	348	494	(160)	899	(55)	1,178				
Total adjustments	677	5,364	6,041	(275)	(499)	(360)	4,907				
Total available capital resources of life assurance businesses on local regulatory bases	677	5,364	6,041	548	1,796	621	9,006				

D5: Capital position statement for life assurance businesses continued

The Group's policyholder liabilities at 31 December 2004 comprise:

	SAIF £m	WPSF £m	Other UK subsidiaries and funds £m	JNL £m	Asian life operations £m	Total life assurance operations £m
With-profits business	10,891	48,285	–	–	3,380	62,556
Unit-linked business	0	2,009	14,897	5,392	1,768	24,066
Other life assurance business	846	12,774	6,499	19,596	2,725	42,440
Total policyholder liabilities as shown in the consolidated balance sheet	11,737	63,068	21,396	24,988	7,873	129,062

Notes

(i) WPSF unallocated surplus includes amounts related to the Hong Kong branch. Policyholder liabilities of the Hong Kong branch are included in the amounts of Asian operations.

(ii) Excluding PAC shareholders' funds that are included in 'parent company and shareholders' equity of other subsidiaries and funds'.

(iii) The term shareholders' equity held in long-term funds refers to the excess of assets over liabilities attributable to shareholders of funds which are required by law to be maintained with segregated assets and liabilities.

(iv) For regulatory purposes the JNL surplus notes are accounted for as capital.

(v) Other adjustments to shareholders' equity and unallocated surplus include amounts for the value of non-participating business for UK regulated with-profits funds, deferred tax, admissibility and other items measured differently on the regulatory basis. For Jackson National Life the principal reconciling item is deferred tax related to deferred acquisition costs of £568 million (2004: £535 million).

(vi) Insurance business accounted for as financial instruments under IAS 39.

(b) Basis of preparation, capital requirements and management

Each of the Group's long-term business operations is capitalised to a sufficiently strong level for its individual circumstances. Details by the Group's major operations are shown below.

(i) UK insurance operations

PAC WPSF and SAIF

In common with other large UK regulated with-profits funds, PAC is required to hold capital equivalent to the greater of their regulatory requirement based on EU directives, (i.e. the 'regulatory peak') and the new FSA basis calculation of expected liabilities (i.e. the 'realistic peak').

Available capital of the WPSF and SAIF of £8.0 billion (2004: £6.0 billion) represents the excess of assets over liabilities on the regulatory realistic basis. Unlike the previously discussed FRS 27 basis, realistic liabilities on the regulatory basis include the shareholders' share of future bonuses. These amounts are shown before deduction of the risk capital margin (RCM) which is estimated to be £2.4 billion (2004: £1.8 billion) at 31 December 2005.

The FSA's basis of setting the RCM is to target at a level broadly equivalent to a Standard & Poor's credit rating of BBB and of judging this by ensuring there are sufficient assets to absorb a 1 in 200 year event. The RCM calculation achieves this by setting rules for the determination of margins to cover defined stress changes in asset values and yields for market risk, credit risk, and termination risk for with-profit policies.

As noted in section D2(d)(ii), the Company has discretion in its management actions in the case of adverse investment conditions. Management actions encompass, but are not confined to, investment allocation decisions, levels of reversionary bonuses, crediting rates, and total claim values. To illustrate the flexibility of management actions, rates of regular bonus are determined for each type of policy primarily by targeting them at a prudent proportion of the long-term expected future investment return on the underlying assets. The expected future investment return is reduced as appropriate for each type of policy to allow for items such as expenses, charges, tax and shareholders' transfers. However, the rates declared may differ by product type, or by date of payment of the premiums or date of issue of the policy, if the accumulated annual bonuses are particularly high or low relative to a prudent proportion of the achieved investment return.

When target bonus levels change, the PAC board has regard to the overall financial strength of the long-term fund when determining the length of time over which it will seek to achieve the amended product target bonus level.

In normal investment conditions, the Company expects changes to regular bonus rates to be gradual over time and changes are not expected to exceed 1 per cent per annum over any year. However, discretion is retained as to whether or not a regular bonus is declared each year, and there is no limit on the amount by which regular bonus rates can be changed.

As regards smoothing of maturity and death benefits, in normal circumstances the Company does not expect most pay-out values on policies of the same duration to change by more than 10 per cent up or down from one year to the next, although some larger changes may occur to balance pay-out values between different policies. Greater flexibility may be required in certain circumstances, for example following a significant rise or fall in market values (either sudden or over a period of years) and in such situations the PAC board may decide to vary the standard bonus smoothing limits to protect the overall interests of policyholders.

For surrender benefits, any substantial fall in the market value of the assets of the with-profits sub-fund would lead to immediate changes in the application of MVRs for accumulating with-profits policies, firstly to increase the size of MVRs already being applied and, secondly, to extend the range of policies for which an MVR is applied.

D5: Capital position statement for life assurance businesses continued

Other UK subsidiaries

The available capital of £759 million (2004: £548 million) reflects the excess of regulatory basis assets over liabilities, before deduction of the capital resources requirement of £580 million (2004: £462 million).

The capital resources requirement for these companies broadly reflects a formula, which for active funds equates to a percentage of regulatory reserves plus a percentage of death strains.

(ii) Jackson National Life

The regulatory framework for JNL is governed by the requirements of the US NAIC approved risk-based capital standards. Under the requirements life insurance companies report on a formula-based capital standard that they calculate by applying factors to various asset, premium and reserve items. The formula takes into account the risk characteristics of a company, including asset risk, insurance risk, interest rate risk and business risk.

The available capital of JNL shown above of £2,257 million (2004: £1,796 million) reflects US regulatory basis assets less liabilities excluding asset valuation reserves but inclusive of provision for interest (the interest maintenance reserve). The asset valuation reserve is designed to provide for future credit-related losses on debt securities and losses on equity investments. The interest maintenance reserve is designed by state regulators to defer recognition of non-credit related realised capital gains and losses.

JNL's risk-based capital ratio is significantly in excess of regulatory requirements.

(iii) Asian operations

The available capital shown above of £570 million (2004: £621 million) represents the excess of local regulatory basis assets over liabilities before deduction of required capital of £149 million (2004: £177 million). These amounts have been determined applying the local regulations in each of the operations.

At the country level, Prudential's businesses in Asia are subject to comprehensive and supervisory schemes in the jurisdictions in which they operate. The Hong Kong business branch of PAC and its capital requirements are subsumed within those of the PAC long-term fund. For the Group's other material Asian operations the details of the basis of determining regulatory capital and regulatory capital requirements are as follows:

Singapore

A new risk-based regulatory framework was introduced at the start of 2005 to replace the previous framework that used a net premium approach.

For participating business, a gross premium reserve, determined using prudent best estimate assumptions and which makes allowance for future bonus, is held. The amount held is subject to a minimum of the higher of the assets attributed to participating business and a gross premium reserve calculated on specified assumptions, but without allowance for future bonus, that include prescribed provisions for adverse deviations (PADs).

For non-participating business, gross premium reserves are held. For linked business the value of units is held together with a non-unit reserve calculated in accordance with standard actuarial methodology.

From 1 January 2005, capital requirements are determined using a risk-based capital approach.

Taiwan

Basic policy reserves are determined using a net premium method. Both mortality and interest rates are specified. For more recent issues, the valuation rate of interest has been linked to the prevailing market rate on 10-year government bonds.

Solvency capital is determined using a risk-based capital approach.

Japan

Mathematical reserves for traditional business are determined on a net premium basis using prescribed mortality and interest rates. Interest rates reflect the original pricing assumptions.

For linked business the value of units is held together with a non-unit reserve calculated in accordance with standard actuarial methodology.

With regard to solvency, the adjusted solvency capital assets of the Company must exceed 200 per cent of the risk related capital requirement value at risk. It is thus a risk-based capital approach.

Malaysia

Mathematical reserves for traditional business are determined on a modified net premium basis using prescribed mortality and interest rates (no higher than 4 per cent).

For linked business the value of units is held together with a non-unit reserve calculated in accordance with standard actuarial methodology.

The capital requirement is determined as 4 per cent of reserves plus a specified percentage of sums at risk. There is an overriding minimum capital requirement of RM100 million.

D5: Capital position statement for life assurance businesses continued

(iv) Group capital requirements

In addition to the requirements at individual company level, FSA requirements under the FCD apply additional prudential requirements for the Group as a whole. Discussion of the Group's estimated FCD position at 31 December 2005 is provided in the operating and financial review section of the Group's 2005 Annual Report.

(c) Movements in total available capital

Total available capital for the Group's life assurance operations has changed during 2005 as follows:

	2005 £m
Available capital at 31 December 2004	**9,006**
Changes:	
WPSF (note i)	**2,615**
SAIF (note ii)	**(677)**
JNL (note iii)	**461**
Other	**160**
	2,559
Available capital at 31 December 2005	**11,565**

Notes

(i) WPSF

The increase in available capital arises from:

	2005 £m
Investment return, net of tax and investment management expenses	**1,329**
Decrease in inadmissible assets	**309**
Decrease in cost of guarantees	**547**
Decrease in cost of bonus smoothing	**195**
Increase in the value of PAL and non-profit business	**212**
Other	**23**
	2,615

(ii) SAIF

The decrease of £677 million, reflects the impact of FSA actuarial guidance note GN 45 as explained in note D2(f).

(iii) JNL

The increase of £461 million reflects an underlying increase of £252 million (applying the 2005 year end exchange rate of 1.72) and £209 million of exchange translation gain.

(d) Transferability of available capital

For PAC and all other UK long-term insurers, long-term business assets and liabilities must, by law, be maintained in funds separate from those for the assets and liabilities attributable to non-life insurance business or to shareholders. Only the 'established surplus' – the excess of assets over liabilities in the long-term fund determined through a formal valuation – may be transferred so as to be available for other purposes. Distributions from the with-profit sub-fund to shareholders reflect the shareholders' one-ninth share of the cost of declared policyholders' bonuses.

Accordingly, the excess of assets over liabilities of the PAC long-term fund is retained within that company. The retention of the capital enables the Company to support with-profits and other business of the fund by, for example, providing the benefits associated with smoothing and guarantees. It also provides investment flexibility for the fund's assets, by meeting the regulatory capital requirements that demonstrate solvency, and by absorbing the costs of significant events or fundamental changes in its long-term business without affecting the bonus and investment policies.

For other UK long-term business subsidiaries the amounts retained within the companies are at levels which provide an appropriate level of capital strength in excess of the regulatory minimum.

For JNL, capital retention is maintained at a level consistent with an appropriate rating by Standard & Poor's. Currently JNL is rated AA. JNL can pay dividends on its capital stock only out of earned surplus unless prior regulatory approval is obtained. Furthermore, dividends which exceed the greater of 10 per cent of JNL's statutory surplus or statutory net gain from operations for the prior year require prior regulatory approval.

For Asian subsidiaries, the amounts retained within the companies are at levels that provide an appropriate level of capital strength in excess of the local regulatory minimum. For ring-fenced with-profit funds the excess of assets over liabilities is retained with distribution tied to the shareholders' share of bonuses through declaration of actuarially determined surplus. The Group's Singapore and Malaysian businesses may remit dividends to the Group, in general, provided the statutory insurance fund meets the capital adequacy standard required under local statutory regulations.

Available capital of the non-insurance business units is transferable to the life assurance businesses after taking account of an appropriate level of operating capital, based on local regulatory solvency targets, over and above basis liabilities. The economic capital model described in section D1 (concentration of risks) takes into account restrictions on mobility of capital across the Group with capital transfers to and from business units triggered at a solvency level consistent with these targets. The model takes into account restrictions on the availability to the Group of the estate of the various with-profits funds throughout the Group.

D5: Capital position statement for life assurance businesses continued

(e) Sensitivity of liabilities and total capital to changed market conditions and capital management policies

Prudential manages its assets, liabilities, and capital locally, in accordance with local regulatory requirements and reflecting the different types of liabilities Prudential has in each business. As a result of the diversity of products offered by Prudential and the different regulatory requirements in which it operates, Prudential employs differing methods of asset/liability and capital management, depending on the business concerned.

Stochastic modelling of assets and liabilities is undertaken in UK, JNL and Asia to assess the economic capital requirements under different confidence intervals and time horizons. In addition, reserve adequacy testing under a range of scenarios and dynamic solvency testing is carried out, including under certain scenarios mandated by the UK, US and Asian regulators.

A stochastic approach models the inter-relationship between asset and liability movements, taking into account asset correlation, management actions and policyholder behaviour, under a large number of alternative economic scenarios. These scenarios are projected forward over a period of time, typically 25 years or longer, and the liabilities and solvency position of the fund are calculated in each scenario in each future year. The fund's policy on management actions, including bonus and investment policy continue to be set in order that they are consistent with the available capital and the targeted risk of default.

The sensitivity of liabilities and other components of total capital vary depending upon the type of business concerned and this conditions the approach to asset/liability management.

For example, for businesses that are most sensitive to interest rate changes, such as immediate annuity business, Prudential uses cash flow analysis to create a portfolio of debt securities whose value changes in line with the value of liabilities when interest rates change. This type of analysis helps protect profits from changing interest rates. This type of analysis is used in the UK for annuity business and by JNL for its interest-sensitive and fixed index annuities and stable value products.

For businesses that are most sensitive to equity price changes, Prudential uses stochastic modelling and scenario testing to look at the future returns on its investments under different scenarios and best reflect the large diversity in returns that equities can produce. This allows Prudential to devise an investment and with-profits policyholder bonus strategy that, on the model assumptions, allows it to optimise returns to its policyholders and shareholders over time while maintaining appropriate financial strength. Prudential uses this methodology extensively in connection with its UK with-profits business.

Bonuses declared in respect of the Group's with-profits business are included in the change in long-term business provisions or, where the policy is no longer in force, in claims incurred.

(f) Intra-group arrangements in respect of SAIF

Should the assets of SAIF be inadequate to meet the guaranteed benefit obligations to the policyholders of SAIF, the PAC long-term fund would be liable to cover any such deficiency.

Due to the quality and diversity of the assets in SAIF and the ability of SAIF to revise guaranteed benefits in the event of an asset shortfall, the directors believe that the probability of either the PAC long-term fund, or the Group's shareholders' funds under its obligation to maintenance of the capital position of long-term funds generally, having to contribute to SAIF is remote.

E: Banking operations

The Group undertakes banking operations through one of its principal subsidiaries, Egg. Financial information in respect to Egg has been included in this note. The results from Jackson Federal Bank, another Group banking subsidiary that was sold in October 2004, have also been included in discontinued operations in the income statement below up to the date of disposal.

The Group has presented the income statement and balance sheet for banking operations in a format that demonstrates the characteristics and principal operations specific to a bank. The format is different to that of the Group consolidated income statement and balance sheet; however, total profit (loss) for the year and net assets remain the same. To understand how the amounts presented from banking operations are consolidated in the Group financial statements, refer to the primary segmental information for the income statement in note F1 and the primary segmental information for the balance sheet in note B5.

E1: Income statement for banking operations

Profit (loss) included in the Group consolidated income statement in respect to banking operations is as follows:

	Note	2005 £m	2004 £m
Interest income		**893**	902
Interest expense		**(581)**	(615)
Net interest income		**312**	287
Fee and commission income		**223**	221
Fee and commission expense		**(23)**	(25)
Other operating income		**16**	15
Operating income		**528**	498
General administrative expenses		**(216)**	(232)
Impairment losses on loans and cash advances to customers	E5	**(241)**	(183)
Other operating expenses		**(27)**	(22)
Profit attributable to shareholders		**44**	61
Tax attributable to shareholders' profits		**1**	(25)
Profit from continuing operations after tax		**45**	36
Discontinued operations (net of tax)	F6	**3**	(98)
Profit (loss) for the year		**48**	(62)

Of the profit (loss) for the year in 2005 and 2004, a profit of £9 million and a loss of £20 million, respectively, are attributable to minority interests in Egg.

Discontinued operations above relate to Egg France, Funds Direct and Jackson Federal Bank (in 2004) and have been treated as discontinued operations in the Group's consolidated income statement. For further information on discontinued operations, see note F6.

E2: Balance sheet for banking operations

Assets, liabilities and shareholders' funds included in the Group consolidated balance sheet with respect to banking operations are as follows:

	2005 £m	2004 £m
Assets		
Cash and balances with central banks	**7**	14
Loans and advances to banks	**718**	616
Securities purchased under agreement to resell	**200**	319
Loans and advances to customers	**7,430**	7,642
Investment securities	**2,117**	3,120
Other assets	**280**	337
Total assets	**10,752**	12,048
Liabilities		
Deposits by banks	**2,452**	2,352
Securities sold under agreement to repurchase	**–**	131
Customer accounts	**5,830**	6,607
Debt securities issued	**1,404**	1,807
Other liabilities	**236**	360
Subordinated liabilities	**452**	451
Total liabilities	**10,374**	11,708
Equity		
Shareholders' equity	**303**	273
Minority interests	**75**	67
Total equity	**378**	340
Total equity and liabilities	**10,752**	12,048

E3: Risk management overview

Egg offers banking and credit card products and intermediated services. Through its normal operations, Egg is exposed to a number of risks, the most significant of which are credit, operational, liquidity, market and currency risk. The overall responsibility for risk management and the risk appetite of Egg is set by the Egg Board and responsibility for managing these risks resides with the Egg Executive Committee. The exposure to specific risks is monitored by the Executive Committee through separate committees: retail credit committee is responsible for retail credit risk, wholesale credit committee is responsible for wholesale credit risk, operational risk committee is responsible for operational risk; and asset and liability committee (ALCO) for liquidity, market and currency risk.

Egg uses financial instruments including derivatives for the purpose of supporting the strategic and operational business activities and to reduce and eliminate the risk of loss arising from changes in interest rates and foreign exchange rates.

Surplus retail and wholesale liabilities are invested in debt securities, including certificates of deposits, government gilts and other high investment grade assets.

E4: Maturities of assets and liabilities and liquidity risk

Liquidity risk is defined for Egg as not having sufficient financial resources available to meet its obligations as they fall due, or if such resources can only be secured at excessive cost. Egg uses various methods including predictions of daily cash positions to monitor and manage liquiditity risk. Maturity mismatches between lending and funding are managed within internal risk policy limits. It ensures that it holds sufficient assets, which are immediately realisable into cash without significant exposure to market risk or costs, to cover a realistic estimate of retail funds that could be withdrawn. While a significant proportion of retail savings balances are on instant access terms, in practice the majority of such funds represent a relatively stable and consistent funding base for Egg.

The matching and controlled mismatching of the maturities and interest rates of assets and liabilities is fundamental to the management of a bank. It is unusual for banks ever to be completely matched since business transacted is often of uncertain terms and of different types.

The following table analyses the assets and liabilities of Egg into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date.

At 31 December 2005	Up to 1 month £m	From 1 month to 3 months £m	From 3 months to 1 year £m	From 1 year to 5 years £m	5 years and over £m	Total £m
Assets						
Cash and balances with central banks	**7**	**–**	**–**	**–**	**–**	**7**
Loans and advances to banks	**636**	**50**	**–**	**5**	**27**	**718**
Securities purchased under agreement to resell	**200**	**–**	**–**	**–**	**–**	**200**
Loans and advances to customers	**0**	**3,343**	**40**	**1,421**	**2,626**	**7,430**
Investment securities	**157**	**439**	**633**	**352**	**536**	**2,117**
Other assets	**3**	**4**	**141**	**125**	**7**	**280**
Total assets	**1,003**	**3,836**	**814**	**1,903**	**3,196**	**10,752**
Liabilities						
Deposits by banks	**157**	**–**	**–**	**2,295**	**–**	**2,452**
Customer accounts	**5,667**	**13**	**110**	**40**	**–**	**5,830**
Debt securities issued	**–**	**3**	**798**	**603**	**–**	**1,404**
Other liabilities	**85**	**34**	**117**	**–**	**–**	**236**
Subordinated liabilities	**–**	**–**	**–**	**–**	**452**	**452**
Total liabilities	**5,909**	**50**	**1,025**	**2,938**	**452**	**10,374**
Net liquidity gap	**(4,906)**	**3,786**	**(211)**	**(1,035)**	**2,744**	**378**

E4: Maturities of assets and liabilities and liquidity risk continued

At 31 December 2004	Up to 1 month £m	From 1 month to 3 months £m	From 3 months to 1 year £m	From 1 year to 5 years £m	5 years and over £m	Total £m
Assets						
Cash and balances with central banks	14	–	–	–	–	14
Loans and advances to banks	344	270	2	–	–	616
Securities purchased under agreement to resell	–	319	–	–	–	319
Loans and advances to customers	1	3,464	39	1,438	2,700	7,642
Investment securities	769	516	371	128	1,336	3,120
Other assets	37	29	139	126	6	337
Total assets	**1,165**	**4,598**	**551**	**1,692**	**4,042**	**12,048**
Liabilities						
Deposits by banks	38	321	5	1,988	–	2,352
Securities sold under agreement to repurchase	–	131	–	–	–	131
Customer accounts	5,962	198	323	124	–	6,607
Debt securities issued	–	–	433	1,374	–	1,807
Other liabilities	125	109	125	1	–	360
Subordinated liabilities	–	–	–	–	451	451
Total liabilities	**6,125**	**759**	**886**	**3,487**	**451**	**11,708**
Net liquidity gap	**(4,960)**	**3,839**	**(335)**	**(1,795)**	**3,591**	**340**

E5: Losses on loans and advances

The following table details the movements in the allowance for losses on loans and advances to customers held by Egg in 2005 and 2004. The aggregate loss on loans at the end of the year and the charge during the year have been included in the consolidated financial statements.

	2005 £m	2004 £m
Balance at the beginning of the year	**250**	193
Transition adjustment to reflect adoption of IAS 39 at 1 January 2005	**5**	–
Amounts written off	**(161)**	(126)
New and additional provisions	**241**	204
Other movements*	**–**	(21)
Balance at the end of the year	**335**	250

*The other movements reflect a release of provisions for bad and doubtful debts following the sale of the Egg France unsecured lending portfolio.

E6: Market risk

Interest rate risk

The primary market risk to which Egg is exposed is interest rate risk. Interest rate risk arises in Egg as a result of fixed rate, variable rate and non-interest bearing assets and liabilities. Exposure to interest rate movements arises when there is a mismatch between interest rate sensitive assets and liabilities.

The composition of interest rate risk is closely monitored and managed on a day-to-day basis by the treasury function where professional expertise and systems exist to control it. This is primarily done via asset and liability models that look at the sensitivity of earnings to movements in interest rates to measure overall exposure which may then be hedged in accordance with the policy limits set by the ALCO.

For the purpose of reducing interest rate risk, Egg uses a number of derivative instruments such as interest rate swaps and forward rate agreements (see note G3).

Financial assets and liabilities not held at fair value through profit and loss and the weighted average effective interest rate for those balances is provided below:

	£m	
Assets		
Debt securities available-for-sale*	2,046	4.6%
Loans and receivables	8,148	7.5%
	10,194	
Liabilities		
Banking customer accounts	5,830	4.3%
Core structural borrowings of shareholder-financed operations	452	8.5%
Operational borrowings attributable to shareholder-financed operations	3,856	4.5%
	10,138	

*Egg has also classified £71 million of debt securities as fair value through profit and loss.

E6: Market risk continued

See note G2 for further information on interest rate risk.

Currency risk

The risks arising from assets and liabilities denominated in foreign currencies are managed by a separate treasury function within Egg and within agreed limits set by the ALCO. During the year, cash flows generated by the foreign currency assets and liabilities are hedged by using derivative contracts to manage exposure to exchange rate fluctuations.

At 31 December 2005, Egg held £539 million of assets and £2,640 million of liabilities with foreign currency exposure.

E7: Credit risk

Egg takes on exposure to credit risk, which is the risk that a counterparty will be unable to pay amounts in full when due. To limit this risk, Egg places limits on the amount of risk accepted in relation to a particular borrower, groups of borrowers, and to particular geographical segments. The acceptable risk levels are monitored regularly, and reviewed where appropriate. From Egg's perspective, the most important step in managing credit risk is the initial decision whether or not to extend credit. Egg's retail and wholesale credit committees define the policies, procedures and sets limits for accepting credit risk.

The following table identifies the geographical concentrations of credit risk, stated in terms of total assets and off balance sheet items, held by Egg at 31 December 2005 and 2004:

	2005 £m	2004 £m
UK	**18,840**	18,049
Rest of Europe	**399**	1,486
North America	**26**	450
Other	**354**	445
Total*	**19,619**	20,430

*This includes £9,104 million (2004: £8,700 million) of off-balance sheet items, which mainly relate to unutilised credit limits on credit cards.

Egg has 3.1 million customers that are defined as 'marketable' based on their activity levels, with the majority of these acquired into its credit card product. These customers are typically aged between 25 and 45, are ABC1 in terms of their social demographics (according to the definition set by the Central Statistical Office of the UK based on occupation) and earn above average salaries. Full use is made of software technology and external bureaus in credit scoring both new and top-up lending applications. The counterparty credit quality is monitored through the analysis of qualitative and quantitative information. There are limits for exposure to individual countries, sectors and corporate and financial institutions.

The following is a breakdown of the credit risk borne by Egg for financial assets and off-balance sheet items at 31 December 2005:

	£m
Loans and advances to banks	718
Securities purchased under agreement to resell	200
Investment securities	2,117
Loans and advances to customers	7,765
Allowances for impairment losses on loans and advances to customers	(335)
Fair value of derivative assets	50
Off-balance sheet items (including unutilised credit limits on credit cards)	9,104
Total credit risk net of allowances and provisions	19,619

Egg has certain credit-related commitments in the form of unused credit limits on credit cards and pre-approved but unused borrowing limits on mortgages and personal loans. At 31 December 2005, these unused limits, included in off-balance sheet items above, amounted to £9,061 million, £14 million and £29 million respectively. Egg is potentially exposed to a loss totalling these amounts, but it is unlikely that such a loss would arise as these credit facilities were granted only on the basis of the customers having achieved certain credit standards. Additionally, it is unlikely that, should all these customers utilise their credit or borrowing limits, that all of them would default on their debt entirely.

Egg holds significant concentrations of credit risk with other financial institutions. At 31 December 2005, this was estimated at £10.9 billion of which £5.7 billion related to derivative financial instruments and £2.3 billion to credit default swaps. Egg also has significant credit exposure in asset-backed security products which totalled approximately £496 million at 31 December 2005. With regard to loans and advances to customers, Egg has significant concentrations of credit risk in respect of its unsecured lending on credit cards, personal loans and mortgage lending secured on property in the UK.

Assets pledged as collateral and securitisation

Egg enters into securities lending arrangements, including repurchase agreements, and over-the-counter derivative transactions as part of normal operating activities. Assets are pledged as collateral to support these activities. Collateral in respect to repurchase agreements was £30.9 million and £nil at 31 December 2005 and 2004, respectively. Collateral in respect to over-the-counter derivative transactions was £5.2 million and £2.3 million at 31 December 2005 and 2004, respectively. See note G4 where amounts related to Egg have been included in the disclosure of these transactions on a Group basis.

For further information on Egg's securitisation of credit card receivables, see note G4.

F: Income statement notes

F1: Segmental information

The Group's primary and secondary segments are described in detail in note B5.

Primary segment information

The segment results for the year ended 31 December 2005 are as follows:

	2005 £m	2004 £m
Revenue		
Long-term business	**39,296**	32,073
Banking	**1,115**	1,110
Broker-dealer and fund management	**895**	823
Unallocated corporate	**98**	151
Intra-group revenue eliminated on consolidation	**(279)**	(253)
Total revenue per income statement	**41,125**	33,904
Charges (before income tax attributable to policyholders and unallocated surplus of long-term insurance funds)		
Long-term business, including post-tax transfers to unallocated surplus of with-profits funds	**(36,968)**	(30,531)
Banking	**(1,071)**	(1,049)
Broker-dealer and fund management	**(740)**	(682)
Unallocated corporate	**(480)**	(334)
Intra-group charges eliminated on consolidation	**279**	253
Total charges per income statement	**(38,980)**	(32,343)
Segment results – revenue less charges (continuing operations)		
Long-term business	**2,328**	1,542
Banking	**44**	61
Broker-dealer and fund management	**155**	141
Unallocated corporate	**(382)**	(183)
Profit before tax*	**2,145**	1,561
Tax attributable to policyholders' returns	**(1,147)**	(711)
Profit before tax attributable to shareholders	**998**	850
Tax attributable to shareholders' profits	**(241)**	(240)
Profit from continuing operations after tax	**757**	610
Segment results – discontinued operations		
Long-term business	**–**	4
Banking	**3**	(98)
	3	(94)
Profit for the year	**760**	516

*Profits before tax represents income net of post-tax transfers to unallocated surplus of with-profits funds, before tax attributable to policyholders and unallocated surplus of with-profits funds, unit-linked policies and shareholders' profits.

Within segment results above, the share of after tax loss of associates that are equity accounted for of £nil (2004: £(1) million) is allocated entirely to the banking segment.

In its capacity as fund manager to fellow Prudential plc subsidiaries, M&G earns fees for investment management and related services. These services are charged at appropriate arm's length prices, typically priced as a percentage of funds under management.

Total charges include £12,745 million (2004: £9,528 million) of non-cash expenses mainly relating to changes in technical reserves and pension actuarial and other gains and losses. The majority of this amount is borne by the long-term business segment.

Secondary segment information

Although the Company is UK registered, the Group manages its business on a global basis. The operations are based in three main geographical areas: UK, US and Asia.

Revenue	2005 £m	2004 £m
UK	**30,688**	24,602
US	**6,912**	6,351
Asia	**3,804**	3,204
Intra-group revenue	**(279)**	(253)
Total revenue per income statement	**41,125**	33,904

F2: Revenue

	2005 £m	2004 £m
Long-term business premiums (note i)		15,161
Insurance contract premiums	**13,583**	
Investment contracts with discretionary participation feature premiums	**1,366**	
Inwards reinsurance premiums	**276**	1,247
Less: reinsurance premiums ceded	**(197)**	(256)
Earned premiums, net of reinsurance	**15,028**	16,152
Realised and unrealised gains and losses on investments (2004)		7,333
Realised and unrealised gains and losses on securities at fair value through profit and loss	**14,640**	
Realised losses on available-for-sale securities, previously recognised directly in equity	**(22)**	
Interest (note ii)	**5,896**	5,705
Dividends	**2,731**	1,883
Other investment income	**768**	829
Investment income	**24,013**	15,750
Fee income from investment contract business, fund management, banking and broker-dealer services (note i)	**926**	653
Income from consolidated venture investments of the PAC with-profits funds	**1,158**	1,349
Other income	**2,084**	2,002
Total revenue	**41,125**	33,904

Notes

(i) As a result of the adoption of IFRS 4 on 1 January 2005, premiums received in respect of investment contracts without discretionary participation features are not recognised as income; instead these amounts are accounted for directly in the balance sheet as deposit liabilities. Only fee income associated with such contracts is accounted for in the income statement in 2005. In 2004, deposits and related fees on these contracts were included within long-term business premiums. In 2004, the long-term business premiums also include premiums from insurance contracts and investment contracts with discretionary participation features.

(ii) Interest income is calculated on the effective interest rate method for all financial assets that are not at fair value through profit and loss.

F3: Acquisition costs and other operating expenditure

	2005 £m	2004 £m
Acquisition costs (note i)	**1,413**	1,419
Staff and pension costs (see note I1)	**991**	1,186
Administrative and operating costs	**3,148**	2,958
Total acquisition costs and other operating expenditure	**5,552**	5,563

Notes

(i) Acquisition costs in 2005 comprise amounts related to insurance contracts of £1,307 million, and investment and investment management contacts of £106 million. These costs include amortisation of £392 million and £9 million, respectively.

(ii) Total depreciation and amortisation expense amounted to £541 million (2004: £540 million). Of this amount, £401 million (2004: £386 million) relates to amortisation of deferred acquisition costs of insurance contracts and investment management contracts, which primarily is borne by the long-term business segment. Of the remainder of the depreciation and amortisation charge of £140 million (2004: £154 million), £101 million (2004: £107 million) related to long-term business, £28 million (2004: £29 million) to banking, £8 million (2004: £15 million) to fund management and £3 million (2004: £3 million) to central companies.

F4: Finance costs: interest on core structural borrowings of shareholder-financed operations

Finance costs consist of interest on core debt of the parent company and related finance subsidiaries and JNL surplus notes of £175 million (2004: £154 million) and of £33 million (2004: £33 million) on Egg subordinated debt.

F5: Tax

(a) Total tax expense by nature of expense

An analysis of the total tax expense of continuing operations recognised in the income statement by nature of expense (benefit) is as follows:

	2005 £m	2004 £m
Current tax expense:		
Corporation tax	**722**	537
Adjustments in respect of prior years	**(209)**	38
Benefit from a previously unrecognised tax loss, tax credit or temporary difference from a prior period	**(2)**	0
Total current tax	**511**	575
Deferred tax arising from:		
Origination and reversal of temporary differences	**870**	374
Benefit from a previously unrecognised tax loss, tax credit or temporary difference from a prior period	**5**	2
Write-down or reversal of a previous write-down of a deferred tax asset	**2**	0
Total deferred tax	**877**	376
Total tax expense	**1,388**	951

The total tax expense arises as follows:

	2005 £m	2004 £m
Current tax expense:		
UK	**339**	523
Foreign	**172**	52
	511	575
Deferred tax expense:		
UK	**780**	282
Foreign	**97**	94
	877	376
Total	**1,388**	951

The deferred tax expense arises as follows:

	2005 £m	2004 £m
Unrealised gains and losses on investments	**599**	286
Short-term timing differences	**263**	(79)
Capital allowances	**13**	13
Balances relating to investment and insurance contracts	**3**	156
Unused tax losses	**(1)**	0
Deferred tax expense	**877**	376

In 2005, a deferred tax credit of £93 million has been taken directly to reserves. When this amount is taken with the deferred tax expense shown above, the result is an increase of £784 million in the Group's net deferred tax liability.

In 2005, there is no tax relating to discontinued operations (2004: £14 million credit) (see note F6).

F5: Tax continued

(b) Reconciliation of effective tax rate

The total tax expense is attributable to shareholders and policyholders as summarised in the income statement.

(i) Summary of pre-tax profit and tax charge

The income statement includes the following items:

	2005 £m	2004 £m
Profit before tax	**2,145**	1,561
Tax attributable to policyholders' returns	**(1,147)**	(711)
Profit before tax attributable to shareholders	**998**	850
Tax attributable to shareholders' profits:		
Tax expense	**(1,388)**	(951)
Less: tax attributable to policyholders' returns	**1,147**	711
Tax attributable to shareholders' profits	**(241)**	(240)
Profit from continuing operations after tax	**757**	610

For the purposes of explaining the relationship between tax expense and accounting profit, it is appropriate to consider the sources of profit and tax by reference to those that are attributable to shareholders and policyholders, as follows:

	2005			2004		
	Attributable to shareholders £m	Attributable to policyholders £m	Total £m	Attributable to shareholders £m	Attributable to policyholders £m	Total £m
Profit before tax	**998**	**1,147**	**2,145**	850	711	1,561
Taxation charge:						
Expected tax rate	**35% (note ii)**	**100%**	**70%**	31% (note ii)	100%	62%
Expected tax charge	**(353)**	**(1,147)**	**(1,500)**	(261)	(711)	(972)
Variance from expected tax charge	**112**	**–**	**112**	21	–	21
Actual tax charge	**(241)**	**(1,147)**	**(1,388)**	(240)	(711)	(951)
Average effective tax rate	**24%**	**100%**	**65%**	28%	100%	61%

Profit before tax comprises profit attributable to shareholders and pre-tax profit attributable to policyholders of linked and with-profits funds and unallocated surplus of with-profits funds.

The tax charge for linked and with-profits business includes tax expense on unit-linked and with-profits funds attributable to policyholders, the unallocated surplus of with-profits funds and the shareholders' profits. Different rules apply under UK tax law for taxing pension business and life insurance business and there are detailed rules for apportioning the investment return and profits of the fund between the types of business. The investment return referable to pension business, and some other less significant classes of business, is exempt from taxation but tax is charged on the profit that the shareholders derive from writing such business at the corporate rate of tax. The rules for taxing life assurance business are more complex. This is because the UK regime seeks to tax the investment return less management expenses (I-E) on this business as it arises. However, a calculation of the shareholder profit from writing life insurance business also has to be made and this performs two main functions. Firstly, the shareholder profit is compared with the I-E profit and if the shareholder profit is higher, then relief for expenses in the I-E has to be restricted until the I-E profit equals the shareholder profit. If on the other hand I-E profit is the greater, then an amount equal to the shareholder profit is taxed at the corporate rate of tax with the remainder of the I-E profit being taxed at the lower policyholder rate of tax. The purpose of this approach is to ensure that the Company is always as a minimum taxed on the profit that it has earned. The shareholders' portion of the long-term business is taxed at the shareholders' rate with the remaining portion taxed at rates applicable to the policyholders.

For accounting purposes in all cases and for all reporting periods the applicable tax rate for profit attributable to policyholders and unallocated surplus is 100 per cent. This percentage reflects the basis of accounting for unallocated surplus coupled with the distinction made for performance reporting between sources of profit attributable to shareholders, policyholders and unallocated surplus.

As described above UK long-term business is taxed on a basis that affects policyholders, unallocated surplus of with-profits funds and shareholders. For the PAC with-profits sub-fund, transfers to and from unallocated surplus are recorded in the income statement so that after charging the total tax borne by the fund, the net balance reflects the statutory transfer from the fund for the year. For SAIF similar transfers are made to derive a net nil balance which reflects the lack of shareholder interest in the financial performance of the fund (other than through investment management arrangements). For unit-linked policies, pre-tax profits attributable to policyholders represent fees earned that are used to pay tax borne by the Company on policyholders' behalf.

F5: Tax continued

(ii) Reconciliation of tax charge on profits attributable to shareholders

2005	UK insurance operations £m	JNL £m	Asian long-term business operations £m	Other operations £m	Total £m
Profit before tax attributable to shareholders:					
Operating profit based on longer-term investment returns	**400**	**348**	**175**	**34**	**957**
Goodwill impairment charge	**–**	**–**	**–**	**(120)**	**(120)**
Short-term fluctuations in investment returns	**36**	**178**	**32**	**(35)**	**211**
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	**(20)**	**–**	**3**	**(33)**	**(50)**
Total	**416**	**526**	**210**	**(154)**	**998**
Expected tax rate (note i):					
Operating profit based on longer-term investment returns	**30%**	**35%**	**26%**	**30%**	**31%**
Goodwill impairment charge	**–**	**–**	**–**	**0%**	**0%**
Short-term fluctuations in investment returns	**30%**	**35%**	**26%**	**30%**	**34%**
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	**30%**	**–**	**0%**	**30%**	**32%**
Total	**30%**	**35%**	**26%**	**6%**	**35%**
Expected tax charge based on expected tax rates:					
Operating profit based on longer-term investment returns	**(120)**	**(122)**	**(46)**	**(10)**	**(298)**
Goodwill impairment charge	**–**	**–**	**–**	**0**	**0**
Short-term fluctuations in investment returns	**(11)**	**(62)**	**(8)**	**10**	**(71)**
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	**6**	**–**	**0**	**10**	**16**
Total	**(125)**	**(184)**	**(54)**	**10**	**(353)**
Variance from expected tax charge (note ii):					
Operating profit based on longer-term investment returns	**3**	**(1)**	**(17)**	**127**	**112**
Goodwill impairment charge	**–**	**–**	**–**	**0**	**0**
Short-term fluctuations in investment returns	**(5)**	**9**	**9**	**(12)**	**1**
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	**(1)**	**–**	**0**	**0**	**(1)**
Total	**(3)**	**8**	**(8)**	**115**	**112**
Actual tax charge:					
Operating profit based on longer-term investment returns	**(117)**	**(123)**	**(63)**	**117**	**(186)**
Goodwill impairment charge	**–**	**–**	**–**	**0**	**0**
Short-term fluctuations in investment returns	**(16)**	**(53)**	**1**	**(2)**	**(70)**
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	**5**	**–**	**0**	**10**	**15**
Total	**(128)**	**(176)**	**(62)**	**125**	**(241)**
Actual tax rate	**31%**	**33%**	**30%**	**(81)%**	**24%**

For 2004, the Group's results reflect the application of IFRS standards with the exception of the standards IAS 32, IAS 39 and IFRS 4. Also the supplementary basis of profit analysis adopted by the Group, as shown in note B1, is not comparable between 2004 and 2005. Supplementary information included within the Group's Annual Report shows an analysis of 2004 profit on the pro forma basis as if IAS 32, IAS 39 and IFRS 4 had been applied to the Group's long-term business operations. The reconciliation of the effective tax rate for 2004 relates to the statutory IFRS basis results.

F5: Tax continued

2004	UK insurance operations £m	JNL £m	Asian long-term business operations £m	Other operations £m	Total £m
Profit before tax attributable to shareholders	325	357	154	14	850
Expected tax rate (note i)	30%	35%	23%	21%	31%
Expected tax charge based on expected tax rates	(98)	(125)	(35)	(3)	(261)
Variance from expected tax charge (note ii)	7	3	(3)	14	21
Actual tax charge	(91)	(122)	(38)	11	(240)
Actual tax rate	28%	34%	25%	(79)%	28%

Notes

(i) Expected tax rates for profit attributable to shareholders
Expected tax rates shown in the table above reflect the corporate tax rates generally applied to taxable profits of the relevant country jurisdictions. For Asian operations the expected tax rates reflect the corporate tax rate weighted by reference to the source of profits of the operations contributing to the aggregate business unit result. The increase in total expected rate from 31 per cent in 2004 to 35 per cent in 2005 is due to the goodwill impairment charge of £120 million in 2005 not being allowable for tax.

(ii) Variances from expected tax charge for results attributable to shareholders
The principal variances arise from differences between the standard corporation tax rate and actual rates for 'other' operations. This is due to a number of factors including:
(a) The settlement of outstanding issues with HM Revenue and Customs at amounts below those previously provided.
(b) The tax credit arising from relief for excess expenses in respect of the shareholder-backed protection business.
(c) Prior year adjustments arising from routine revisions of tax returns.
(d) The benefit from Egg's previously unused French losses.

F6: Discontinued operations

The £3 million post-tax profit from discontinued operations (2004: £94 million post-tax loss) is comprised of the sum of the gain on disposal of operations and profit or loss generated by discontinued operations.

	2005 £m	2004 £m
Gain on sale of operations		
Pre-tax gain recognised on the sale of operations	**0**	45
Taxation	**0**	(19)
Post-tax gain recognised on the sale of operations	**0**	26
Profit (loss) generated by discontinued operations		
Revenue	**1**	50
Expenses	**2**	(203)
Pre-tax profit (loss) on results of discontinued operations	**3**	(153)
Taxation	**0**	33
Post-tax profit (loss) on results of discontinued operations	**3**	(120)
Post-tax profit (loss) from discontinued operations	**3**	(94)

In October 2004, JNL sold Jackson Federal Bank for £166 million. After taking into account net assets and goodwill totalling £128 million at the date of disposal, the profit on sale was £38 million before tax. Jackson Federal Bank, made an operating profit up to the date of disposal of £17 million.

In August 2004, the Group sold its interest in Life Assurance Holding Corporation Limited for £41 million. After taking into account the carrying value of the investment of £34 million at the date of disposal, the profit on sale was £7 million before tax.

In July 2004, Egg announced that it intended to take the necessary steps to withdraw from the French market. Egg France was sold in 2004. The loss before tax of Egg France in 2004 was £150 million which was made up of a provision for exit costs of £113 million and other operating losses of £37 million.

During the year ended 31 December 2005, the exit process from France by Egg was completed. The final costs incurred were lower than the provision made in July 2004, therefore, £4 million of the provision was released in the year.

In addition, during 2005, Egg sold Funds Direct, its investment wrap platform business. The sale was completed in October 2005. Funds Direct incurred losses before tax of £1 million (2004: £20 million) including exit costs in the year.

Jackson Federal Bank, Egg France and Funds Direct are included within banking operations in the segment analysis whilst Life Assurance Holding Corporation Limited is included within long-term business of UK insurance operations.

G: Financial assets and liabilities

G1: Financial instruments – designation and fair values

The Group formally adopted IAS 39 on 1 January 2005. On application of IAS 39, all financial assets are designated as either fair value through profit and loss, available-for-sale, or as loans and receivables and financial liabilities are designated as either fair value through profit and loss or amortised cost or for investment contracts with discretionary participation features accounted for under IFRS 4 as described in note A4.

2005	Fair value through profit and loss £m	Available-for-sale £m	Loans and receivables £m	Total carrying value £m	Fair value £m
Financial assets					
Deposits	–	–	7,627	7,627	7,627
Equity securities and portfolio holdings in unit trusts	71,985	–	–	71,985	71,985
Debt securities (note iii)	56,814	25,657	–	82,471	82,471
Loans and receivables	–	–	13,245	13,245	14,268
Other investments (note i)	3,879	–	–	3,879	3,879
Accrued investment income	–	–	1,791	1,791	1,791
Other debtors	–	–	1,318	1,318	1,318
	132,678	25,657	23,981	182,316	

2005	Fair value through profit and loss £m	Amortised cost £m	IFRS 4 £m	Carrying value £m	Fair value £m
Financial liabilities					
Banking customer accounts	–	5,830	–	5,830	5,830
Core structural borrowings of shareholder-financed operations (note iii and note H13)	–	3,191	–	3,191	3,550
Operational borrowings attributable to shareholder-financed operations (note H13)	–	6,432	–	6,432	6,432
Borrowings attributable to with-profits funds (note H13)	559	1,339	–	1,898	1,929
Obligations under funding, stock lending and sale and repurchase agreements	–	4,529	–	4,529	4,524
Net asset value attributable to unit holders of consolidated unit trust and similar funds	965	–	–	965	965
Investment contracts with discretionary participation features (note ii)	–	–	26,523	26,523	–
Investment contracts without discretionary participation features	10,524	1,502	–	12,026	12,035
Accruals and deferred income	–	506	–	506	506
Other creditors	–	1,478	–	1,478	1,478
Other liabilities (including derivatives)	851	918	–	1,769	1,769
	12,899	25,725	26,523	65,147	

Notes

(i) See note G3 for details of the derivative assets included. The balance also contains the PAC with-profit fund's participation in various investment funds and limited liability property partnerships.

(ii) It is impractical to determine the fair value of investment contracts with discretionary participation features due to the lack of a reliable basis to measure such features.

(iii) As at 31 December 2005, £450 million of convertible bonds were included in debt securities and £311 million were included in borrowings.

Determination of fair value

The fair values of quoted investments are based on current bid prices, where appropriate. If the market for a financial asset is not active, the Group establishes fair value by using quotations from independent third parties such as brokers or by using valuation techniques. The valuation techniques include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis and option pricing models.

The fair value estimates are made at a specific point in time, based upon available market information and judgements about the financial instruments, including estimates of the timing and amount of expected future cash flows and the credit standing of counterparties. Such estimates do not reflect any premium or discount that could result from offering for sale at one time the Group's entire holdings of a particular financial instrument, nor do they consider the tax impact of the realisation of unrealised gains or losses. In some cases the fair value estimates cannot be substantiated by comparison to independent markets, nor can the disclosed value be realised in immediate settlement of the financial instrument.

The loans and receivables have been shown net of provisions for impairment. The fair value of loans has been estimated from discounted cash flows expected to be received. The rate of discount used was the market rate of interest.

The estimated fair value of derivative financial instruments reflects the estimated amount the Group would receive or pay in an arm's length transaction. This amount is mainly determined using quotations from independent third parties.

G1: Financial instruments – designation and fair values continued

The fair value of borrowings is based on quoted market prices, where available.

Refer to section A4 for the determination of fair value for investment contracts without fixed and guaranteed terms (notably UK unit-linked policies). For investment contracts in the US with fixed and guaranteed terms the fair value is determined based on the present value of future cash flows discounted at current interest rates.

The fair value of other financial liabilities is determined using discounted cash flows of the amounts expected to be paid.

Use of valuation techniques

Valuation techniques – UK

At 31 December 2005, UK insurance operations held investments with a fair value of £3,729 million (of which £3,466 million were held in the PAC with-profits fund) which were measured in full or in part using valuation techniques. The majority of these assets are private debt securities such as private placements, project finance, asset securitisations and local authority securities. The securities are mainly long-dated and not regularly traded and are valued internally using market standard practices. These practices mainly use matrix pricing, which is based on assessing credit quality of the underlying borrower to derive a suitable discount rate relative to government securities.

In accordance with the Group's risk management framework, all internally generated calculations are subject to independent assessment by the M&G Fair Value Committee which comprises members who are independent of the fund managers involved in the day-to-day trading in these assets.

Changing any one of the underlying assumptions used in determining the fair value would not have a significant impact on the value of the assets.

The total amount of the change in fair value estimated using valuation techniques, including valuation techniques based on assumptions not wholly supported by observable market prices or rates, recognised in the profit and loss account in 2005 was £93 million.

Valuation techniques – US

The US operations of Prudential had two groups of assets which were valued using valuation techniques – derivatives and securities held by the Piedmont trust entity, an 80 per cent JNL held static trust formed as a result of a securitisation of asset-backed securities in 2003. As at 31 December 2005, the fair value of the Piedmont and derivative assets valued using valuation techniques were £700 million and £518 million, respectively.

The majority of the factors entering into the valuation of the derivatives are readily observable in the market and, therefore, are not subject to interpretation in the model. The most significant non-observable factor is the level of implied volatility assumed in the valuation. However, changing the implied volatility would not have had a significant impact on the fair value of the assets.

Significant estimates and judgement are also employed in valuing certain asset-backed and mortgage-backed securities held by the Piedmont trust entity. These valuations may impact reported shareholder profit and loss amounts through the determination of impairment and recovery amounts. While management believes that the estimates and assumptions employed in developing the fair value estimates are reasonable and present management's best estimate of such values, a reasonable range of values exists with respect to most assumptions utilised in determining these values. As a result of the potentially significant variability in the estimates of the assumptions used in these models, the range of reasonable estimates of the fair value of these securities is significant.

Management has obtained broker bids on these securities that represent the value at which the Group could sell the investments, if forced. These bids are not based on full knowledge and hence analysis of the investments but represent the best estimate of the worst case decline in market value of these securities. The broker bids for these securities at 31 December 2005 totalled £514 million, a difference of £186 million.

Interest income and expense

The interest income on financial assets not at fair value through profit and loss was £2,662 million for the year ended 31 December 2005.

The interest expense on financial liabilities not at fair value through profit and loss was £893 million for the year ended 31 December 2005.

Listed investments – 2004

Of the Group's financial investments of £151,083 million as at 31 December 2004, £115,294 million were listed investments. The amount of the Group's total financial investments that were due to mature in less than one year was £15,409 million.

G2: Market risk

Interest rate risk

The following table shows an analysis of the classes of financial assets and liabilities with direct exposure to interest rate risk. Each applicable class of the Group's financial assets or liabilities are analysed between those exposed to fair value interest rate risk, cash flow interest rate risk and those with no direct interest rate risk exposure:

2005	Fair value interest rate risk £m	Cash flow interest rate risk £m	Not directly exposed to interest rate risk £m	Total £m
Financial assets				
Deposits	4,531	3,096	–	7,627
Debt securities	74,806	7,665	–	82,471
Loans and receivables	4,269	8,976	–	13,245
Other investments (including derivatives)	345	1,553	1,981	3,879
	83,951	21,290	1,981	107,222
Financial liabilities				
Banking customer accounts	–	5,830	–	5,830
Core structural borrowings of shareholder-financed operations	3,191	–	–	3,191
Operational borrowings attributable to shareholder-financed operations	1,638	4,780	14	6,432
Borrowings attributable to with-profits funds	916	883	99	1,898
Obligations under funding, securities lending and sale and repurchase agreements	703	3,826	–	4,529
Investment contracts without discretionary participation features	723	779	10,524	12,026
Other liabilities (including derivatives)	275	380	1,114	1,769
	7,446	16,478	11,751	35,675

The following table sets out the Group's commitments to lend funds at a fixed rate:

2005	Amount £m	Weighted average interest rate %
Term to maturity:		
Less than 1 year	16	11.9
1 to 5 years	58	5.4
5 to 10 years	52	7.4
10 to 15 years	27	7.4
15 to 20 years	9	5.3
Over 20 years	5	5.6
	167	

Of the above commitments £104 million related to US operations, £32 million related to the banking operations and £31 million related to Asian operations.

G2: Market risk continued

The table below details the effective interest rates for applicable classes of financial assets and liabilities not held at fair value through profit and loss, notably financial assets designated as available-for-sale, loans and receivables and liabilities held at amortised cost:

	Balance of financial instruments not at fair value through profit and loss £m	Range of effective interest rates applicable as at 31 Dec 2005 %
Assets		
Deposits	7,627	1.6 – 5.4
Debt securities	25,657	4.0 – 8.0
Loans and receivables:		
Mortgage loans	4,928	2.3 – 7.6
Policy loans	865	3.0 – 9.0
Other loans	7,452	4.5 – 10.5
	46,529	
Liabilities		
Banking customer accounts	5,830	1.6 – 5.0
Core structural borrowings of shareholder-financed operations	3,191	5.5 – 9.4
Operational borrowings attributable to shareholder-financed operations	6,432	2.2 – 6.5
Borrowings attributable to with-profits funds	1,339	6.0 – 10.0
Obligations under funding, stocklending and sale and repurchase agreements	4,529	2.4 – 8.0
Investment contracts without discretionary participation features	1,502	2.0 – 8.2
Other liabilities (including derivatives)	918	0.0 – 0.0
	23,741	

For further information on effective interest rates specific to the banking operations, please refer to section E6.

In relation to interest rate exposure, the following table sets out the earlier of contractual maturities and repricing dates for applicable classes of financial instruments, excluding investment contracts without discretionary participation features:

2005	1 year or less £m	After 1 year to 5 years £m	After 5 years to 10 years £m	After 10 years to 15 years £m	After 15 years to 20 years £m	Over 20 years £m	No stated maturity £m	Total carrying value £m
Financial assets								
Deposits	**7,029**	**38**	**20**	**–**	**–**	**52**	**488**	**7,627**
Debt securities	**3,475**	**11,857**	**23,162**	**8,594**	**9,610**	**24,754**	**1,019**	**82,471**
Loans and receivables	**3,495**	**4,275**	**1,875**	**1,199**	**1,393**	**172**	**836**	**13,245**
Other investments (including derivatives)	**1,893**	**189**	**83**	**29**	**17**	**208**	**1,460**	**3,879**
	15,892	**16,359**	**25,140**	**9,822**	**11,020**	**25,186**	**3,803**	**107,222**
Financial liabilities								
Banking customer accounts	**5,830**	**–**	**–**	**–**	**–**	**–**	**–**	**5,830**
Core structural borrowings of shareholder-financed operations	**–**	**399**	**250**	**–**	**857**	**820**	**865**	**3,191**
Operational borrowings attributable to shareholder-financed operations	**2,440**	**3,040**	**–**	**139**	**–**	**813**	**–**	**6,432**
Borrowings attributable to with-profits funds	**39**	**309**	**775**	**–**	**–**	**81**	**694**	**1,898**
Obligations under funding, stocklending and sale and repurchase agreements	**4,529**	**–**	**–**	**–**	**–**	**–**	**–**	**4,529**
Other liabilities (including derivatives)	**1,096**	**256**	**70**	**30**	**68**	**130**	**119**	**1,769**
	13,934	**4,004**	**1,095**	**169**	**925**	**1,844**	**1,678**	**23,649**

Durations of long-term business contracts, including investment contracts, are included in section D.

G2: Market risk continued

Currency risk

As at 31 December 2005, the Group held 18 per cent and 21 per cent of its financial assets and financial liabilities respectively, in currencies, mainly US dollar and Euro, other than the functional currency of the relevant business unit.

The financial assets, of which 86 per cent are held by the PAC with-profits fund, allow the PAC with-profits fund to obtain exposure to foreign equity markets.

The financial liabilities, of which 22 per cent are held by the PAC with-profits fund, mainly relate to foreign currency borrowings.

The exchange risks inherent in these exposures are mitigated through the use of derivatives, mainly forward currency contracts (see G3 below).

The amount of exchange gains recognised in the income statement in 2005 except for those arising on financial instruments measured at fair value through profit and loss is £152 million (2004: £27 million). Of this amount, £134 million (2004: £31 million) is offset by value movements on cross-currency swaps and £12 million (2004: exchange loss of £2 million) relates to investments of the PAC with-profits fund.

See also note E3 for details of the market risks faced by the banking business.

G3: Derivatives and hedging

Derivatives

The Group enters into a variety of exchange traded and over-the-counter derivative financial instruments, including futures, options, forward currency contracts and swaps such as interest rate swaps, cross-currency swaps, swaptions and credit default swaps.

All over-the-counter derivative transactions are conducted under standardised ISDA (International Swaps and Derivatives Association Inc) master agreements and the Group has collateral agreements between the individual group entities and relevant counterparties in place under each of these market master agreements.

The total fair value balances of derivative assets and liabilities as at 31 December 2005 were as follows:

2005	UK insurance operations £m	US £m	Banking operations £m	Other operations £m	Total £m
Derivative assets	**338**	**166**	**50**	**86**	**640**
Derivative liabilities	**(403)**	**(208)**	**(77)**	**(163)**	**(851)**
	(65)	**(42)**	**(27)**	**(77)**	**(211)**

The above derivative assets and derivative liabilities are included in 'other investments' and 'other liabilities' in the primary statements.

The notional amount of the derivatives, distinguishing between UK insurance, US, banking and other operations were as follows as at 31 December 2005:

	UK insurance operations		US		Banking operations	
	Notional amount on which future payments are based		Notional amount on which future payments are based		Notional amount on which future payments are based	
	Asset £m	Liability £m	Asset £m	Liability £m	Asset £m	Liability £m
Cross-currency swaps*	800	774	552	392	941	952
Equity index call options	–	–	796	13	–	–
Swaptions	1,125	–	9,320	14,562	–	–
Futures	1,621	1,239	9	–	–	–
Forwards*	10,711	10,878	–	–	743	744
Inflation swaps	1,070	1,070	–	–	–	–
Credit default swaps	–	–	–	–	2,256	–
Single stock options	83	18	–	–	–	–
Put options	–	–	1,427	–	–	–
FTSE swap	–	–	–	–	49	49
Total return swaps	479	479	612	120	–	–
Interest rate swaps	2,790	3,302	2,367	4,250	2,855	2,855

*In addition, the other operations, including the Group Treasury function and the Asian operations, have cross-currency swap assets and liabilities with notional amounts of £2,761 million and £2,692 million, respectively, forward currency contracts assets and liabilities with notional amounts of £501 million and £167 million, respectively and interest rate swaps of £1,310 million and £1,310 million, respectively.

These derivatives are used for efficient portfolio management to obtain cost effective and efficient exposure to various markets in accordance with the Group's investment strategies and to manage exposure to interest rate, currency, credit and other business risks. See also section D3 for use of derivatives by the Group's US operations.

The Group uses the various interest rate derivative instruments, such as interest rate swaps to reduce exposure to interest rate volatility.

G3: Derivatives and hedging continued

The UK insurance operations use various currency derivatives in order to limit volatility due to foreign currency exchange rate fluctuations arising on securities denominated in currencies other than Sterling. See also note G2 above. In addition, total return swaps and interest rate swaps are held for efficient portfolio management.

As part of the efficient portfolio management of the PAC with-profits fund, the fund may, from time to time, invest in cash-settled forward contracts over Prudential plc shares, which are accounted for consistently with other derivatives. This is in order to avoid a mismatch of the with-profits investment portfolio with the investment benchmarks set for its equity-based investment funds. The contracts will form part of the long-term investments of the with-profits fund. These contracts are subject to a number of limitations for legal and regulatory reasons.

Some of the Group's products, especially those sold in the US, have certain guarantee features linked to equity indexes. A mismatch between product liabilities and the performance of the underlying assets backing them exposes the Group to equity index risk. In order to mitigate this risk, the relevant business units purchase swaptions, equity options and futures to match asset performance with liabilities under equity-indexed products.

The US operations and some of the UK operations hold large amounts of interest rate sensitive investments that contain credit risks on which a certain level of defaults is expected. These entities have purchased some swaptions in order to manage the default risk on certain underlying assets and hence reduce the amount of regulatory capital held to support the assets.

Egg uses derivative instruments for the purpose of supporting the strategic and operational business activities and reducing and eliminating the risk of loss arising from changes in interest rates and foreign exchange rates. Derivatives are used solely to hedge risk exposures and Egg does not take any trading position in derivatives.

For the purpose of reducing interest rate risk, Egg uses a number of derivative instruments, including interest rate swaps and forward agreements. Additionally, swaps are used to provide caps to the funding cost of the credit card product.

Egg has also made general use of credit default swaps to manage credit risk without changing the underlying product or investment portfolios.

For the purpose of reducing currency risk, Egg uses forward exchange contracts and currency swaps.

Hedging

The Group has formally assessed and documented the effectiveness of the following hedges:

Fair value hedges

The Group has a US$1 billion fair value hedge in place which hedges the interest exposure on the US$1 billion, 6.5 per cent perpetual subordinated capital securities.

In addition, Jackson has entered into a collar fair value hedge, which has been hedge accounted for from 1 March 2005. This common stock equity collar transaction was entered into to protect the Company's unrealised gain of US$5.9 million on an equity investment. The hedge expires in March 2008.

Cash flow hedges

Egg has cash flow hedged certain balance sheet items which are subject to interest rate risk. As at 31 December 2005, the notional amount of this cash flow hedge was £2,296 million. The cash flows are periodically updated based on the underlying banking portfolios.

Net investment hedges

In November 2005, the Group's US$500 million net investment hedge relating to the currency exposure of the US operations matured.

In December 2005, the Group entered into a series of forward currency transactions which together form a US$2 billion net investment hedge of the currency exposure of the net investments in the US operations.

The Group has designated perpetual subordinated capital securities totalling US$1.55 billion as a net investment hedge to hedge the currency risks related to the net investment in JNL. The carrying value of the subordinated capital securities was £865 million as at 31 December 2005.

The net investment hedges were 100 per cent effective.

G4: Derecognition, securitisation and collateral

Securities lending and reverse repurchase agreements

The Group has entered into securities lending (including repurchase agreements) whereby blocks of securities are loaned to third parties, primarily major brokerage firms. The agreements require that amounts between 102 per cent and 105 per cent of the fair value of the loaned securities be held as collateral, depending on the quality of the collateral, calculated on a daily basis. The loaned securities are not removed from the Group's consolidated balance sheet, rather they are retained within the appropriate investment classification. Collateral typically consists of cash, debt securities, equity securities and letters of credit. At 31 December 2005, the Group had lent £10,594 million (of which £8,250 million was lent by the PAC with-profits fund) of securities and held collateral under such agreements of £11,112 million (of which £8,657 million was held by the PAC with-profits fund).

At 31 December 2005, the Group had entered into reverse repurchase transactions under which it purchased securities and had taken on the obligation to resell the securities for the purchase price, £1,214 million, together with accrued interest.

Collateral and pledges under derivative transactions

At 31 December 2005, the Group had pledged £403 million for liabilities and held collateral of £193 million in respect of over-the-counter derivative transactions.

Securitisation

During 2005, Egg transferred additional UK credit card receivables to its trust vehicle, Arch (Term) Limited, created in 2002 for the purpose of asset-backed securitisation, bringing the outstanding balance of assets in this vehicle to £2.8 billion (2004: £2.59 billion). The noteholders in securitisations from this vehicle have a proportional interest in each account balance in the trust. As at 31 December 2005, the value of this interest was £2.3 billion (2004: £2.23 billion). This securitisation does not qualify for derecognition under IAS 39 and the total portfolio is, therefore, included in loans and receivables. The funding giving rise to the note-holders interest is included within operational borrowings attributable to shareholder-financed operations.

G5: Impairment of financial assets

In accordance with the Group's accounting policy set out in note A4, impairment reviews were performed for available-for-sale securities and loans and receivables. In addition, impairment reviews were undertaken for the reinsurers' share of policyholder liability provisions.

During the year ended 31 December 2005, an amount of £278 million for impairment losses was recognised, mainly for loans and advances to customers in Egg and available-for-sale securities held by JNL.

The impairment losses have been recorded in 'acquisition costs and other operating expenditure'.

H: Other information on balance sheet items

H1: Goodwill

	2005 £m	2004 £m
Cost		
At 1 January	**2,250**	1,813*
Additions	**151**	537
Disposals (including, for 2005, goodwill of held for sale venture investment subsidiaries – see note H9)	**(333)**	(100)
At 31 December	**2,068**	2,250
Aggregate impairment		
At 1 January	**(5)**	0
Impairment losses in the year recognised in the profit and loss	**(120)**	(5)
Write-offs related to disposals and discontinued operations	**5**	0
At 31 December	**(120)**	(5)
Net book amount as at 31 December	**1,948**	2,245
The carrying value of goodwill is attributable to:		
The PAC with-profits fund (in respect of venture investment subsidiaries)	**607**	784
Shareholders (principally in respect of M&G and Asian businesses)	**1,341**	1,461
	1,948	2,245

*Under IFRS 1, the carrying value of goodwill of £1,504 million under UK GAAP is the deemed cost under IFRS on the date of transition, 1 January 2004. An additional £309 million relates to newly consolidated venture investment subsidiaries of the PAC with-profits fund.

The additions of £151 million (2004: £537 million) relate to additions to the PAC with-profits fund venture holdings in which the Group has a controlling interest. All goodwill additions relate to the UK and the long-term business segments. Additional details on the acquisitions are provided in note I6.

Goodwill disposals in 2004 relate to the sale of Jackson Federal Bank (£38 million) and sales of a PAC with-profits fund venture subsidiary (£62 million). In 2005, goodwill disposals relate entirely to PAC with-profits fund venture subsidiaries.

H1: Goodwill continued

The £5 million charge for impairments in 2004 related to the write-down of Funds Direct (£2 million) and Zebank (£3 million), parts of the Egg group. The impairment has been reflected in discontinued operations (note F6) in the consolidated income statement.

During 2005, the acquired goodwill of the Japanese life company was tested for impairment and a charge of £120 million has been separately disclosed in the consolidated income statement. The charge reflects the slower than expected development of the Japanese life business.

Impairment testing

Goodwill does not generate cash flows independently of other groups of assets and thus is assigned to cash generating units (CGUs) for the purposes of impairment testing. These CGUs are based upon how management monitors the business and represent the lowest level to which goodwill can be allocated on a reasonable basis. An allocation of the Group's goodwill to CGUs is shown below:

	2005 £m	2004 £m
M&G	**1,153**	1,153
Japan life company	–	120
Venture investment subsidiaries of the PAC with-profits fund	**607**	784
Other	**188**	188
	1,948	2,245

'Other' represents goodwill amounts allocated across cash generating units in Asia and US operations. These goodwill amounts are not individually material. There are no other intangible assets with indefinite useful lives other than goodwill.

Assessment of whether goodwill may be impaired

With the exception of M&G and venture investment subsidiaries of the PAC with-profits fund the goodwill in the balance sheet relates to acquired life businesses. The Company routinely compares the aggregate of net asset value and acquired goodwill on an IFRS basis of acquired life business with the value of the business as determined using the EEV methodology, as described in section D1. Any excess of IFRS over EEV carrying value is then compared with EEV basis value of current and projected future new business to determine whether there is any indication that the goodwill in the IFRS balance sheet may be impaired.

Goodwill is tested for impairment by comparing the CGUs carrying amount, excluding any goodwill, with its recoverable amount.

M&G

The recoverable amount for the M&G CGU has been determined by calculating its value in use. This has been calculated by aggregating the present value of future cash flows expected to be derived from the component businesses of M&G (based upon management projections) and its current surplus capital.

The discounted cash flow valuation has been based on a three-year plan prepared by M&G, and approved by the directors of Prudential plc, and cash flow projections for later years.

As a cross check to the discounted cash flow analysis, a review was undertaken of publicly available information for companies engaged in businesses comparable to the component businesses, including reported market prices for such companies' shares. In addition, a review was undertaken of publicly available terms of transactions involving companies comparable to the component businesses. In particular, comparison has been made of the valuation multiples implied by the discounted cash flow analysis to current trading multiples of companies comparable to the component businesses, as well as to multiples achieved in precedent transactions.

The value in use is particularly sensitive to a number of key assumptions, as follows:

(i) The assumed growth rate on forecast cash flows beyond the terminal year of the budget. A growth rate of 2.5 per cent has been used to extrapolate beyond the plan period.

(ii) The risk discount rate. Differing discount rates have been applied in accordance with the nature of the individual component businesses. For retail and institutional business a risk discount rate of 12 per cent has been applied. This represents the average implied discount rate for comparable UK listed asset managers calculated by reference to risk-free rates, equity risk premiums of 5 per cent and an average 'beta' factor for relative market risk of comparable UK listed asset managers. A similarly granular approach has been applied for the other component businesses of M&G.

(iii) That asset management contracts continue on similar terms.

Management believes that any reasonable change in the key assumptions would not cause the carrying amount of M&G to exceed its recoverable amount.

H1: Goodwill continued

Japanese life company

As noted above, the entire goodwill relating to the Japanese life operation of £120 million has been deemed to be impaired following impairment testing carried out in 2005. This testing was based on a recoverable amount for the Japanese company that was determined by calculating its value in use based on net present value cash flow projections. Such projections reflected existing business over the expected duration of the contracts and expected new business. A risk discount rate of 5 per cent was applied to the projected cash flows. On the basis of the results of this exercise it was determined that all goodwill held in relation to the Japanese business should be written off in 2005.

PAC with-profits fund venture investment subsidiaries

The recoverable amount for the ventures entities controlled by the Group through PPM Capital has been determined on a portfolio CGU basis by aggregating fair values calculated for each entity less costs to sell these entities.

The fair value of each entity is calculated by PPM Capital in accordance with the International Private Equity and Venture Capital Valuation Guidelines which set out industry best practice for determining the fair value of private equity investments. The guidelines require that an enterprise value is calculated for each investment, typically using an appropriate multiple applied to the Company's maintainable earnings. All amounts relating to financial instruments ranking higher in a liquidation than those controlled by PPM Capital are then deducted from the enterprise value and a marketability discount applied to the result to give a fair value attributable to the instruments controlled by PPM Capital. The marketability discount ranges from 10 per cent to 30 per cent, depending on PPM Capital's level of control over a realisation process.

Management believes that any reasonable change in the key assumptions would not give rise to an impairment charge.

H2: Other intangible assets

Other intangible assets in the Group consolidated balance sheet consist of:

	2005 £m	2004 £m
Deferred acquisition costs (DAC) related to insurance contracts as classified under IFRS 4 (2004 – all long-term business)	**2,235**	2,912
Deferred acquisition costs related to investment management contracts, including life assurance contracts classified as financial instruments and investment management contracts under IFRS 4 (2004 – fund management contracts other than long-term business only)	**104**	8
	2,339	2,920
Present value of acquired in-force policies for insurance contracts as classified under IFRS 4 (2004 – all long-term business)	**92**	122
Present value of future profits of acquired investment management contracts, including life assurance contracts classified as financial instruments and investment management contracts under IFRS 4 (2004 – fund management contracts other than long-term business only)	**9**	0
	101	122
The carrying value of other intangible assets is attributable to:		
PAC with-profits fund	**35**	798
Shareholder operations	**2,405**	2,244
	2,440	3,042

Deferred acquisition costs related to insurance contracts

IFRS 4, which is adopted from 1 January 2005, permits deferred acquisition costs for insurance contracts and investment contracts with discretionary participation features to be accounted for under existing GAAP. Under UK GAAP, acquisition costs are deferred with amortisation on a basis commensurate with the anticipated emergence of margins under the contract.

On 1 January 2005, the Group adopted FRS 27, 'Life Assurance' into existing GAAP as part of the adoption of IFRS 4 which is reflected in the transition adjustment in the table below. The effect of this is to derecognise deferred acquisition costs for with-profits contracts of the UK regulated with-profits funds. The transition adjustment also removes deferred acquisition costs on with-profits investment contracts without discretionary participation features of UK regulated with-profits funds. Costs associated with the investment management element of other life assurance contracts classified as financial instruments and investment management contracts under IFRS 4 and fund management contracts are remeasured under the provisions of IAS 18. In addition, the transition adjustment includes adjustments to JNL DAC, including shadow DAC, resulting from implementation of IFRS investment measurement bases.

H2: Other intangible assets continued

The movement in deferred acquisition costs relating to insurance contracts and investment contracts with discretionary participation features is as follows:

	£m
Deferred acquisition costs at 1 January 2004	2,943
Additions	473
Amortisation	(381)
Impairment	(2)
Exchange differences	(121)
Deferred acquisition costs at 31 December 2004	2,912
Transition adjustment on application of IAS 32, IAS 39 and IFRS 4 (see note A6):	
Derecognition of deferred acquisition costs for UK regulated with-profits funds as a result of adopting FRS 27	(765)
Removal of deferred acquisition costs on investment contracts without discretionary participation features	(38)
Shadow DAC and other impacts as a result of measurement changes in JNL's investment portfolio	(456)
	(1,259)
Deferred acquisition costs at 1 January 2005	1,653
Additions	501
Amortisation	(392)
Impairment	(21)
Exchange differences	173
Change in shadow DAC	321
Deferred acquisition costs at 31 December 2005	**2,235**

In 2005, deferred acquisition costs of £21 million relating to the Taiwanese life assurance operation were impaired. See note D4(f) for further details.

H2: Other intangible assets continued

Deferred acquisition costs related to investment management contracts

Incremental costs associated with the origination of investment management contracts written by the Group's insurance and fund management businesses are capitalised and amortised as the related revenue is recognised. Deferred acquisition costs related to investment management contracts are all internally generated.

Amortisation of this intangible asset is included in the 'acquisition costs and other operating expenditure' line in the income statement.

	£m
At 1 January 2004	
Gross amount	12
Accumulated amortisation	–
Net book amount	12
Year ended 31 December 2004	
Opening net book amount	12
Additions (through internal development)	1
Amortisation	(5)
At 31 December 2004	8
Transition adjustment on application of IAS 32, IAS 39 and IFRS 4	67
At 1 January 2005	
Gross amount	80
Accumulated amortisation	(5)
Net book amount	75
Year ended 31 December 2005	
Opening net book amount	**75**
Additions (through internal development)	**45**
Amortisation	**(9)**
Other changes	**(7)**
Closing net book amount	**104**
At 31 December 2005	
Gross amount	**118**
Accumulated amortisation	**(14)**
Net book amount	**104**

Present value of acquired in-force business

Long-term business

Prior to the adoption of IFRS 4, the present value of acquired in-force business (PVAIF) was accounted for under UK GAAP. On 1 January 2005, following the adoption of IFRS 4, PVAIF relating to investment contracts without discretionary participation features, which was included within long-term business, is removed and replaced by an asset representing the present value of the future profits of the investment management component of these contracts, where applicable. These contracts are accounted for under the provisions of IAS 18. The remainder of the PVAIF balance relates to insurance contracts and continues to be accounted for under UK GAAP as permitted by IFRS 4.

The amortisation charge is included in acquisition costs and other operating expenditure in the income statement.

H2: Other intangible assets continued

Investment management

The present value of future profits of acquired investment management contracts relates to unit-linked contracts acquired as part of the M&G acquisition in 1999.

Amortisation is charged to the 'acquisition costs and other operating expenditure' line in the income statement over the period of provision of investment management services as those profits emerge.

	Long-term business £m	Investment management £m
At 1 January 2004		
Cost	256	0
Accumulated amortisation	(103)	0
Net book amount	153	0
Year ended 31 December 2004		
Opening net book amount	153	0
Exchange differences	(6)	0
Amortisation charge	(25)	0
At 31 December 2004	122	0
Transition adjustment on application of IAS 32, IAS 39 and IFRS 4	(18)	12
At 1 January 2005		
Cost	217	12
Accumulated amortisation	(113)	0
Net book amount	104	12
Year ended 31 December 2005		
Opening net book amount	**104**	**12**
Exchange differences	**9**	**0**
Amortisation charge	**(21)**	**(3)**
Closing net book amount	**92**	**9**
At 31 December 2005		
Cost	**233**	**12**
Accumulated amortisation	**(141)**	**(3)**
Net book amount	**92**	**9**

H3: Reinsurers' share of policyholder liabilities

	2005 £m	2004 £m
Insurance contract liabilities (note i)	**1,203**	–
Claims outstanding	**75**	99
Long-term business provision	**–**	612
Technical provisions for linked liabilities	**–**	307
	1,278	1,018

Note

(i) Movement on reinsurers' share of insurance contract liabilities

	2005 £m
Balance at 31 December 2004 and 1 January 2005 following adoption of IFRS 4*	**919**
Amount included in income statement	**242**
Foreign exchange translation differences	**42**
Balance at 31 December 2005	**1,203**

* Comprising long-term business provision plus technical provisions for linked liabilities which all relate to contracts classified as insurance under IFRS 4.

H4: Tax assets and liabilities

Assets

Of the £231 million (2004: £159 million) current tax recoverable, the majority is expected to be settled in one year or less.

Deferred tax asset

	2005 £m	2004 £m
Unrealised losses on investments	**84**	186
Balances relating to investment and insurance contracts	**317**	357
Short-term timing differences	**258**	260
Capital allowances	**91**	21
Unused deferred tax losses	**5**	3
	755	827

Deferred tax assets are recognised to the extent that they are regarded as recoverable, that is to the extent that, on the basis of all available evidence, it can be regarded as more likely than not that there will be suitable taxable profits from which the future reversal of the underlying temporary differences can be deducted. The UK taxation regime applies separate rules to trading and capital profits and losses. The distinction between temporary differences that arise from items of either a capital or trading nature may affect the recognition of deferred tax assets. Accordingly, for the 2005 results and balance sheet position at 31 December 2005 the possible tax benefit of approximately £333 million (2004: £430 million), which may arise from capital losses valued at approximately £1.7 billion, is sufficiently uncertain that it has not been recognised. In addition, a potential deferred tax asset of £67 million, which may arise from trading losses of approximately £237 million, is sufficiently uncertain that it has not been recognised.

Liabilities

Of the £962 million (2004: £1,018 million) current tax liability, it is not practicable to estimate how much is expected to be settled in one year or less due to the uncertainty over when outstanding issues will be agreed with HM Revenue and Customs.

Deferred tax liability

	2005 £m	2004 £m
Unrealised gains on investments	**1,907**	1,477
Balances relating to investment and insurance contracts	**554**	675
Short-term timing differences	**450**	131
Capital allowances	**80**	(4)
	2,991	2,279

Unprovided deferred income tax liabilities on temporary differences associated with investment in subsidiaries, associates and interests in joint ventures are considered to be insignificant due to the availability of various UK tax exemptions and reliefs.

Discounting

Deferred tax asset and liability balances have not been discounted.

H5: Accrued investment income and other debtors

	2005 £m	2004 £m
Accrued investment income		
Interest receivable	**1,235**	1,287
Other	**556**	446
	1,791	1,733
Other debtors		
Premiums receivable:		
From policyholders	**230**	106
From intermediaries	**10**	8
From reinsurers	**21**	20
Other	**1,057**	1,054
	1,318	1,188
Total	**3,109**	2,921

Of the £3,109 million (2004: £2,921 million) of accrued investment income and other debtors, £992 million (2004: £990 million) is expected to be settled after one year or more.

H6: Property, plant and equipment

Property, plant and equipment comprise Group occupied properties, development property and tangible assets. A reconciliation of the carrying amount of these items from the beginning of the year to the end of the year is as follows:

	Group occupied property £m	Development property £m	Tangible assets £m	Total £m
At 1 January 2004				
Cost	266	66	866	1,198
Accumulated depreciation	(29)	–	(458)	(487)
Net book amount	237	66	408	711
Year ended 31 December 2004				
Opening net book amount	237	66	408	711
Exchange differences	(3)	–	(5)	(8)
Depreciation charge	(6)	–	(123)	(129)
Additions	17	69	141	227
Arising on acquisition of subsidiaries	63	–	149	212
Disposals	(3)	–	(23)	(26)
Impairment	–	–	(20)	(20)
Closing net book amount	305	135	527	967
At 1 January 2005				
Cost	340	135	1,094	1,569
Accumulated depreciation	(35)	–	(567)	(602)
Net book amount	305	135	527	967
Year ended 31 December 2005				
Opening net book amount	**305**	**135**	**527**	**967**
Exchange differences	**5**	**–**	**6**	**11**
Depreciation charge	**(6)**	**–**	**(110)**	**(116)**
Additions	**5**	**27**	**128**	**160**
Arising on acquisition of subsidiaries	**38**	**–**	**44**	**82**
Disposals	**(105)**	**–**	**(102)**	**(207)**
Reclassification from held for investment	**–**	**13**	**–**	**13**
Closing net book amount	**242**	**175**	**493**	**910**
At 31 December 2005				
Cost	**279**	**175**	**1,082**	**1,536**
Accumulated depreciation	**(37)**	**–**	**(589)**	**(626)**
Net book amount	**242**	**175**	**493**	**910**

Of the above net book amounts, £125 million (2004: £193 million) of Group occupied property and £269 million (2004: £287 million) of tangible assets are attributable to consolidated venture investment subsidiaries of the PAC with-profits fund at 31 December 2005. All additions arising on acquisitions relate to acquisitions of venture investment subsidiaries of the PAC with-profits fund.

Capital expenditure: property, plant and equipment by primary segment

	2005 £m	2004 £m
Long-term business	**124**	159
Banking	**28**	60
Broker-dealer and fund management	**6**	8
Unallocated corporate	**2**	–
	160	227

Capital expenditure: property, plant and equipment by secondary segment

	2005 £m	2004 £m
UK	**117**	192
US	**14**	12
Asia	**29**	23
	160	227

H7: Investment properties

Investment properties principally relate to the PAC with-profits fund and are carried at fair value. A reconciliation of the carrying amount of investment properties at the beginning and end of the year is set out below:

	2005 £m	2004 £m
At 1 January 2005	**13,303**	11,489
Additions:		
Resulting from acquisitions	**844**	924
Resulting from expenditure capitalised	**56**	224
Resulting from acquisitions through business combinations	**22**	–
Disposals	**(1,224)**	(295)
Net gains from fair value adjustments	**720**	1,063
Net foreign exchange differences	**24**	(2)
Transfers to held for sale assets (note H9)	**(552)**	(100)
Transfers to development properties	**(13)**	–
At 31 December 2005	**13,180**	13,303

The income statement includes the following items in respect of investment properties:

	2005 £m	2004 £m
Rental income from investment properties	**765**	828
Direct operating expenses (including repairs and maintenance expenses) arising from investment properties:		
That generated rental income during the year	**133**	119
That did not generate rental income during the year	**7**	1
Total direct operating expenses	**140**	120

H7: Investment properties continued

Investment properties of £4,463 million (2004: £5,095 million) are held under finance leases. A reconciliation between the total of future minimum lease payments at the balance sheet date, and their present value is shown below:

	2005 £m	2004 £m
Future minimum lease payments at 31 December	**564**	679
Future finance charges on finance leases	**(450)**	(563)
Present value of minimum lease payments	**114**	116
Future minimum lease payments are due as follows:		
Less than 1 year	**12**	8
1 to 5 years	**23**	25
Over 5 years	**529**	646
	564	679
The present values of these minimum lease payments are:		
Less than 1 year	**11**	7
1 to 5 years	**22**	23
Over 5 years	**81**	86
	114	116

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on the future value of a factor that changes other than with the passage of time. Contingent rent recognised as an expense in 2005 amounted to £21 million (2004: £27 million). Contingent rents recognised as income in the year amounted to £46 million (2004: £42 million).

The Group's policy is to rent investment properties to tenants through operating leases. Minimum future rentals to be received on non-cancellable operating leases are receivable in the following periods:

	2005 £m	2004 £m
Less than 1 year	**702**	731
1 to 5 years	**2,535**	2,672
Over 5 years	**7,005**	7,424

The total minimum future rentals to be received on non-cancellable sub-leases for land and buildings for the year ended 31 December 2005 are £4,006 million (2004: £3,760 million).

H8: Investments in participating interests

The Group's investments in participating interests at 31 December 2005 and 2004 comprise associates and joint ventures. Disclosures relating to these investments are provided below. The Group also had an interest of 15 per cent in Life Assurance Holding Corporation Limited that was sold in August 2004 and realised a profit on sale of £7 million before tax. This has been further disclosed in the discontinued operations note (see note F6).

Investments in associates

The Group had one associate at 31 December 2005 and 2004 that is accounted for using the equity method, IfOnline Group Limited (IfOnline), a company whose principal activity is mortgage intermediation. Until its sale in September 2004, the Group also accounted for its share in Hazell Carr Pensions Consulting plc (Hazell Carr) as an equity accounted associate.

The Group also has investments in associates which meet the IAS 28 criteria for measurement at fair value through profit and loss in accordance with IAS 39.

Associates accounted for using the equity method

The Group holds 38.6 per cent of the total issued share capital of IfOnline which comprises 29.9 per cent of the ordinary share capital and 96.0 per cent of the preference share capital. The Group also holds £1 Founder share capital and £1 AN share capital. IfOnline is not a listed investment. Equity accounting is applied based on its reporting period of the year to 30 November and is adjusted for material changes up to 31 December. Accordingly, the information is deemed to cover the same period as that of the Group.

In September 2004, the Company sold its 25 per cent share of Hazell Carr for £5 million. The profit on sale before tax of £2 million is included in investment income in the consolidated income statement.

H8: Investments in participating interests continued

A summary of the movements in investments in associates accounted for using the equity method in 2005 and 2004 is set out below:

	Share of capital £m	Share of reserves £m	Share of net assets £m	Goodwill £m	Total carrying value £m
Balance at 1 January 2004	6	(7)	(1)	10	9
Share of loss for the year after tax	–	(1)	(1)	–	(1)
Disposal of Hazell Carr	(2)	2	–	(3)	(3)
Balance at 31 December 2004	4	(6)	(2)	7	5
Share of profit for the year after tax	–	–	–	–	–
Balance at 31 December 2005	4	(6)	(2)	7	5

There have been no changes recognised directly in the equity of associates that would also be recognised directly in equity by the Group.

The Group's share of the assets, liabilities, revenues and profit and loss of associates accounted for using the equity method at 31 December 2005 and 2004 is as follows:

	2005 £m	2004 £m
Financial position		
Total assets (excluding goodwill)	**1**	1
Total liabilities	**(3)**	(3)
Net assets	**(2)**	(2)
Results of operations		
Revenue	**2**	1
Profit (loss) in the year	**–**	(1)

Associates carried at fair value through profit and loss

The Group's associates that are carried at fair value through profit and loss comprise investments in OEICs, unit trusts, funds holding collateralised debt obligations, property unit trusts, and venture capital investments of the PAC with-profits fund managed by PPM Capital, where the Group has significant influence. These investments are incorporated both in the UK and overseas, and some have year ends which are non-coterminous with that of the Group. In these instances, the investments are recorded at fair value at 31 December 2005 based on valuations or pricing information at that specific date. The aggregate fair value of associates carried at fair value through profit and loss where there are published price quotations is approximately £2 billion at 31 December 2005.

The aggregate assets of these associates are approximately £9 billion. Aggregate liabilities, excluding liabilities to unit holders and shareholders for unit trusts and OEICs, are approximately £3 billion. Fund revenues, with revenue arising in unit trusts and OEICs deemed to constitute the investment return for these vehicles, was approximately £2 billion and net profit in the year, excluding unit trusts or OEICs where all investment returns accrue to unit holders or shareholders respectively, was approximately £0.1 billion.

Investments in joint ventures

Joint ventures represent activities over which the Group exercises joint control through contractual agreement with one or more parties. The Group's significant joint ventures, which are accounted for using proportionate consolidation, comprise various joint ventures relating to property investments where the Group has a 50 per cent interest as well as the following interests:

Investment	% held	Principal activity	Country
ICICI Prudential Life Insurance Company Limited	26	Life assurance	India
BOCI – Prudential Asset Management Limited	36	Pensions	China
Marlborough Stirling Mortgage Services Limited	50	Mortgage processing services	UK
PruHealth	50	Private medical insurance	UK
CITIC Prudential Fund Management Company Limited	33	Fund Management	China
Prudential ICICI Asset Management Company Limited	49	Fund Management	India

H8: Investments in participating interests continued

CITIC Prudential Fund Management Company Limited and Prudential ICICI Asset Management Company Limited are new joint ventures in 2005. Prudential ICICI Asset Management Company Limited was previously a subsidiary with an ownership interest of 55 per cent. However, in 2005 the Group sold a 6 per cent holding resulting in a new interest of 49 per cent. Hence, the Group now accounts for this investment as a joint venture, as there is a contractual agreement to share control.

The investments noted in the table above have the same accounting year end as the Group, except for Marlborough Stirling Mortgage Services Limited and Prudential ICICI Asset Management Company Limited. Although these two investments have a reporting period of 31 March, 12 months of financial information up to 31 December is recorded. Accordingly, the information is deemed to cover the same period as that of the Group.

The summarised financial data for the Group's share of investments in joint ventures is as follows:

	2005 £m	2004 £m
Financial position		
Current assets	**233**	39
Non-current assets	**281**	288
Total assets	**514**	327
Current liabilities	**(30)**	(17)
Non-current liabilities	**(272)**	(179)
Total liabilities	**(302)**	(196)
Net equity	**212**	131
Results of operations		
Revenues	**156**	74
Expenses	**(161)**	(85)
Net loss	**(5)**	(11)

The joint ventures have no significant contingent liabilities to which the Group is exposed nor does the Group have any significant contingent liabilities in relation to its interest in the joint ventures.

H9: Assets and liabilities held for sale

Assets and liabilities held for sale comprise investment property and consolidated venture subsidiaries of the PAC with-profits fund.

Investment properties are classified as held for sale when contracts have been exchanged but the sale has not been completed at the period end.

As at 31 December 2005, there were two venture subsidiaries classified as held for sale, Upperpoint Distribution Limited and Taverner Hotel Group Pty Ltd. The disposals of these subsidiaries were completed on 31 January 2006 and 6 February 2006, respectively. There were no venture subsidiaries classified as held for sale at 31 December 2004.

Major classes of assets and liabilities held for sale are as follows:

	2005 £m	2004 £m
Assets		
Goodwill	**16**	–
Property, plant and equipment	**21**	–
Other assets	**139**	–
Investment properties	**552**	100
Non-current assets held for sale	**728**	100
Liabilities		
Other liabilities	**42**	–
Borrowings	**104**	–
Non-current liabilities held for sale	**146**	–

H10: Cash and cash equivalents

Cash and cash equivalents consist of cash in hand, balances with banks, and certain short-term deposits and debt instruments. Cash and cash equivalents included in the cash flow statement comprise the following balance sheet amounts:

	2005 £m	2004 £m
Cash	**2,380**	2,799
Cash equivalents	**1,206**	1,542
Total cash and cash equivalents	**3,586**	4,341

Cash and cash equivalents held in the parent company and finance subsidiaries are considered to be available for use by the Group. These funds amount to £263 million and £325 million in 2005 and 2004, respectively. The remaining amounts, generally not available for use by the Group, predominantly consist of cash and cash equivalents held for the benefit of policyholders and loans and advances to banks held by Egg.

H11: Shareholders' equity: share capital, share premium and reserves

The authorised share capital of the Company is £170 million (divided into 3,000,000,000 ordinary shares of 5 pence each and 2,000,000,000 sterling preference shares of 1 pence each) and US$20 million (divided into 2,000,000,000 US dollar preference shares of 1 cent each) and Euros 20 million (divided into 2,000,000,000 Euro preference shares of 1 cent each). None of the preference shares has been issued. A summary of the ordinary shares in issue is set out below:

	2005 £m	2004 £m
Share capital and share premium		
Ordinary share capital: 2,387m (2004: 2,375m)		
Shares issued	**119**	119
Share premium	**1,564**	1,558
Reserves		
Retained earnings	**3,236**	2,972
Translation reserve	**173**	(160)
Available-for-sale and hedging reserves	**102**	0
Total shareholders' equity	**5,194**	4,489

Share capital and share premium

	Number of ordinary shares	Share capital £m	Share premium £m
2004			
Issued shares of 5p each fully paid:			
At the beginning of the year	2,009,176,830	100	553
Shares issued under Rights Issue, net of expenses	339,011,347	17	1,004
Shares issued under share option schemes	567,121	–	1
Shares issued in lieu of cash dividends	26,637,722	2	116
Transfer to retained earnings in respect of shares issued in lieu of cash dividends			(116)
At end of the year	2,375,393,020	119	1,558
2005			
Issued shares of 5p each fully paid:			
At the beginning of the year	**2,375,393,020**	**119**	**1,558**
Transition adjustment on adoption of IAS 32, IAS 39 and IFRS 4			**2**
	2,375,393,020	**119**	**1,560**
Shares issued under share option schemes	**745,478**	**–**	**4**
Shares issued in lieu of cash dividends	**10,645,768**	**–**	**51**
Transfer to retained earnings in respect of shares issued in lieu of cash dividends			**(51)**
At end of the year	**2,386,784,266**	**119**	**1,564**

H11: Shareholders' equity: share capital, share premium and reserves continued

Amounts recorded in share capital represent the nominal value of the shares issued. The difference between the proceeds received on issue of shares, net of issue costs and the nominal value of shares issued is credited to the share premium account.

In October 2004, the Company announced a one for six Rights Issue at 308 pence per new share. The Rights Issue raised £1,044 million and issue expenses were £23 million.

At 31 December 2005, there were options subsisting under Save As You Earn schemes to subscribe for 12,503,956 (2004: 13,254,966) shares at prices ranging from 266 pence to 715 pence (2004: 266 pence to 723 pence) and exercisable by the year 2012 (2011). In addition, there are 4,668,534 (2004: 5,153,308) conditional options outstanding under the RSP exercisable at nil cost in the balance of a 10-year period.

The cost of own shares of £97 million as at 31 December 2005 is deducted from retained earnings.

The Company has established trusts to facilitate the delivery of shares under employee incentive plans and savings-related share option schemes. In 2005, the Company purchased 1.4 million (2004: 1.0 million) shares in respect of employee incentive plans at a cost of £6 million (2004: £4 million). At 31 December 2005, 10.7 million (2004: 10.6 million) Prudential plc shares with a market value of £59 million (2004: £48 million) were held in such trusts. This was also the maximum number held at any time during the year. Of this total, 5.7 million (2004: 5.4 million) shares were held in trusts under employee incentive plans.

Of the total shares held in trust, 5 million (2004: 5.2 million) shares were held by a qualifying employee share ownership trust. These shares are expected to be fully distributed in the future on maturity of savings-related share option schemes at a weighted average exercise price of 286 pence (2004: 277 pence).

The Group has consolidated a number of authorised investment funds where it is deemed to control these funds under IFRS. Certain of these funds hold shares in Prudential plc. The total number of shares held by these funds at 31 December 2005 was 5 million (2004: 5.9 million) and the cost of acquiring these shares of £26 million (2004: £29 million) is included in cost of own shares. The market value of these shares as at 31 December 2005 was £28 million (2004: £27 million).

Reserves

The translation reserve represents cumulative foreign exchange translation differences taken directly to equity in accordance with IFRS, net of related tax. In accordance with IFRS 1, cumulative translation differences are deemed to be zero at 1 January 2004, the date of transition to IFRS.

The hedging reserve at 31 December 2005 consists of the portion of the cash flow hedge that is determined to be an effective hedge, net of related tax. The available-for-sale reserve includes gains or losses arising from changes in fair value of available-for-sale securities, net of related tax. These reserves arise as a result of the application of IAS 39 which the Group has chosen to adopt at 1 January 2005 as permitted by IFRS 1.

H12: Insurance contract liabilities and unallocated surplus of with-profits funds

Movement in year

	Insurance contract liabilities £m	Unallocated surplus of with-profits funds £m
Policyholder liabilities at 31 December 2004 as reported under UK GAAP		
Technical provisions in respect of non-linked business (note i)	104,964	
Technical provisions for linked liabilities	24,137	
Unallocated surplus of with-profits funds reflecting previous UK GAAP basis provisioning		16,686
Total at 31 December 2004 as reported under UK GAAP	129,101	16,686
Effect of changes on implementation of IFRS (note A5)	(39)	(537)
Total at 31 December 2004 under IFRS (excluding IAS 32, IAS 39 and IFRS 4)	129,062	16,149
Transition adjustments on application of IAS 32, IAS 39 and IFRS 4 (note ii and note A6)	(25,480)	(7,807)
At 1 January 2005	103,582	8,342
Income and expense included in the income statement	12,193	3,003
Liabilities acquired on purchase of insurance business (note I6)	837	0
Foreign exchange translation differences	3,824	12
At 31 December 2005	**120,436**	**11,357**

Notes

(i) 2004 technical provisions in respect of non-linked business as reported under UK GAAP include £826 million of claims outstanding.

(ii) Transitional adjustments include adoption of FRS 27 and reallocation of £22.7 billion and £9.8 billion to investment contracts with and without discretionary participation features, respectively.

H13: Borrowings

Core structural borrowings of shareholder-financed operations

	2005 £m	2004 £m
Subordinated debt (excluding Egg)		
UK operations:		
€500m 5.75% Subordinated Notes 2021	**341**	351
£435m 6.125% Subordinated Notes 2031	**426**	426
US$1,000m 6.5% Perpetual Subordinated Capital Securities	**554**	512
US$250m 6.75% Perpetual Subordinated Capital Securities (note i)	**142**	126
US$300m 6.5% Perpetual Subordinated Capital Securities (note ii)	**169**	–
€20m Medium Term Subordinated Notes 2023	**14**	14
	1,646	1,429
Other core structural borrowings of shareholder-financed operations, other than Egg		
UK operations:		
US$250m 7.125% Bonds 2005	**–**	130
£150m 9.375% Guaranteed Bonds 2007	**150**	150
£250m 5.5% Bonds 2009	**249**	250
£250m 5.875% Bonds 2029	**249**	250
£300m 6.875% Bonds 2023	**300**	300
Commercial paper	**–**	171
Currency translation net asset on swap transactions	**–**	(13)
US operations:		
US$250m 8.15% Surplus Notes 2027 (note iii)	**145**	130
	1,093	1,368
Egg		
£200m 6.875% Subordinated Notes 2021	**202**	202
£250m 7.5% Subordinated Notes 2013	**250**	249
	452	451
Total	**3,191**	3,248

Notes

(i) This balance represents convertible debt issued in 2004. The debt is exchangeable into preference shares. The proceeds of the issue have been used to pre-finance US$250 million debt maturing in 2005. Conversion of these securities into preference shares is at Prudential's option.

(ii) This debt is exchangeable into preference shares at Prudential's option.

(iii) These Surplus Notes are unsecured and subordinated to all present and future indebtedness, policy claims and other creditor claims of the US operations.

(iv) Maturity analysis
The following table sets out the maturity analysis of the Group's core structural borrowings:

	2005 £m	2004 £m
Less than 1 year	**–**	301
1 to 2 years	**150**	–
2 to 3 years	**–**	150
3 to 4 years	**249**	–
4 to 5 years	**–**	250
Over 5 years	**2,792**	2,547
Total	**3,191**	3,248

H13: Borrowings continued

Operational borrowings attributable to shareholder-financed operations

	2005 £m	2004 £m
Borrowings in respect of short-term fixed income securities programmes		
Commercial paper 2006	**1,461**	1,057
Medium-term notes 2010	**11**	9
Currency translation net liability on swap transactions	**–**	13
	1,472	1,079
Non-recourse borrowings of investment subsidiaries managed by PPM America		
Non-recourse borrowings of investment subsidiaries (notes i and iii)	**133**	183
Non-recourse borrowings of Piedmont and CDO funds (notes ii and iii)	**952**	972
	1,085	1,155
Borrowings in respect of banking operations (note iv)	**3,856**	4,159
Other borrowings		
Bank loans and overdrafts	**11**	17
Obligations under finance leases	**8**	11
	19	28
Total	**6,432**	6,421

Notes

(i) These borrowings include senior and subordinated debt. The senior debt is secured on the investments held by the relevant subsidiaries. The weighted average interest rates on the senior debt are variable based on a market rate and were 4.48 per cent and 2.38 per cent at 31 December 2005 and 31 December 2004 respectively. The interests of the holders of the subordinated debt issued by these subsidiaries are subordinate to the entitlements of the holders of the senior debt.

(ii) Piedmont is an investment trust investing in certain asset-backed and mortgage-backed securities in the US. These borrowings pertain to debt instruments issued to external parties.

(iii) In all instances the holders of the debt instruments issued by these subsidiaries and other companies and funds do not have recourse beyond the assets of those subsidiaries and funds.

(iv) The borrowings in respect of banking operations comprise deposits by banks of £2,452 million (2004: £2,352 million) and unsubordinated debt securities issued by Egg of £1,404 million (2004: £1,807 million). The deposits by banks mainly relate to securitisation of credit card receivables. See also note G4.

(v) Maturity analysis
The following table sets out the maturity analysis of the Group's operational borrowings attributable to shareholder-financed operations:

	2005 £m	2004 £m
Less than 1 year	**2,440**	1,896
1 to 2 years	**1,055**	792
2 to 3 years	**523**	1,056
3 to 4 years	**1,013**	500
4 to 5 years	**449**	1,022
Over 5 years	**952**	1,155
Total	**6,432**	6,421

Borrowings attributable to with-profits funds

	2005 £m	2004 £m
Non-recourse borrowings of venture fund investment subsidiaries of the PAC with-profits fund	**988**	1,167
£100m 8.5% Undated Subordinated Guaranteed Bonds of Scottish Amicable Finance plc (note i)	**100**	100
Other borrowings (predominantly external funding of consolidated investment vehicles)	**810**	870
	1,898	2,137

Notes

(i) The interests of the holders of the bonds issued by Scottish Amicable Finance plc, a subsidiary of the Scottish Amicable Insurance Fund, are subordinate to the entitlements of the policyholders of that fund.

(ii) Maturity analysis
The following table sets out the maturity analysis of the Group's borrowings attributable to with-profits funds:

	2005 £m	2004 £m
Less than 1 year	**39**	359
1 to 2 years	**74**	52
2 to 3 years	**40**	204
3 to 4 years	**62**	21
4 to 5 years	**133**	118
Over 5 years	**1,550**	1,383
Total	**1,898**	2,137

H14: Provisions and contingencies

Provisions

	2005 £m	2004 £m
Provision in respect of defined benefit pension schemes (note I1):		
Deficits, gross of deferred tax, based on scheme assets held, including investments in Prudential insurance policies:		
Attributable to PAC with-profits fund (ie absorbed by the liability for unallocated surplus)	**329**	525
Attributable to shareholder-financed operations (ie to shareholders' equity)	**214**	175
	543	700
Add back: investments in Prudential insurance policies	**253**	125
Provision after elimination of investments in Prudential insurance policies and matching policyholder liability from Group balance sheet	**796**	825
Other provisions (see below)	**176**	181
Total provisions	**972**	1,006

Analysis of other provisions:

	2005 £m	2004 £m
At 1 January	**181**	173
Charged to income statement:		
Additional provisions	**85**	163
Unused amounts reversed	**(25)**	(21)
Used during the year	**(63)**	(137)
Exchange differences	**(2)**	3
At 31 December	**176**	181
Comprising:		
Legal provisions	**11**	13
Restructuring provisions	**41**	66
Other provisions	**124**	102
	176	181

Of the other provisions balance, £74 million (2004: £53 million) is expected to be settled within one year. Employer contributions expected to be paid into Group defined benefit pension schemes within one year are shown in note I1.

Legal provisions

The legal provisions of £11 million (2004: £13 million) relate predominantly to JNL. JNL has been named in civil proceedings, which appear to be substantially similar to other class action litigation brought against many life insurers in the US, alleging misconduct in the sale of insurance products. During 2005, an additional provision of £4 million was made, £1 million was reversed, £3 million was paid and there was a £2 million exchange gain. As at 1 January 2004, the provision amounted to £10 million. During 2004, an additional provision of £8 million was made, £1 million was reversed, £3 million was paid and there was a £1 million exchange gain.

Restructuring provisions

Restructuring provisions of £41 million (2004: £66 million) comprise £30 million (2004: £49 million) relating to restructuring activity of UK insurance operations, £10 million (2004: £nil) relating to closure costs in Japan and £1 million (2004: £17 million) relating to Egg.

In February 2001, Prudential announced the restructuring of the direct sales force and customer service channels of its UK insurance operations. In November 2001, Prudential announced further details of changes to the structure of those operations, in particular the intention to pursue a single brand strategy for life and pensions business including the integration of its Scottish Amicable operations under the Prudential brand. The changes also included a simplification of the organisational structure and plans for a significant reduction in operating costs. In September 2002, Prudential announced plans to establish an offshore service centre in India to improve customer contact service levels for its UK insurance operations customers and to achieve further cost savings to those announced in November 2001. The new processing centre opened in May 2003 and was fully operational during 2004. As part of this restructuring, Prudential had planned to make 4,300 employees redundant, of which approximately 4,194 affected had been notified and 4,117 redundancies completed by 31 December 2005. The restructuring is expected to be completed in 2006.

As at 1 January 2004, the provision for these restructurings was £80 million. During 2004, £20 million costs were paid, £12 million was released to the profit and loss account and an additional provision of £1 million was made. During 2005, costs of £9 million were paid, £11 million of costs were released and an additional £1 million was provided. At 31 December 2005, the remaining £30 million all relates to property charges.

In 2004, Egg announced its withdrawal from the French market. £113 million was charged in 2004 to cover the costs of the exit of which £25 million related to redundancy costs and £88 million related to other associated costs up to the completion of the closure. During 2004, £96 million of the provision had been utilised with a further £12 million utilised in 2005 and a £4 million release to the income statement.

H14: Provisions and contingencies continued

In 2005, Japan closed its Financial Advisor distribution channel. A £10 million provision has been set up relating to closure and redundancy costs.

Other provisions

Other provisions of £124 million (2004: £102 million) include provisions of £94 million (2004: £77 million) relating to staff benefit schemes. During 2005, another £27 million was provided and £10 million was paid. In 2004, a provision of £51 million was brought forward, an additional £36 million was provided, £2 million of unused provision was released and £8 million was paid. Other provisions also include £19 million (2004: £17 million) relating to various onerous contracts where, in 2005, an additional £6 million was provided and £4 million was used. In 2004, £5 million was released and £4 million was paid. The remaining provisions of £11 million (2004: £8 million) include VAT provisions.

Contingencies and related obligations

Litigation

In addition to the legal proceedings relating to JNL mentioned above, the Group is involved in other litigation and regulatory issues arising in the ordinary course of business. Whilst the outcome of such matters cannot be predicted with certainty, the directors believe that the ultimate outcome of such litigation will not have a material adverse effect on the Group's financial condition, results of operations or cash flows.

Pension mis-selling review

In 1988, the UK government introduced new pensions legislation intended to encourage more individuals to make their own arrangements for their pensions. During the period from April 1988 to June 1994, many individuals were advised by insurance companies, Independent Financial Advisers and other intermediaries to not join, to transfer from or to opt out of their occupational pension schemes in favour of private pension products introduced under the UK Income and Corporation Taxes Act 1988. The UK insurance regulator (previously the Personal Investment Authority, now the FSA), subsequently determined that many individuals were incorrectly advised and would have been better off not purchasing the private pension products sold to them. Industry participants are responsible for compensating the persons to whom private pensions were mis-sold. As a result, the FSA required that all UK life insurance companies review their potential cases of pension mis-selling and pay compensation to policyholders where necessary and, as a consequence, record a provision for the estimated costs. The Group met the requirement of the FSA to issue offers to all cases by 30 June 2002.

The table below summarises the change in the pension mis-selling provision for the years ended 31 December 2005 and 2004. The change in the provision is included in benefits and claims in the income statement and the movement in unallocated surplus of with-profits funds has been determined accordingly.

	2005 £m	2004 £m
Balance at beginning of year	**487**	530
Change arising from adoption of FRS 27	**(109)**	–
Changes to actuarial assumptions and method of calculation	**(28)**	(32)
Discount unwind	**14**	22
Redress to policyholders	**(21)**	(26)
Payment of administrative costs	**(12)**	(7)
Balance at end of year	**331**	487

The change arising from the adoption of FRS 27 is due to two factors, namely:

(i) Under the FRS 27 basis, which follows the FSA realistic Peak 2 approach, best estimate assumptions apply. Previously a margin for adverse deviation was incorporated; and

(ii) The pension mis-selling provision is the additional amount needed i.e. between the value of the guarantees given to policyholders and the values of the personal pension policies. The latter item is calculated differently under the previous Peak 1 and Peak 2 bases. The Peak 1 calculation is deterministic and excludes provision for terminal bonus. The Peak 2 calculation is stochastic and includes provision for terminal bonus.

The FSA regularly updates the actuarial assumptions to be used in calculating the provision, including interest rates and mortality assumptions. The pension mis-selling provision represents the discounted value of future expected payments, including benefit payments and all internal and external legal and administrative costs of adjudicating, processing and settling those claims. To the extent that amounts have not been paid, the provision increases each year reflecting the shorter period of discount.

The directors believe that, based on current information, the provision, together with future investment return on the assets backing the provision, will be adequate to cover the costs of pension mis-selling as well as the costs and expenses of the Group's pension review unit established to identify and settle such cases. Such provision represents the best estimate of probable costs and expenses. However, there can be no assurance that the current provision level will not need to be increased.

The costs associated with the pension mis-selling review 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 pension mis-selling.

H14: Provisions and contingencies continued

In 1998, Prudential stated that deducting mis-selling costs from the inherited estate would not impact its bonus or investment policy and it 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, so as 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. The assurance will continue to apply to any policy in force at 31 December 2003, both for premiums paid before 1 January 2004, and for subsequent regular premiums (including future fixed, RPI or salary related increases and Department of Work and Pensions rebate business). The assurance has not applied to new business 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 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 or not 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.

Mortgage endowment products review

In common with several other UK insurance companies, the Group used to sell low-cost endowment products related to repayment of residential mortgages. At sale, the initial sum assured is set at a level such that the projected benefits, including an estimate of the annual bonus receivable over the life of the policy, will equal or exceed the mortgage debt. Because of a decrease in expected future investment returns since these products were sold, the FSA is concerned that the maturity value of some of these products will be less than the mortgage debt. The FSA has worked with insurance companies to devise a program whereby the companies write to customers indicating whether they may have a possible shortfall and outline the actions that the customers can take to prevent this possibility.

The Group is exposed to mortgage endowment products in respect of policies issued by Scottish Amicable Life plc (SAL) and policies issued by Scottish Amicable Life Assurance Society (SALAS) and transferred into SAIF. At 31 December 2005, provisions of £6 million (2004: £7 million) in SAL and £50 million (2004: £47 million) in SAIF were held to cover potential compensation in respect of mortgage endowment product mis-selling claims. As SAIF is a separate sub-fund of the Prudential Assurance long-term business fund, this provision has no impact on shareholders.

In addition, in the year ended 31 December 2005 Prudential Assurance's main with-profits fund paid compensation of £24 million (2004: £16 million) in respect of mortgage endowment products mis-selling claims and at 31 December 2005 held a provision of £63 million (2004: £61 million) in respect of further compensation. The movement in this provision has no impact on the Group's profit before tax.

Guaranteed annuities

Prudential Assurance used to sell guaranteed annuity products in the UK and at 31 December 2005 held a provision of £52 million (2004: £49 million) within the main with-profits fund to honour guarantees on these products. The Group's main exposure to guaranteed annuities in the UK is through SAIF and at 31 December 2005 a provision of £619 million (2004: £648 million) was held in SAIF to honour the guarantees. As SAIF is a separate sub-fund of the Prudential Assurance long-term business fund. The movement in this provision has no impact on shareholders.

Other matters

Prudential assurance's inherited estate

The assets of the main with-profits fund within the long-term fund of Prudential Assurance comprise the amounts 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 fund is equal to the policyholders' accumulated asset shares plus any additional payments that may be required by way of smoothing or to meet guarantees. The balance of the assets of the with-profits fund is called the 'inherited estate' and has accumulated over many years from various sources.

The inherited estate represents the major part of the working capital of Prudential Assurance's long-term fund. This enables the Company to support with-profits business by providing the benefits associated with smoothing and guarantees, by providing investment flexibility for the fund's assets, by meeting the regulatory capital requirements that demonstrate solvency and by absorbing the costs of significant events or fundamental changes in its long-term business without affecting the 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. In due course, and only after discussion with the FSA, the Company may therefore take steps to achieve that clarity, whether through guidance from the Court or otherwise. In any event 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.

H14: Provisions and contingencies continued

Support for long-term business funds by shareholders' funds

As a proprietary insurance company, the Group is liable to meet its obligations to policyholders even if the assets of the long-term funds are insufficient to do so. The assets, represented by the 'unallocated surplus of with-profits funds', in excess of amounts expected to be paid for future terminal bonuses and related shareholder transfers (the excess assets) in the long-term funds could be materially depleted over time by, for example, a significant or sustained equity market downturn, costs of significant fundamental strategic change or a material increase in the pension mis-selling provision. In the unlikely circumstance that the depletion of the excess assets within the long-term fund was such that the Group's ability to satisfy policyholders' reasonable expectations was adversely affected, it might become necessary to restrict the annual distribution to shareholders or to contribute shareholders' funds to the long-term funds to provide financial support.

In 1997, the business of SALAS, a mutual society, was transferred to Prudential Assurance. In effecting the transfer, a separate sub-fund, SAIF, was established within Prudential Assurance's long-term business fund. This sub-fund contains all the with-profits business and all other pension business that was transferred. No new business has been or will be written in the sub-fund and the sub-fund is managed to ensure that all the invested assets are distributed to SAIF policyholders over the lifetime of SAIF policies. With the exception of certain amounts in respect of the unitised with-profits life business, all future earnings arising in SAIF are retained for SAIF policyholders. Any excess (deficiency) of revenue over expense within SAIF during a period is offset by a transfer to (from) the SAIF unallocated surplus. Shareholders have no interest in the profits of SAIF but are entitled to the investment management fees paid on this business. With the exception of certain guaranteed annuity products mentioned earlier in this note, and certain products which include a minimum guaranteed rate of accumulation, the majority of SAIF with-profits policies do not guarantee minimum rates of return to policyholders.

Should the assets of SAIF be inadequate to meet the guaranteed benefit obligations to the policyholders of SAIF, the Prudential Assurance long-term fund would be liable to cover any such deficiency. Due to the quality and diversity of the assets in SAIF and the ability of SAIF to revise guaranteed benefits in the event of an asset shortfall, the directors believe that the probability of either the Prudential Assurance long-term fund or the Group's shareholders' funds having to contribute to SAIF is remote.

Guarantees and commitments

Guarantee funds in both the UK and the US provide for payments to be made to policyholders on behalf of insolvent life insurance companies. These guarantee funds are financed by payments assessed on solvent insurance companies based on location, volume, and types of business. The Group estimated its reserve for future guarantee fund assessments for JNL to be £11 million at 31 December 2005 (2004: £10 million). Similar assessments for the UK businesses were not significant. The directors believe that the reserve is adequate for all anticipated payments for known insolvencies.

JNL has commitments for future payments related to equity index call options totalling £3 million at 31 December 2005 (2004: £8 million). The commitments were entered into in the normal course of business to hedge obligations associated with the issuance of equity index-linked immediate and deferred annuities and fall due for payment over the next two years.

At 31 December 2005, JNL has unfunded commitments of £227 million (2004: £157 million) related to its investments in limited partnerships and of £104 million (2004: £101 million) related to commercial mortgage loans. These commitments were entered into in the normal course of business and the directors do not expect a material adverse impact on the operations to arise from them.

The Group has provided, from time to time, other guarantees and commitments to third parties entered into in the normal course of business but the directors do not consider that the amounts involved are significant.

H15: Other liabilities

	2005 £m	2004 £m
Creditors arising from direct insurance and reinsurance operations	**474**	401
Interest payable	**61**	67
Derivative liabilities	**851**	73
Other items	**383**	634
Total	**1,769**	1,175

I: Other notes

I1: Staff and pension plans

Staff and employment costs

The average number of staff employed by the Group during the year were:

	2005	2004
Business operations:		
UK operations	**10,708**	10,849
US operations	**2,588**	2,589
Asian operations	**9,652**	8,277
Venture investment subsidiaries of the PAC with-profits fund	**8,713**	18,735
Total	**31,661**	40,450

The costs of employment were:

	2005 £m	2004 £m
Business operations:		
Wages and salaries	**799**	762
Social security costs	**64**	62
Other pension costs (see below)	**77**	63
Pension actuarial (gains) losses (credited) charged to income statement (as shown on page 172)	**(155)**	46
	(78)	109
Venture investment subsidiaries of the PAC with-profits fund (see below)	**206**	253
Total	**991**	1,186

Other pension costs comprises £54 million (2004: £45 million) relating to defined benefit schemes and £23 million (2004: £18 million) relating to defined contribution schemes. Of the defined contribution scheme costs £13 million (2004: £12 million) related to overseas defined contribution schemes.

Of the £206 million (2004: £253 million) costs of employment for venture investment subsidiaries, £169 million (2004: £219 million) relates to wages and salaries, £31 million (2004: £25 million) relates to social security costs and £6 million (2004: £9 million) relates to pension costs.

Pension plans

Defined benefit plans

Background and corporate governance

The Group business operations operate a number of pension schemes. The specific features of these plans vary in accordance with the regulations of the country in which the employees are located, although they are, in general, funded wholly by the Group and based either on a cash balance formula or on years of service and salary earned in the last year or years of employment. The largest defined benefit scheme is the principal UK scheme, namely the Prudential Staff Pension Scheme (PSPS). 90 per cent (2004: 90 per cent) of the liabilities of the Group defined benefit schemes are accounted for within PSPS.

Defined benefit schemes in the UK are generally required to be subject to a 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 on 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 has been required until now.

The PSPS valuation as at 5 April 2005 is currently being finalised and it is expected to show a small deficit, by comparison with scheme liabilities on the actuarial basis. Following discussions with the Trustee, the Company expects that for 2006 and future years the employers' contributions for ongoing service of current employees will approximately double to some £35 million to £40 million per annum based on current levels of active members of the scheme. In addition, deficit funding amounts designed to eliminate the actuarial deficit over a 10-year period will be made of some £35 million per annum. These amounts compare to current total contributions in 2005 of £19 million.

The discussions with the Scheme Trustee have also led to an altered expectation as to future discretionary increases. Previously, it had been the custom to award discretionary increases by reference to inflation levels. It is now intended that discretionary increase will in most circumstances not exceed 2.5 per cent.

Finally, a revised allocation of the deficit between the PAC with-profits fund and shareholder-backed operations has been applied in 2005. Previously the deficit of the PSPS had been attributed between the PAC with-profits fund and shareholders in the ratio of 80/20. Following extensive analysis of the source of contributions paid into the scheme over the last 10 years the allocation has been revised to 70/30, thus increasing the shareholders' proportion. The effects of these changes and other movements on the financial positions of the Group's defined benefits schemes are explained below.

I1: Staff and pension plans continued

The Group also operates two smaller defined benefit schemes for UK employees in respect of Scottish Amicable and M&G activities. For all three schemes the projected unit method was used for the most recent full actuarial valuations. There is also a small defined benefit scheme in Taiwan.

The rules of the Group's largest pension arrangement, the defined benefit section of PSPS, a final salary scheme, specify that, in exercising its investment powers, the Trustee's objective is to achieve the best overall investment return consistent with the security of the assets of the scheme. In doing this, regard is had to the nature and duration of the scheme's liabilities. The Trustee sets the benchmark for the asset mix, following analysis of the liabilities by the Scheme's Actuary and, having taken advice from the Investment Managers, then selects benchmark indices for each asset type in order to measure investment performance against a benchmark return.

The Trustee reviews strategy, the asset mix benchmark and the Investment Managers' objectives every three years, to coincide with the Actuarial Valuation, or earlier if the Scheme Actuary recommends. Interim reviews are conducted annually based on changing economic circumstances and financial market levels.

The Trustee sets the general investment policy and specifies any restrictions on types of investment and the degrees of divergence permitted from the benchmark, but delegates the responsibility for selection and realisation of specific investments to the Investment Managers. In carrying out this responsibility, the Investment Managers are required by the Pensions Act 1995 to have regard to the need for diversification and suitability of investments. Subject to a number of restrictions contained within the relevant investment management agreements, the Investment Managers are authorised to invest in any class of investment asset. However, the Investment Managers will not invest in any new class of investment asset without prior consultation with the Trustee.

The Trustee consults the Principal Employer, the Prudential Assurance Company, on these investment principles, but the ultimate responsibility for the investment of the assets of the scheme lies with the Trustee.

The investment policies and strategies for the other two UK defined benefit schemes, the M&G Group Pension Scheme and the Scottish Amicable Staff Pension Scheme, which are both final salary schemes, follow similar principles, but have different target allocations, reflecting the particular requirements of the schemes.

Assumptions

The calculations are based on current actuarially calculated mortality estimates with a specific allowance made for future improvements in mortality, which is broadly in line with that adopted for the 92 series of mortality tables prepared by the Continuous Mortality Investigation Bureau of the Institute and Faculty of Actuaries.

The actuarial assumptions used in determining benefit obligations and the net periodic benefit costs for the years ended 31 December were as follows:

	2005 %	2004 %
Discount rate	**4.8**	5.3
Rate of increase in salaries	**4.8**	4.8
Rate of increase of pensions in payment for inflation:		
Guaranteed (maximum 5%)	**2.8**	2.8
Guaranteed (maximum 2.5%)*	**2.5**	2.8
Discretionary*	**2.5**	2.8
Expected returns on plan assets	**6.1**	6.8

*The rates of 2.5 per cent shown are those for PSPS. Assumed rates of increase of pensions in payment for inflation for all other schemes remains at 2.8 per cent in 2005.

The change of assumption for discretionary increases follows discussion with the PSPS trustee. For the purpose of future discretionary awards, it is assumed that a cap of a 2.5 per cent rate of increase will apply rather than, as previously applied, the assumed long-term inflation rate.

Using external actuarial advice provided by Watson Wyatt Partners for the valuation of PSPS and by Aon Limited for the M&G scheme, and internal advice for the Scottish Amicable scheme, the most recent full valuations have been updated to 31 December 2005, applying the principles prescribed by IAS 19.

I1: Staff and pension plans continued

Summary financial position

The Group liability in respect of defined benefit pension schemes is as follows:

	2005 £m	2004 £m
Economic position:		
Deficits, gross of deferred tax, based on scheme assets held, including investments in Prudential insurance policies:		
Attributable to the PAC with-profits fund (ie absorbed by the liability for unallocated surplus)	**(329)**	(525)
Attributable to shareholder-financed operations (ie to shareholders' equity)	**(214)**	(175)
Economic deficit	**(543)**	(700)
Add back: investments in Prudential insurance policies (eliminated on consolidation against insurance liabilities)	**(253)**	(125)
Provision included in balance sheet under IAS 19	**(796)**	(825)

The following disclosures explain the economic position and IAS 19 basis of accounting after eliminating investment in Prudential insurance policies on consolidation.

Group economic financial position

In assessing the underlying economic position of the Group in respect of the defined benefit pension schemes, two factors need to be taken into account. These are:

(i) The deficits on the PSPS and Scottish Amicable schemes are partially attributable to the PAC with-profits fund; and

(ii) The IAS 19 basis assets of the PSPS and M&G schemes, as consolidated into the Group balance sheet, exclude investments in Prudential insurance policies.

The M&G pension scheme has invested £147 million at 31 December 2005 (2004: £125 million) in Prudential insurance policies. Additionally, the PSPS scheme has invested £106 million at 31 December 2005 (2004: £nil) in Prudential insurance policies. As required by IFRS, this amount of pension asset is eliminated against the policyholder liability and hence, for the purposes of preparing the consolidated balance sheet, the net pension liability is £253 million (2004: £125 million) greater than the 'economic basis' deficit of £543 million (2004: £700 million).

On the 'economic basis', after including investments in Prudential insurance policies as scheme assets, the assets of the schemes at 31 December were:

	2005 £m	2004 £m
Equities	**2,543**	2,566
Bonds	**1,663**	1,055
Properties	**590**	533
Other	**79**	63
Total value of assets	**4,875**	4,217

The present value of the liabilities of the four schemes at 31 December 2005 was £5,418 million (2004: £4,917 million). The resulting scheme deficits arising from the excess of liabilities over assets at 31 December 2005 comprised £329 million (2004: £525 million) attributable to the PAC with-profits fund and £214 million (2004: £175 million) attributable to shareholder operations.

The movements in the deficit on the 'economic basis' between scheme assets and liabilities were:

	2005 £m	2004 £m
Current service cost	**(65)**	(69)
Contributions	**29**	30
Other finance income	**22**	32
Actuarial gains (losses)	**171**	(43)
Net decrease (increase)	**157**	(50)

I1: Staff and pension plans continued

Estimated pension scheme liability attributable to shareholder operations

Movements on the pension scheme deficits (determined on the 'economic basis'), to the extent attributable to shareholder operations are as follows:

2005	At beginning of year £m	Charge to operating results (based on longer-term investment returns) (note i) £m	Actuarial and other gains and losses: Actuarial gains (losses) attributable to shareholders (note ii) £m	Actuarial and other gains and losses: Charge for revised estimate of PSPS deficit allocation (note ii) £m	Contributions paid by shareholder operations £m	At end of year £m
Gross of tax deficit	**(175)**	**(21)**	**32**	**(63)**	**13**	**(214)**
Related deferred tax	**49**	**6**	**(9)**	**19**	**(4)**	**61**
Net of tax deficit	**(126)**	**(15)**	**23**	**(44)**	**9**	**(153)**
2004						
Gross of tax deficit	(163)	(16)	(7)	–	11	(175)
Related deferred tax	45	4	3	–	(3)	49
Net of tax deficit	(118)	(12)	(4)	–	8	(126

Notes

(i) Charge to operating results (based on longer-term investment returns)
This comprises:

	2005 £m	2004 £m
Current service cost	**(65)**	(69)
Finance income (expense):		
Interest on pension scheme liabilities	**(257)**	(245)
Expected return on pension scheme assets	**279**	277
	22	32
Total charge net of finance income	**(43)**	(37)
Less: amount attributable to PAC with-profits fund	**22**	21
Charge to operating results, based on longer-term investment returns, attributable to shareholders	**(21)**	(16)

(ii) Actuarial and other gains and losses
This comprises:

	2005 £m	2004 £m
Actual less expected return on pension scheme assets	**544**	115
Experience gains (losses) on scheme liabilities	**1**	(17)
Changes in assumptions underlying the present value of scheme liabilities	**(374)**	(141)
Total actuarial and other gains (losses)	**171**	(43)
Less: amount attributable to PAC with-profits fund	**(139)**	36
Actuarial gains (losses) attributable to shareholders	**32**	(7)
Add: additional loss on change of estimate of allocation of opening deficit between shareholder operations and the PAC with-profits fund	**(63)**	–
Charge for actuarial and other gains and losses attributable to shareholders, excluded from operating results based on longer-term investment returns, but included in profit before tax attributable to shareholders	**(31)**	(7)

Since shareholder profits in respect of the PAC with-profits funds are a function of the actuarially determined surplus for distribution, the overall income statement result is not directly affected by the level of pension cost or other expenses attributable to the fund.

Amounts attributed to the PAC with-profits funds for 2005 reflect the current estimate of 70 per cent for the PSPS scheme and 50 per cent for the Scottish Amicable scheme. For 2004, the amounts attributed reflect the then current estimates of 80 per cent and 50 per cent, respectively. The additional pre-tax loss to shareholder operations of £63 million reflects the changed estimate of the life fund share for the PSPS scheme.

Included within the charge for 2005 of £374 million for changes in assumptions is a credit for past service costs of £115 million for a reduction in the assumed level of discretionary increase for future pensions in payment for PSPS.

I1: Staff and pension plans continued

Estimated pension scheme deficits attributable to PAC with-profits fund

Movements on the pension scheme deficits (determined on the 'economic basis' under which PSPS scheme assets include investments in Prudential insurance policies) are as follows:

			Actuarial and other gains and losses			
2005	At beginning of year £m	Service cost less net finance income (note i above) £m	Actuarial gains (losses) (note ii above) £m	Credit for revised estimate of PSPS deficit allocation (note ii above) £m	Contributions paid by PAC with-profits fund £m	At end of year £m
Gross of tax deficit	**(525)**	**(22)**	**139**	**63**	**16**	**(329)**
Related deferred tax	**53**	**2**	**(14)**	**(6)**	**(2)**	**33**
Net of tax deficit	**(472)**	**(20)**	**125**	**57**	**14**	**(296)**
2004						
Gross of tax deficit	(487)	(21)	(36)	–	19	(525)
Related deferred tax	49	2	4	–	(2)	53
Net of tax deficit	(438)	(19)	(32)	–	17	(472)

The charges and credits for service cost, net finance income, and actuarial and other gains and losses are included within the income statement but taken account of in determining the charge in the income statement for the transfer to the liability for unallocated surplus of with-profits funds.

Reconciliation to IAS 19 basis financial position

The change in the present value of the benefit obligation and the change in fair value of the assets for the total of the PSPS, Scottish Amicable, M&G and Taiwan schemes over the period were as follows:

2005	IAS 19 basis: change in fair value of plan assets £m	Investments in Prudential insurance policies £m	Economic basis: total assets £m	IAS 19 basis: change in present value of benefit obligation £m	Economic basis: net obligation £m
Fair value of plan assets, beginning of year	**4,092**	**125**	**4,217**		**4,217**
Present value of benefit obligation, beginning of year				**(4,917)**	**(4,917)**
	4,092	**125**	**4,217**	**(4,917)**	**(700)**
Less: PSPS scheme plan assets used to acquire Prudential insurance policy	**(99)**	**99**	**0**		**0**
Service cost – current charge only				**(65)**	**(65)**
Interest cost				**(257)**	**(257)**
Expected return on plan assets	**268**	**11**	**279**		**279**
Employee contributions	**0**	**1**	**1**	**(1)**	**0**
Employer contributions	**25**	**4**	**29**		**29**
Actuarial and other gains*	**528**	**16**	**544**	**(373)**	**171**
Benefit payments	**(192)**	**(3)**	**(195)**	**195**	**0**
Fair value of plan assets, end of year	**4,622**	**253**	**4,875**		
Present value of benefit obligation, end of year				**(5,418)**	
Economic basis deficit					**(543)**

*Including £115 million credit for past service costs as described above.

I1: Staff and pension plans continued

2004	IAS 19 basis: change in fair value of plan assets £m	Investments in Prudential insurance policies £m	Economic basis: total assets £m	IAS 19 basis: change in present value of benefit obligation £m	Economic basis: net obligation £m
Fair value of plan assets, beginning of year	3,986		3,986		3,986
Present value of benefit obligation, beginning of year				(4,636)	(4,636)
	3,986	0	3,986	(4,636)	(650)
Less: M&G scheme plan assets used to acquire Prudential insurance policy*	(112)	112	0		0
Service cost				(69)	(69)
Interest cost				(245)	(245)
Expected return on plan assets	269	8	277		277
Employee contributions	0	1	1	(1)	0
Employer contributions	26	4	30		30
Actuarial gains (losses)	112	3	115	(158)	(43)
Benefit payments	(189)	(3)	(192)	192	0
Fair value of plan assets, end of year	4,092	125	4,217		
Present value of benefit obligation, end of year				(4,917)	
Economic basis deficit					(700)

* The M&G pension scheme assets are wholly invested in Prudential insurance policies. For IFRS accounting purposes, the M&G scheme is in effect unfunded.

Group IAS 19 basis financial position

The IAS 19 basis net pensions deficit can be summarised as follows:

	2005 £m	2004 £m
Fair value of plan assets, end of year	**4,622**	4,092
Present value of funded benefit obligation	**(5,228)**	(4,777)
Funded status	**(606)**	(685)
Present value of unfunded obligations (M&G scheme)*	**(190)**	(140)
Provision recognised in the balance sheet	**(796)**	(825)

* The M&G pension scheme assets are invested in Prudential insurance policies. For IFRS accounting purposes, the M&G scheme is in effect unfunded. Please see above for more details.

	2005 £m	2004 £m
Components of net periodic pension cost		
Current service cost	**(65)**	(69)
Interest cost	**(257)**	(245)
Expected return on assets – economic basis	**279**	277
Less: expected return on investments of scheme assets in Prudential insurance policies	**(11)**	(8)
Expected return on assets – IAS 19 basis	**268**	269
Actuarial gains (losses) – economic basis	**171**	(43)
Less: actuarial gains on investments of scheme assets in Prudential insurance policies	**(16)**	(3)
Actuarial gains (losses) – IAS 19 basis	**155**	(46)
Net periodic pension credit (cost) (included within acquisition and other operating expenditure in the income statement)	**101**	(91)

I1: Staff and pension plans continued

The long-term expected rate of return has been taken to be the weighted average (by market value) of the long-term expected rates of return on each major asset class shown below:

	2005 £m	2005 %	2004 £m	2004 %
Plan assets (IAS 19 basis)				
Equity	**2,376**	**51**	2,516	61
Bonds	**1,593**	**35**	993	24
Real estate	**575**	**12**	520	13
Cash	**78**	**2**	63	2
Total	**4,622**	**100**	4,092	100

	2005 %	2004 %
Long-term expected rate of return		
Equity	**7.1**	7.5
Bonds	**4.5**	5.0
Real estate	**6.4**	6.8
Cash	**4.5**	4.75
Weighted average long-term expected rate of return	**6.1**	6.75

The actual return on plan assets was £796 million (2004: £381 million) on an IAS 19 basis.

None of the scheme assets included shares in Prudential plc or property occupied by the Prudential Group.

	2005 £m	2004 £m
Fair value of plan assets, end of year (IAS 19 basis)	**4,622**	4,092
Present value of the benefit obligation, end of year	**(5,418)**	(4,917)
Plan assets in deficit of benefit obligation	**(796)**	(825)
Experience adjustments on plan liabilities	**1**	(17)
Percentage of plan liabilities at 31 December	**(0.02)%**	0.35%
Experience adjustments on plan assets (IAS 19 basis)	**528**	112
Percentage of plan assets at 31 December	**11.42%**	2.74%

Total employer contributions expected to be paid into the Group defined benefit schemes for the year ending 31 December 2006 amounts to £85 million (2004: £31 million).

Other pension plans

The Group operates various defined contribution pension schemes including schemes in JNL, Egg and Asia. As noted earlier, the cost of the Group's contributions to these schemes in 2005 was £23 million (2004: £18 million).

I2: Share-based payments

(a) Relating to Prudential plc shares

The Group maintains eight main share award and share option plans relating to Prudential plc shares, which are described below.

The Restricted Share Plan (RSP) is the Group's long-term incentive plan for executive directors and other senior executives designed to provide rewards linked to the returns to shareholders. Each year participants are granted a conditional option to receive a number of shares. There is a deferment period, currently three years, at the end of which the award vests to an extent that depends on the performance of the Group's shares including notional reinvested dividends and on the Group's underlying financial performance. After vesting, the award may then be exercised at zero cost at any time, subject to closed period rules, in the balance of a 10-year period. Shares are purchased in the open market by a trust for the benefit of qualifying employees. Currently, the trust holds at least the maximum number of shares conditionally awarded and not yet forfeited or exercised. The RSP replaced the Executive Share Option Scheme in 1995 and all options under this prior plan had been exercised at 31 December 2005.

I2: Share-based payments continued

No rights are granted if the Company's total shareholder return (TSR) performance as ranked against the comparator group is below 50th percentile. For performance at 50th percentile, an award of 25 per cent of the maximum award is made. The maximum grant is made only if the TSR ranking of the Company is 20th percentile or above. Between these points, the size of the grant made is calculated on a straight-line sliding scale. This performance measure was chosen when the RSP was introduced as it reflected a combination of market practice, an assessment of Prudential's main competitors and the focus of UK investors at that time. In normal circumstances, directors may take up their right to receive shares at any time during the following seven years.

The Savings-Related Share Option Scheme is designed to foster share ownership among UK and certain non-UK employees. Permanent employees are eligible for this plan if they have been employed by the Group for the previous six months. At the outset, participants choose an option period (three, five or seven years, or a combination of these periods) and the amount of monthly contributions to be made from their earnings during the option period, which determines the number of options granted. The option price is fixed at the start and is based on a discount of 20 per cent to the market price. Participants may exercise their options within six months of the end of the option period. If options are not exercised, participants are entitled to receive a refund of their cash contributions plus interest.

The Prudential International Savings-Related Share Option Scheme operates on a similar basis to the UK Savings-Related Share Option Scheme, for employees in Hong Kong, Malaysia, Singapore, Taiwan, India and Korea.

The International Savings-Related Share Option Scheme for Non-Employees also operates on a similar basis to the UK Savings-Related Share Option Scheme, for agents in Hong Kong.

No options may be granted under the three savings-related schemes described above if such grant would cause the number of shares which have been issued, or which remain issuable pursuant to options granted in the preceding 10 years under the scheme and other share option schemes operated by the Company, or which have been issued under any other share incentive scheme of the Company, to exceed 10 per cent of the Company's issued ordinary share capital at the proposed date of grant.

The Prudential UK Share Incentive Plan (SIP) is also designed to foster share ownership amongst staff in designated UK businesses. It enables employees to buy shares on a tax efficient basis. For every four partnership shares bought, an additional matching share is granted, purchased in the open market. Participants have voting rights and are entitled to dividend payments which are reinvested in the SIP. Partnership shares may be withdrawn from the scheme at any time while matching shares may only be withdrawn five years after their award date.

JNL operates a performance-related share award which, subject to the prior approval of the Jackson National Life Remuneration Committee, may grant share awards to eligible employees in the form of a contingent right to receive shares or a conditional allocation of shares. These share awards have vesting periods of four years and are at nil cost to the employee. The employee does not have any beneficial ownership of the shares and, accordingly, does not have any right to dividends or voting rights attaching to the shares. Only issued shares purchased from the open market are used for the performance share award and there is no limit on the value of shares which may be granted to a participant in any year or over the life of the plan, which is usually no longer than 10 years.

The Annual Incentive Plan is designed so that a portion of any overall award may be made in the form of a deferred share award. A deferred share award is awarded to board members in respect of any overall annual incentive award above 50 per cent of salary, and will represent the element of the bonus above 50 per cent of salary. The award is restricted for three years before it can be released, subject to close periods, to the participant who must not be under a period of notice at the time and must still be in employment of Prudential. The shares are held in the employee share trust and, shares equivalent to dividends otherwise payable will accumulate up to the release date.

The Share Participation Plan was designed to encourage share ownership amongst senior executives and to provide rewards based upon various performance factors of the Group. Each year, participants were offered the choice of a cash award, a matching share award if cash or shares to the value of the cash award were lodged, or a combination of 50 per cent of each. Share awards vested after five years for executive directors of Prudential plc and three years (formerly five years) for all other eligible employees and were transferred to the participants at no additional cost. Ordinary shares for share awards were purchased in the open market by a trust, which held them during the vesting period for the benefit of qualifying employees. At 31 December 2005, all outstanding shares in this plan have been paid for by employees and are registered in the names of the participants. No new shares have been granted in this scheme since 1999.

In addition, there are other share awards which include the 1,000 Day Long Term Incentive Plan (LTIP) and other arrangements.

The 1,000 Day LTIP plan is a UK insurance operations performance-based plan in which the UK Remuneration Committee may, at any time up to 5 October 2005, select employees at its absolute discretion, for participation in the plan. The performance period was 1,000 days and, based on the final performance level being at, or above, the threshold level, the committee shall grant participants 10 per cent of the allocated award in 2005, 20 per cent in 2006 and the remaining 70 per cent in 2007. There are no beneficial interests, or any rights to dividends until such time as the awards are released, at nil cost, to participants.

The other arrangements relate to various awards that have been made without performance conditions to individual employees, typically in order to secure their appointment or ensure retention.

I2: Share-based payments continued

Movements in share options outstanding under the Group's share-based compensation plans relating to Prudential plc shares during 2005 and 2004 were as follows:

Options outstanding (including conditional options)	2005 Number of options (millions)	2005 Weighted average exercise price £	2004 Number of options (millions)	2004 Weighted average exercise price £
Beginning of year:	**18.4**	**2.21**	18.4	2.76
Granted	**3.7**	**1.83**	4.1	1.37
Exercised	**(1.1)**	**2.78**	(0.9)	3.19
Forfeited	**(1.9)**	**0.81**	(1.9)	3.52
Expired	**(1.9)**	**2.21**	(2.6)	3.37
Adjustment in respect of Rights Issue	**–**	**–**	1.3	2.93
End of year	**17.2**	**2.23**	18.4	2.21
Options immediately exercisable, end of year	**0.4**	**3.30**	0.5	3.19

The weighted average share price of Prudential plc for the year ended 31 December 2005 was £5.01 compared to £4.51 for the year ended 31 December 2004.

Movements in share awards outstanding under the Group's share-based compensation plans relating to Prudential plc shares at 31 December 2005 and 2004 were as follows:

Awards outstanding	2005 Number of awards (millions)	2004 Number of awards (millions)
Beginning of year:	**2.4**	1.4
Granted	**2.8**	1.2
Exercised	**(0.1)**	(0.1)
Forfeited	**(0.1)**	(0.2)
Expired	**(0.1)**	–
Adjustment in respect of Rights Issue	**–**	0.1
End of year	**4.9**	2.4

The following table provides a summary of the range of exercise prices for Prudential plc options (including conditional options) outstanding at 31 December 2005.

Range of exercise prices	Outstanding: Number outstanding (millions)	Outstanding: Weighted average remaining contractual life (years)	Outstanding: Weighted average exercise prices £	Exercisable: Number exercisable (millions)	Exercisable: Weighted average exercise prices £
Between £0 and £1	4.7	8.3	–	–	–
Between £1 and £2	–	–	–	–	–
Between £2 and £3	8.0	1.3	2.66	–	–
Between £3 and £4	3.5	2.1	3.53	0.4	3.29
Between £4 and £5	0.8	3.0	4.07	–	–
Between £5 and £6	0.2	0.7	5.63	0.0	5.39
Between £6 and £7	0.0	0.4	6.56	0.0	6.66
Between £7 and £8	0.0	1.1	7.15	0.0	7.15
	17.2	3.5	2.23	0.4	3.30

I2: Share-based payments continued

The following table provides a summary of the range of exercise prices for Prudential plc options (including conditional options) outstanding at 31 December 2004.

Range of exercise prices	Outstanding: Number outstanding (millions)	Outstanding: Weighted average remaining contractual life (years)	Outstanding: Weighted average exercise prices £	Exercisable: Number exercisable (millions)	Exercisable: Weighted average exercise prices £
Between £0 and £1	5.1	8.4	0.00	0.2	0.00
Between £1 and £2	–	–	–	–	–
Between £2 and £3	8.5	2.3	2.66	0.0	3.00
Between £3 and £4	3.9	2.4	3.41	–	–
Between £4 and £5	0.2	0.0	4.19	0.2	4.19
Between £5 and £6	0.5	1.3	5.51	0.0	5.87
Between £6 and £7	0.1	0.6	6.66	0.1	6.58
Between £7 and £8	0.1	0.9	7.23	0.0	7.68
Between £8 and £9	–	–	–	–	–
Between £9 and £10	0.0	3.7	9.46	0.0	9.46
	18.4	4.0	2.21	0.5	3.19

The weighted average fair values of Prudential plc options and awards granted during the period are as follows:

	2005 Weighted average fair value			2004 Weighted average fair value		
	RSP £	**Other options £**	**Awards £**	RSP £	Other options £	Awards £
	2.96	**1.82**	**4.59**	3.86	1.57	3.37

The fair value amounts relating to RSP options and other options above were determined using the Black-Scholes and the Monte Carlo option-pricing models using the following assumptions:

	2005		2004	
	RSP	**Other options**	RSP	Other options
Dividend yield (%)	**3.19**	**3.19**	3.82	3.82
Expected volatility (%)	**42.93**	**40.38**	47.23	43.74
Risk-free interest rate (%)	**4.65**	**4.41**	4.68	4.73
Expected option life (years)	**3.00**	**3.62**	3.00	3.78
Weighted average exercise price (£)	**–**	**3.97**	–	3.62
Weighted average share price (£)	**5.01**	**5.12**	4.53	4.48

Under IFRS, compensation costs for all share-based compensation plans are determined using the Black-Scholes model and the Monte Carlo model. Share options and awards are valued using the share price at the date of grant. The compensation costs for all awards and options are recognised in net income over the plans' respective vesting periods. The Group uses the Black-Scholes model to value all options other than the RSP. For the RSP (nil cost option), the Group uses a Monte Carlo model in order to allow for the impact of the TSR performance conditions. These models are used to calculate fair values for share options and awards at the grant date based on the quoted market price of the stock at the measurement date, the amount, if any, that the employees are required to pay, the dividend yield, expected volatility, risk-free interest rates and exercise prices.

The expected volatility is measured at the standard deviation of expected share price returns based on statistical analysis of daily share prices over a period up to the grant date equal to the expected life of options. Risk-free interest rates are UK gilt rates with projections for three, five and seven year terms to match corresponding vesting periods. Dividend yield is determined as the average yield over the year of grant and expected dividends are not incorporated into the measurement of fair value. Additionally, for the RSP, volatility and correlation of the comparator group with the Group are required. These assumptions are based on the TSR of the comparators over a period up to the grant date equal to the performance period. For grants in 2005, an average comparator volatility of 31 per cent and an average correllation of comparators of 33 per cent were used.

When options are granted or awards made to employees, an estimate is made of what percentage is more than likely to vest, be forfeited, lapse or cancelled based on historical information. Based on these estimates, compensation expense to be accrued at that date is calculated and amortised over the vesting period. For early exercises of options or release of awards due to redundancy, death or resignation, the compensation expense is immediately recognised and for forfeitures due to employees leaving the Group, any previously recognised expense is reversed. However, if an employee loses their award because of the Group's failure to meet the performance criteria, previously recognised expense is not reversed.

I2: Share-based payments continued

During the year, the Group granted share options to certain non-employee independent financial advisors. Those options were measured using the Black-Scholes option pricing model with assumptions consistent with those of other share options. These transactions were measured using an option model because the Group does not receive a separate and measurable benefit from those non-employees in exchange for the options granted. As such, the fair value of the options themselves is more readily determinable than the services received in return.

(b) Relating to Egg plc shares

In 2005 and 2004, the Group maintained three main share award and share option plans relating to Egg plc shares, which are described below. As a result of the offer by Prudential to acquire the minority shareholding in Egg (note I8), executive share options are exercisable for six months from 19 December 2005, although this period may be shortened should Prudential become entitled to make a compulsory acquisition of the remaining Egg shares. Also as a result of the offer, awards under the RSP were assessed against the performance conditions. None of the awards met the performance conditions and they have therefore lapsed in February 2006 following consideration of the performance measurement results by the Remuneration Committee.

Egg made awards of shares at no cost to eligible employees selected by the Remuneration Committee under the plan. All Egg's directors and employees, including employees of its subsidiaries, were eligible to participate, subject to the discretion of the Remuneration Committee. It was, however, intended that participation would, in practice, be restricted to selected individuals in key positions. Employees within two years of their anticipated retirement date were not eligible to participate, except in circumstances which the Remuneration Committee considered to be exceptional.

Egg established a discretionary employee benefit trust, the Egg Employee Trust, by a trust deed dated 26 April 2000 between Egg and Mourant & Co. Trustees Limited. At 31 December 2005, the trust held 3.4 million ordinary shares (2004: 3.4 million), with a market value of £4.2 million (2004: £3.4 million) which are intended to be used principally for delivery of shares under the employee incentive plans and a nominal value of £1.7 million (2004: £1.7 million). All of the remaining 3.4 million shares held by the trust were purchased on the open market at a cost of £4.5 million.

Egg made the vesting of awards subject to the satisfaction of performance conditions from January 2004 onwards. Previously the awards have been conditional on service completed. The arrangements for the distribution to employees of shares held in trust and for entitlement to dividend depend on the particulars of each award. Shares held in trust are conditionally gifted to employees. The costs of share awards are charged to the income statement evenly over the period of service for which awards are made for schemes granted after 7 November 2002.

Egg also operated a sharesave scheme, which was an Inland Revenue approved all-employee Save as You Earn scheme. Under this scheme, employees entered into either three or five year contracts, at the end of which time they will be entitled to exercise their options and purchase shares at an exercise price fixed at a 20 per cent discount to the share price at the date of grant. Employees have six months after the contract matures in which to exercise the options. These options will continue in force until their normal maturity dates.

Prior to the implementation of the RSP schemes, Egg granted options to employees under Inland Revenue approved and unapproved share option schemes.

Analysis of the movements in the number of shares and weighted average exercise price (with the exception of the Egg RSP where the exercise price is £nil) of options are set out below:

Egg RSP awards made prior to 7 November 2002.

	Number (millions)	
	2005	2004
Outstanding at beginning of year	**0.8**	3.9
Forfeited	**(0.7)**	(0.1)
Exercised	**(0.1)**	(3.0)
Outstanding and exercisable at the end of year	**0.0**	0.8

Egg RSP awards made after 7 November 2002.

	Number (millions)	
	2005	2004
Outstanding at beginning of year	**6.2**	3.7
Granted	**1.7**	3.1
Forfeited	**(1.5)**	–
Exercised	**(0.3)**	–
Expired	**–**	(0.6)
Outstanding and exercisable at the end of year	**6.1**	6.2

I2: Share-based payments continued

Egg sharesave scheme awards made prior to 7 November 2002.

	3 Year Employee Sharesave Scheme				5 Year Employee Sharesave Scheme			
	Number (millions)		Weighted average exercise price £		Number (millions)		Weighted average exercise price £	
	2005	2004	**2005**	2004	**2005**	2004	**2005**	2004
Outstanding at beginning of year	**0.7**	1.5	**1.16**	1.19	**0.4**	0.7	**1.20**	1.19
Forfeited	**(0.2)**	(0.7)	**1.20**	1.22	**(0.1)**	(0.3)	**1.19**	1.18
Exercised	**(0.0)**	(0.1)	**1.15**	1.21	**–**	(0.0)	**–**	1.23
Outstanding and exercisable at the end of year	**0.5**	0.7	**1.15**	1.16	**0.3**	0.4	**1.20**	1.20

Egg sharesave scheme awards made after 7 November 2002.

	3 Year Employee Sharesave Scheme				5 Year Employee Sharesave Scheme			
	Number (millions)		Weighted average exercise price £		Number (millions)		Weighted average exercise price £	
	2005	2004	**2005**	2004	**2005**	2004	**2005**	2004
Outstanding at beginning of year	**3.0**	0.8	**0.85**	1.17	**1.0**	0.2	**0.84**	1.17
Granted	**0.9**	2.6	**0.86**	0.80	**0.1**	0.9	**0.86**	0.80
Forfeited	**(0.7)**	(0.4)	**0.87**	1.10	**(0.2)**	(0.1)	**0.88**	1.11
Exercised	**(0.0)**	(0.0)	**0.80**	1.17	**–**	–	**–**	–
Outstanding and exercisable at the end of year	**3.2**	3.0	**0.86**	0.85	**0.9**	1.0	**0.83**	0.84

Egg share option scheme awards made prior to 7 November 2002.

	Number (millions)		Weighted average exercise price £	
	2005	2004	**2005**	2004
Outstanding at beginning of year	**11.5**	16.7	**1.42**	1.42
Forfeited	**(2.2)**	(1.4)	**1.43**	1.46
Exercised	**–**	(3.8)	**–**	1.40
Outstanding and exercisable at the end of year	**9.3**	11.5	**1.42**	1.42

The weighted average share price of Egg plc during the year ended 31 December 2005 was 106 pence compared to 134 pence for the year ended 31 December 2004.

I2: Share-based payments continued

The exercise prices and the weighted average remaining contractual life of the number of options outstanding at the year end are as follows:

	2005			2004		
	Exercise price £	**Number of options (millions)**	**Weighted average remaining contractual life (years)**	Exercise price £	Number of options (millions)	Weighted average remaining contractual life (years)
Restricted share plan						
Pre 2003 grant	**–**	**–**	**–**	–	0.8	0.3
2003 grant	**–**	**2.8**	**0.2**	–	3.1	1.2
2004 grant	**–**	**2.0**	**1.6**	–	3.1	2.5
2005 grant	**–**	**1.2**	**2.2**	–	–	–
3 Year Sharesave Scheme						
2001 grant	**1.30**	**–**	**–**	1.30	0.1	–
2002 grant	**1.15**	**0.4**	**–**	1.15	0.6	0.9
2003 grant	**1.17**	**0.3**	**0.9**	1.17	0.5	1.9
2004 grant	**0.80**	**1.9**	**1.9**	0.80	2.5	2.9
2005 grant	**0.86**	**0.9**	**2.9**	–	–	–
5 Year Sharesave Scheme						
2001 grant	**1.30**	**0.1**	**0.9**	1.30	0.1	1.9
2002 grant	**1.15**	**0.2**	**1.9**	1.15	0.2	2.9
2003 grant	**1.17**	**0.1**	**2.9**	1.17	0.1	3.9
2004 grant	**0.80**	**0.7**	**3.9**	0.80	0.9	4.9
2005 grant	**0.86**	**0.2**	**4.9**	–	–	–
Share option schemes						
Pre 2003 grant	**1.42**	**9.3**	**–**	1.42	11.5	0.4

The fair value of the Egg RSP scheme at the date of grant was calculated using a Present Economic Value (binomial) model. The fair values of the sharesave schemes at the date of grant were determined using a Black-Scholes model.

The significant assumptions and inputs used to estimate the fair value of the options granted in 2005 are as follows:

	2005			2004		
	RSP	**3 Year Sharesave**	**5 Year Sharesave**	RSP	3 Year Sharesave	5 Year Sharesave
Share price (£)	**1.09**	**1.03**	**1.03**	1.01	0.94	0.94
Exercise price (£)	**–**	**0.86**	**0.86**	–	0.80	0.80
Risk-free interest rate (%) (note i)	**–**	**4.14**	**4.15**	–	4.70	4.76
Expected life (years)	**3**	**3**	**5**	3	3	5
Expected volatility (%) (note ii)	**40**	**40**	**40**	40	40	40
Dividend yield (%)	**–**	**–**	**–**	–	–	–
Share price volatility of comparator group (%) (note iii)	**20**	**–**	**–**	20	–	–
Fair value of option (£)	**1.91**	**0.41**	**0.50**	1.90	0.37	0.45

Notes

(i) The risk-free interest rate reflects yields available on government bonds of similar terms at the date of grant.

(ii) The expected volatility input is estimated based on Egg's own historical volatility and the historical volatility of businesses in the banking sector.

(iii) Analysis of the share price volatility of the FTSE 100 has been used as a reasonable proxy for the share price volatility of the comparator group of the RSP, this comparator group being the constituents of the FTSE 350 index.

(c) Total share-based payment expense

Total expense recognised in the year in the consolidated financial statements related to share-based compensation is as follows:

	2005 £m	2004 £m
Share-based compensation expense	**19**	13
Amount accounted for as equity-settled	**15**	10
Carrying value at 31 December of liabilities arising from share-based payment transactions	**10**	3
Intrinsic value of above liabilities for which rights had vested at 31 December	**1**	–

I3: Key management remuneration

Key management constitutes the directors of Prudential plc as they have authority and responsibility for planning, directing and controlling the activities of the Group.

Total key management remuneration amounts to £13,688,000 (2004: £11,274,000). This comprises salaries and short-term benefits of £8,087,000 (2004: £7,639,000), post-employment benefits of £1,032,000 (2004: £1,058,000), termination benefits of £1,600,000 (2004: £nil) and share-based payments of £2,969,000 (2004: £2,577,000).

Post-employment benefits comprise the change in the transfer value of the accrued benefit relating to directors' defined benefit pension schemes in the year and the total contributions made to directors' other pension arrangements.

The share-based payments charge is the sum of £1,842,000 (2004: £1,815,000), which is determined in accordance with IFRS 2, 'Share-Based Payments' (see note I2) and £1,127,000 (2004: £762,000) of deferred share awards.

Total key management remuneration includes total directors' emoluments of £9,214,000 as shown in the remuneration report on pages 46 to 57, and additional amounts in respect of pensions, share-based payments and termination benefits. Further information on directors' remuneration is given in the remuneration report.

I4: Fees payable to auditors

	2005 £m	2004 £m
Audit services:		
Statutory audit fees	**4.2**	4.0
Interim financial statements	**0.7**	0.4
US GAAP reporting	**0.8**	0.8
Regulatory reporting	**0.7**	0.5
EEV and achieved profits basis audit	**0.4**	0.1
Total audit services	**6.8**	5.8
Further assurance services associated with:		
Implementation of Sarbanes-Oxley requirements	**2.2**	1.8
Implementation of accounting and regulatory requirements	**1.4**	0.4
Prospectuses for equity and debt issues	**0.6**	0.5
Comfort and attestation letters	**0.6**	0.2
Tax compliance	**0.5**	0.2
	5.3	3.1
Other services:		
Acquisitions and disposals due diligence	**0.0**	0.5
Other services	**0.3**	0.5
Total	**12.4**	9.9

Fees, excluding statutory audit fees, payable to KPMG Audit Plc and its associates include £6.7 million (2004: £4.6 million) for work performed in the UK. Audit fees include fees paid to KPMG where they are the auditors of PPM Capital consolidated entities.

The Audit Committee regularly monitors the non-audit services provided to the Group by its auditors and has developed a formal Auditor Independence Policy which sets out the types of services that the auditors may provide, consistent with the guidance in Sir Robert Smith's report 'Audit Committees – Combined Code Guidance' and with the provisions of the US Sarbanes-Oxley Act. The Audit Committee annually reviews the auditors' objectivity and independence. More information on these issues is given in the corporate governance report on page 40.

I5: Related party transactions

Transactions between the Company and its subsidiaries are eliminated on consolidation.

In addition, the Company has transactions and outstanding balances with certain unit trusts, OEICs, collateralised debt obligations and similar entities, which are not consolidated and where a Group company acts as manager. These entities are regarded as related parties for the purposes of IAS 24. The balances are included in the Group's balance sheet at fair value or amortised cost in accordance with their IAS 39 classifications. The transactions are included in the income statement and include amounts paid on issue of shares or units, amounts received on cancellation of shares or units and paid in respect of the periodic charge and administration fee. Further details of the aggregate assets, liabilities, revenues, profits or losses and reporting dates of entities considered to be associates under IFRS are disclosed in note H8.

Various executive officers and directors of Prudential may from time to time purchase insurance, investment management or annuity products, or be granted mortgages or credit card facilities marketed by Prudential group companies in the ordinary course of business on substantially the same terms, including interest rates and security requirements, as those prevailing at the time for comparable transactions with other persons.

Apart from the transactions with directors referred to below, no director had an interest in shares, transactions or arrangements that requires disclosure, other than those given in the remuneration report. Key management remuneration is disclosed in note I3.

In 2005 (2004), three (four) directors had mortgages and other borrowings with Egg plc of £125,000 (2004: £171,000). One director had a life policy with a sum assured of £4.0 million (2004: £3.5 million). In 2005 and 2004, other transactions with directors were de-minimis both by virtue of their size and in the context of the directors' financial positions. As indicated above, all of the above noted transactions are on terms equivalent to those that prevail in arm's length transactions.

I6: Subsidiary undertakings

(i) Principal subsidiaries

The principal subsidiary undertakings of the Company at 31 December 2005, all wholly owned except Egg Banking plc and PCA Life Assurance Company Limited were:

	Main Activity	Country of Incorporation
The Prudential Assurance Company Limited	Insurance	England and Wales
Prudential Annuities Limited*	Insurance	England and Wales
Prudential Retirement Income Limited (PRIL)*	Insurance	Scotland
M&G Investment Management Limited*	Investment management	England and Wales
Egg Banking plc*	Banking	England and Wales
Jackson National Life Insurance Company*	Insurance	US
Prudential Assurance Company Singapore (Pte) Limited*	Insurance	Singapore
PCA Life Assurance Company Limited*	Insurance	Taiwan

*Owned by a subsidiary undertaking of the Company.

Each subsidiary has one class of ordinary shares and operates mainly in its country of incorporation, except for PRIL which operates mainly in England and Wales. In February 2005, the proportion of ordinary shares of PCA Life Assurance Company Limited owned by the Company was increased from 97 per cent to 99 per cent.

Egg Banking plc is a subsidiary of Egg plc. At 31 December 2005, the ordinary shares of Egg plc were listed and there was only one class of shares which were 78 per cent owned by the Company, 1 per cent owned by other companies within the Prudential Group and 21 per cent owned by shareholders external to the Prudential Group. In December 2005, the Company announced its intention to acquire the whole of the issued and to be issued shares of Egg not already owned by the Prudential Group as set out in note I8.

(ii) Dividend restrictions and minimum capital requirements

Certain Group subsidiaries are subject to restrictions on the amount of funds they may transfer in the form of cash dividends or otherwise to the parent company. UK insurance companies are required to maintain solvency margins which must be supported by capital reserves and other resources, including unrealised gains on investments. JNL can pay dividends on its capital stock only out of earned surplus unless prior regulatory approval is obtained. Furthermore, without the prior regulatory approval, dividends cannot be distributed if all dividends made within the preceding 12 months exceed the greater of JNL's statutory net gain from operations or 10 per cent of JNL statutory surplus for the prior year. As JNL paid dividends in 2005, in order to fund the purchase of the Life Insurance Company of Georgia (see section (iii) below), at 31 December 2005, the maximum amount of dividends that could be paid by JNL without prior regulatory approval was nil (2004: US$221 million (£115 million)). The Group's Asian subsidiaries, mainly the Singapore and Malaysia businesses, may remit dividends to the Group, in general, provided the statutory insurance fund meets the capital adequacy standard required under local statutory regulations.

PAC and JNL are the two principal insurance subsidiaries of the Group, which together comprise approximately 77 per cent (2004: 77 per cent) of total Group assets. At 31 December 2005, the PAC long-term fund's excess of assets over its required minimum solvency margin (as per line 42 of Form 2 of the PAC FSA regulatory returns) was estimated to be £11,783 million (2004: £4,665 million) and the statutory capital and surplus of JNL was US$3,434 million (£2,000 million) (2004: US$3,141 million (£1,636 million)). The Group capital position statement for life assurance businesses is set out in note D5.

I6: Subsidiary undertakings continued

(iii) Acquisition of subsidiaries

A. Acquisition of subsidiaries in 2005

On 18 May 2005, the Group purchased, in exchange for £142 million in cash, 100 per cent of the share capital of Life Insurance Company of Georgia, a life insurance company domiciled in the US, from ING Groep N.V. (ING). The results of Life Insurance Company of Georgia's operations have been included in the consolidated financial statements commencing 18 May 2005, and contributed £4 million to the consolidated net profit. The preliminary purchase price is subject to post-closing adjustments and has been allocated to the assets acquired and liabilities assumed using management's best estimate of fair value as of the acquisition date. JNL is in negotiations with ING over certain post-closing purchase price adjustments. During 2006, any unresolved differences will be submitted to an arbitrator for resolution. If the final purchase price is reduced as a result of the arbitrator's review, the opening balance sheet will be reassessed accordingly, with any excess adjustment over the amounts presented in the balance sheet recognised as a gain.

The carrying value immediately prior to acquisition of the assets and liabilities of Life Insurance Company of Georgia was as follows:

	2005 £m
Assets	
Financial investments	**920**
Reinsurer's share of policyholder liability provision	**12**
Tax recoverable	**4**
Other assets	**6**
Cash and cash equivalents	**47**
Total assets	**989**
Equity and liabilities	
Equity	**141**
Liabilities	
Insurance contract liabilities	**837**
Other non-insurance liabilities	**11**
Total liabilities	**848**
Total equity and liabilities	**989**

A fair value adjustment of £1 million was made, representing the value of in-force business on acquisition. As indicated above, this amount may be adjusted depending upon the outcome of arbitration proceedings. There is currently no goodwill recorded on acquisition.

Group revenue and consolidated net profit for the year ended 31 December 2005 are shown on a pro forma basis below as if the Life Insurance Company of Georgia acquisition took place on 1 January 2005. These pro forma amounts have been derived by adding pre-acquisition revenue and other components of net profit to these items included in the Group's consolidated income statement.

	Pro forma 2005 £m
Earned premiums, net of reinsurance	**15,050**
Investment and other income	**26,119**
Total revenue	**41,169**
Profit after tax for the year	**768**

In addition to the acquisition of Life Insurance Company of Georgia, the PAC with-profits fund acquired a number of venture capital holdings through PPM Capital in which the Group is deemed to have a controlling interest, in aggregate with, if applicable, other holdings held by, for example, the PSPS. There were three such acquisitions during 2005:

- Acquired 40 per cent of the voting equity interests of Aperio Group Pty Ltd (AeP), a flexible packaging manufacturing company, in May 2005;
- acquired 75 per cent of the voting equity interests of Jost Luxembourg S.a.r.l. (JOST), a manufacturer of components of the truck and trailer industry, in August 2005; and
- acquired 75 per cent of the voting equity interests of BST Safety Textiles Luxembourg S.a.r.l. (BST), an airbag production company, in August 2005.

These acquisitions are considered individually immaterial and therefore all 2005 information relating to ventures acquisitions has been presented in aggregate throughout the note. Due to the nature of venture investments, it is not practicable to provide certain information for acquisitions occurring in 2005 and 2004, including the pro forma Group revenue and consolidated net profit information as if the acquisitions had occurred at the beginning of the year, and the carrying amounts, in accordance with IFRS, of each class of the acquirees assets, liabilities, and contingent liabilities immediately before acquisition.

The results of the aggregated ventures acquisitions in 2005 have been included in the consolidated financial statements of the Group commencing on the respective dates of acquisition and contributed £0.1 million to earnings within the income statement, which is also reflected as part of the change in unallocated surplus of the with-profits fund.

16: Subsidiary undertakings continued

The table below identifies the net assets acquired and reconciles this amount to the consideration paid for the aggregated ventures acquisitions in 2005:

	Fair value on acquisition £m
Cash and cash equivalents	29
Other current assets	144
Property, plant and equipment	82
Other non-current assets	5
Less liabilities, including current liabilities and borrowings	(408)
	(148)
Less minority interests	1
Net assets acquired	(149)
Goodwill	151
Cash consideration	2

Aggregate goodwill of £151 million has been recognised for the excess of the cost over the Group's interest in the net fair value of the entities' assets, liabilities, and contingent liabilities acquired in 2005.

There are no intangible assets that were not recognised separately from goodwill for these companies because the fair value of the intangible asset could not be reliably measured.

B. Acquisition of subsidiaries in 2004

Acquisitions in 2004 relate to the PAC with-profits fund venture capital holdings. There were five such acquisitions during 2004:

- Acquired 39 per cent of the voting equity interests of Pharmacia Diagnostics (Pharmacia), a Swedish healthcare company, in April 2004;
- acquired 45 per cent of the voting equity interests of TMF Group (TMF), a Dutch business administration company, in September 2004;
- acquired 75 per cent of the voting equity interests of Muller & Weygandt GmbH (M&W), a German healthcare company, in October 2004;
- acquired 73 per cent of the voting equity interests of Sterigenics International, Inc. (Sterigenic), a US based healthcare company, in June 2004; and
- acquired 100 per cent of the voting equity interests of Edotech (Edotech), a UK business services company, in March 2004.

These acquisitions are considered individually immaterial and therefore all 2004 information has been presented in aggregate throughout the note. As noted above, it is not practicable to provide certain information due to the nature of venture investments and hence these disclosures are not included in this note.

The results of the aggregated acquisitions in 2004 have been included in the consolidated financial statements of the Group commencing on the respective dates of acquisition and contributed £16 million to earnings within the income statement which is also reflected as part of the change in the liability for unallocated surplus ie profit before tax attributable to shareholders is not affected. This aggregate amount of £16 million does not include earnings from Edotech for the period since the date of acquisition. Disclosure of this amount is impracticable as Edotech is an acquisition by a consolidated PPM Capital venture subsidiary.

The table below identifies the net assets acquired and reconciles this amount to the consideration paid for the aggregated acquisitions in 2004:

	Fair value on acquisition £m
Cash and cash equivalents	44
Other current assets	205
Property, plant and equipment	212
Other non-current assets	43
Less liabilities, including current liabilities and borrowings	(905)
	(401)
Less minority interests	0
Net assets acquired	(401)
Goodwill	537
Cash consideration	136

Aggregate goodwill of £537 million has been recognised for the excess of the cost over the Group's interest in the net fair value of the entities' assets, liabilities, and contingent liabilities acquired in 2004.

There are no intangible assets that were not recognised separately from goodwill for these companies because the fair value of the intangible asset could not be reliably measured.

I6: Subsidiary undertakings continued

(iv) Disposals of subsidiaries

A. Disposals of subsidiaries in 2005

In 2005, the Astron Group Ltd, Barracuda Group Ltd, Saint Clair Luxembourg S.a.r.l., RAL Holdings Ltd, Roventa-Henex Holdings SA and Global Brands Co. Inc., all venture subsidiaries of the PAC with-profits fund, were disposed of for cash consideration of £284 million. Goodwill of £312 million and cash and cash equivalents of £32 million were disposed of. Note that, in addition, two venture subsidiaries were classified as held for sale at 31 December 2005 (see note H9).

B. Disposals of subsidiaries in 2004

The Group disposed of its interest in Jackson Federal Bank on 27 October 2004 to Union Bank of California (see note F6).

The net assets of Jackson Federal Bank at the date of disposal and at 31 December 2003 were as follows:

	At date of disposal £m	31 Dec 2003 £m
Intangible assets	38	38
Financial investments:		
Debt securities	45	270
Equity securities and portfolio holdings in unit trusts	13	13
Loans and receivables	683	659
Other investments	–	3
	741	945
Accrued investment income	10	9
Cash and cash equivalents	21	14
Total liabilities (predominantly customer accounts)	(682)	(894)
Net identifiable assets and liabilities	128	112
Gain on disposal, before tax	38	
Total consideration, satisfied by cash	**166**	
Net cash inflow arising on disposal		
Cash consideration	166	
Cash and cash equivalents disposed of	(21)	
	145	

In addition, Oxoid a venture subsidiary of the PAC with-profits fund was disposed of on 1 March 2004 for cash consideration of £73 million. Goodwill of £62 million was the primary asset that was disposed of. Cash and cash equivalents disposed of were insignificant.

I7: Commitments

(i) Operating leases

The Group leases various offices to conduct its business. Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the income statement on a straight-line basis over the period of the lease.

	2005 £m	2004 £m
Future minimum lease payments for non-cancellable operating leases are due for the following periods:		
Not later than 1 year	**61**	58
Later than 1 year and not later than 5 years	**186**	167
Later than 5 years	**204**	201

The total minimum future sublease rentals to be received on non-cancellable operating leases for land and buildings for the year ended 31 December 2005 was £2 million (2004: £2 million).

Minimum lease rental payments for the year ended 31 December 2005 of £55 million (2004: £50 million) are included in the consolidated income statement.

(ii) Capital commitments

The Group has provided, from time to time, certain guarantees and commitments to third parties including funding the purchase or development of land and buildings and other related matters. At 31 December 2005, the aggregate amount of contractual obligations to purchase and develop investment properties amounted to £199 million (2004: £42 million). The vast majority of these commitments have been made by the PAC with-profits fund.

I8: Post-balance sheet events

In December 2005, the Company announced its intention to acquire the minority interests in Egg representing approximately 21.7 per cent of the existing issued share capital of Egg. Under the terms of the offer, Egg shareholders would receive 0.2237 new ordinary shares in the Company for each Egg share. In January 2006, the Company announced that it had received acceptances in respect of 80.3 per cent of the shares that it did not already own and that it would extend the offer until further notice. In February 2006, the Board of Egg announced the delisting of Egg shares. Full acceptance of the offer would result in the issue of 41 million new ordinary shares in the Company representing 1.7 per cent of its issued ordinary share capital as enlarged by this acquisition.

I9: Foreign exchange translation

Foreign currency profit and losses have been translated at average exchange rates for the year. Foreign currency assets and liabilities have been translated at year end rates of exchange.

The principal exchange rates applied are:

Local currency: £	**Closing rate at 31 Dec 2005**	Average for 2005	Closing rate at 31 Dec 2004	Average for 2004	Opening rate at 1 Jan 2004
Hong Kong	**13.31**	14.15	14.92	14.27	13.90
Japan	**202.63**	200.13	196.73	198.08	191.85
Malaysia	**6.49**	6.89	7.30	6.96	6.80
Singapore	**2.85**	3.03	3.13	3.10	3.04
Taiwan	**56.38**	58.47	60.84	61.10	60.78
US	**1.72**	1.82	1.92	1.83	1.79

I10: Cash flows

Structural borrowings of shareholder-financed operations comprise core debt of the parent company and related finance subsidiaries, JNL surplus notes and Egg debenture loans. Core debt excludes borrowings to support short-term fixed income securities reinvestment programmes and non-recourse borrowings of investment subsidiaries of shareholder-financed operations. Cash flows in respect of these borrowings are included within operating cash flows.

Structural borrowings of with-profits operations relate solely to the £100 million 8.5 per cent undated subordinated guaranteed bonds which contribute to the solvency base of SAIF. Cash flows on other borrowings of with-profits funds, which principally relate to venture investment subsidiaries, are categorised as operating.

Cash flows relating to discontinued operations, as detailed in note F6, are outflows of £5 million and inflows of £174 million for 2005 and 2004 respectively. All of these relate to cash flows from operating activities.