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. On 29 January 2007 the Company announced that it had entered into a binding agreement to sell its Egg banking business to Citi, as described in note I8.

In the US, the Group's principal subsidiary is Jackson National Life Insurance Company (Jackson). 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 Jackson 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 240 to 249.

In 2005, the Group early adopted the amendment to IAS 39, 'The Fair Value Option' and IAS 19, 'Employee Benefits' (as amended in 2004).

The Group has applied all IFRS standards and interpretations adopted by the EU and effective at 31 December 2006.

A3: Critical accounting policies, estimates and judgements

(a) Critical accounting policies

Prudential's discussion and analysis of its financial condition and results of operations are based upon Prudential's consolidated financial statements, which have been prepared in accordance with IFRS adopted for use in the EU. Were the Group to apply IFRS as published by the International Accounting Standards Board, as opposed to EU-adopted IFRS, no additional adjustments would be required.

The preparation of these financial statements requires Prudential to make estimates and judgements that affect the reported amounts of assets, liabilities, and revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, Prudential evaluates its estimates, including those related to long-term business provisioning, the fair value of assets and the declaration of bonus rates. Prudential bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgements about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgements and uncertainties, and potentially give rise to different results under different assumptions and conditions. Prudential believes that its critical accounting policies are limited to those described below.

The critical accounting policies in respect of the items discussed below are critical for the Group's results insofar as they relate to the Group's shareholder-financed business, in particular for Jackson. The policies are not critical in respect of the Group's with-profits business. Accordingly, explanation is provided in this note and cross-referenced notes as to why the distinction between with-profits business and shareholder-backed business is relevant.

Notes on the Group financial statements continued

A3: Critical accounting policies, estimates and judgements continued

The items discussed below and in cross-referenced notes explain the effect of changes in estimates and the effect of reasonably likely changes in the key assumptions underlying these estimates as of the latest balance sheet date so as to provide analysis that recognises the different accounting effects on profit and loss or equity. In order to provide relevant analysis that is appropriate to the circumstances applicable to the Group's businesses, the explanations refer to types of business, fund structure, the relationship between asset and policyholder liability measurement, and the differences in the method of accounting permitted under IFRS 4 for accounting for insurance contract assets, policyholder liabilities and unallocated surplus of the Group's with-profits funds.

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 2006 and 2005 results.

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 were required for UK with-profits funds were:

- 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 was 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) from 1 January 2005.

Under UK GAAP, the fund for future appropriations (FFA) represented the excess of assets over policyholder liabilities for the Group's with-profits 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 Jackson, 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 2006 and 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 Jackson

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 Jackson, 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 Jackson's derivative book;
- the complexity of asset and liability matching of US life insurers such as those with Jackson'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.

A3: Critical accounting policies, estimates and judgements continued

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 Jackson's derivative book. As a result of this decision the total income statement results are more volatile as the movements in the value of Jackson'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 Jackson 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.

Supplementary analysis of results and earnings attributable to shareholders

With the exception of debt securities held by Jackson 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 before and after short-term fluctuations in investment returns.

Previously under UK GAAP (i.e. prior to 2005), 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(d).

(b) Critical accounting estimates and judgements

Investments

Determining the fair value of unquoted investments

The Group holds financial investments which are not quoted on active markets. Their fair values are determined in full or in part by using valuation techniques. If the market for a financial investment of the Group is not active, the Group establishes fair value by using quotations from independent third parties, such as brokers or by using valuation techniques. The fair values of investments valued using a valuation technique at 31 December 2006 was £4,548 million (31 December 2005: £4,947 million). 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, 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. Additional details are explained in note G1.

Determining impairments relating to financial assets

Available-for-sale securities

Financial investments carried on an available-for-sale basis are represented by Jackson's and Egg's debt securities portfolio. These are considered to be impaired if there has been a significant or 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 recovers, 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. Additional details are described in note G5.

Notes on the Group financial statements continued

A3: Critical accounting policies, estimates and judgements continued

Assets held at amortised cost

Loans and receivables are carried at amortised cost using the effective interest rate method. The loans and receivables include loans collateralised by mortgages, deposits and loans to policyholders. For these assets, the Group measures the amount of any impairment loss by comparing the carrying amount of the asset with the present value of its estimated future cash flows.

In estimating 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 that has been adjusted for conditions in the historical loss experience which no longer exist or for conditions that 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.

The principal holdings of loans and receivables where credit risk is of particular significance are loans and advances to customers held by Egg. 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. The table in note E5 details the movements in the allowance for losses on such loans and advances.

Changes in the estimates of credit risk in any reporting period could result in a change in the allowance for losses on the loans and advances.

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:

(a) that are likely to be a significant portion of the total contract benefits;

(b) whose amount or timing is contractually at the discretion of the insurer; and

(c) that are contractually based on asset or fund performance, as discussed in IFRS 4.

Accordingly, insurers must perform a product classification exercise across their portfolio of contracts issued to determine the allocation to these various categories. IFRS 4 permits the continued usage of previously applied GAAP for insurance contracts and investment contracts with discretionary participating features. Except for UK regulated with-profits funds, as described subsequently, this basis has been applied by the Group.

For 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 assets and liabilities attaching to the contract that may diverge from those previously applied. The principal lines of business for which measurement changes arose on adoption of IFRS are certain unit-linked savings and similar contracts in the UK. Further details of this exercise are given in note D1.

Valuation assumptions

(i) Contracts of with-profits funds

The Group's insurance contracts and investment contracts with discretionary participating features are primarily with-profits and other protection type policies. For UK regulated with-profits funds, the contract liabilities are valued by reference to the UK Financial Services Authority's (FSA) realistic basis. In aggregate, this basis 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.

The basis of determining liabilities for the Group's with-profits business has little or no effect on the results attributable to shareholders. This is because movements on liabilities of the with-profits funds are absorbed by the unallocated surplus. The unallocated surplus represents the excess of assets over liabilities that have yet to be appropriated between policyholders and shareholders. Except through indirect effects, or in remote circumstances as described below, changes to liability assumptions are therefore reflected in the carrying value of the unallocated surplus rather than shareholders' equity.

A detailed explanation of the basis of liability measurement is contained in note D2(d)(ii).

A3: Critical accounting policies, estimates and judgements continued

The Group's other with-profits contracts are written in with-profits funds that operate in some of the Group's Asian operations. The liabilities for these contracts and those of Prudential Annuities Limited, which is a subsidiary company of the PAC with-profits funds, are determined differently. For these contracts 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.

For liabilities determined using the basis described above for UK regulated with-profits funds, and the other liabilities described in the preceding paragraph, changes in estimates arising from the likely range of possible changes in underlying key assumptions have no direct impact on the reported profit.

This lack of sensitivity reflects the with-profits fund structure, basis of distribution, and the application of previous GAAP to the unallocated surplus of with-profits funds as permitted by IFRS 4. Changes in liabilities of these contracts that are caused by altered estimates are absorbed by the unallocated surplus of the with-profits funds. As noted previously, the unallocated surplus is accounted for as a liability and thus, except in the remote circumstances where support for the funds by shareholders' funds was required, changes in its level do not directly affect shareholders' equity. The Company's obligations and more detail on such circumstances are described in note H14.

(ii) Other contracts

Contracts, other than those of with-profits funds, are written in shareholder-backed operations of the Group. The significant shareholder-backed product groupings and the factors that may significantly affect IFRS results due to experience against assumptions or changes of assumptions vary significantly between business units. For some types of business the effect of changes in assumptions may be significant, whilst for others, due to the nature of the product, assumption setting may be of less significance. The nature of the products and the significance of assumptions are discussed in notes D2, D3 and D4. From the perspective of shareholder results the key sensitivity relates to assumed future investment returns for the Taiwan life operation as described in note D4.

Jackson

Jackson offers individual fixed annuities, fixed index annuities, immediate annuities, variable annuities, individual and variable life insurance and institutional products. With the exception of institutional products and an incidental amount of business for annuity certain contracts, which are accounted for as investment contracts under IAS 39, all of Jackson life assurance contracts are accounted for under IFRS 4 as insurance contracts by applying US GAAP, the previous GAAP used before IFRS adoption. Under US GAAP the requirements of SFAS 60 'Accounting and Reporting for Insurance Enterprises' and SFAS 97 'Accounting and Reporting by Insurance Enterprises for certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments' apply to these contracts. The accounting requirements under these standards and the effect of changes in valuation assumptions are considered below for fixed annuity, variable annuity and traditional life insurance contracts.

Fixed annuity contracts, which are investment contracts under US GAAP terminology, 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, namely deferred income, any amounts previously assessed against policyholders that are refundable on termination of the contract, and any premium deficiency, i.e., any probable future loss on the contract. These types of contract contain considerable interest rate guarantee features. Notwithstanding the accompanying market risk exposure, 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 Jackson's fixed annuity 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.

Variable annuity contracts written by Jackson may provide for guaranteed minimum death, income, or withdrawal 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 assumptions. For variable annuity business the key assumption is the expected long-term level of equity market returns which for 2006 and 2005 was 8.4 per cent per annum determined using a mean reversion methodology. Likely changes to this percentage return are not expected to be significant.

These returns affect the level of future expected profits through their effects on the fee income with consequential impact on the amortisation of deferred acquisition costs as described below and the required level of provision for guaranteed minimum death benefit claims.

For traditional life insurance contracts, provisions for future policy benefits are determined under SFAS 60 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.

Except to the extent of mortality experience, which primarily affects profits through variations in claim payments and the guaranteed minimum death benefit reserves, the profits of Jackson are relatively insensitive to changes in insurance risk.

Notes on the Group financial statements continued

A3: Critical accounting policies, estimates and judgements continued

Asian operations

The insurance products written in the Group's Asian operations principally cover with-profits business, unit-linked business, and other non-participating business. The results of with-profits business are relatively insensitive to changes in estimates and assumptions that affect the measurement of policyholder liabilities. As for the UK business, this feature arises because unallocated surplus is accounted for by the Group as a liability. The results of Asian unit-linked business are also relatively insensitive to changes in estimates or assumptions.

The principal non-participating business in the Group's Asian operations, for which changes in estimates and assumptions are important from year to year, is the traditional whole-life business written in Taiwan. The premiums for the in-force business for these contracts 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 an allowance for mortality and expenses. The required rates of guarantee have fallen over time as interest rates have reduced from a high of eight per cent to current levels of around two per cent. The current low 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 £40 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. For 2005, it was projected that rates of return for Taiwanese bond yields would trend from the then current levels of some two per cent to 5.5 per cent by 31 December 2012. For 2006, it has been assumed that the longer-term bond rate will be attained one year later, i.e. by 31 December 2013.

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 2007, and the target date for attainment of the long-term bond yield deferred to 31 December 2014, the premium reserve, net of deferred acquisition costs, would be broadly sufficient. If interest rates were to remain at current levels in 2008 with a further one year delay in the progression period, then some level of write-off of deferred acquisition costs may be necessary. However, the amount of the charge based on current in-force business which is estimated at £70-90 million, is sensitive for the previously mentioned variables.

Furthermore, the actual amount of any write-off would be affected by the impact of new business written between 31 December 2006 and the future reporting dates to the extent that the business is taken into account as part of the liability adequacy testing calculations for the portfolio of contracts.

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 altered, the carrying value of the deferred acquisition costs and policyholder liabilities would potentially be affected. Details of this sensitivity are shown in note D4(h)(ii).

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 results for shareholder-financed long-term business of Jackson and Asian operations. The majority of the UK shareholder-backed operations is for individual and group annuity business where the incidence of acquisition costs is negligible.

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A3: Critical accounting policies, estimates and judgements continued

Jackson National Life Insurance Company (Jackson)
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 long-term spread between the earned rate and the rate credited to policyholders, which is based on the 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 Jackson companies, industry experience and future expectations. A detailed analysis of actual experience is measured by the internally developed mortality studies.

For variable annuity business, as described above, the key assumption is the expected long-term level of equity market returns, which for 2006 and 2005 was 8.4 per cent per annum determined using a mean reversion methodology.

Asian operations
The key shareholder-backed Asian operation is the Taiwan life business.

The sensitivity of the results for this operation, including the potential effect on write-offs of deferred acquisition costs, is significant and is described above.

Pensions
The Group applies the requirements of IAS 19, 'Employee benefits', to its defined benefit pension schemes. Due to the inclusion of actuarial gains and losses in the income statement rather than being recognised directly in equity, the results of the Group are affected by changes in interest rates for corporate bonds that affect the rate applied to discount projected pension payments and changes in mortality assumptions.

The economic participation in the surplus or deficits attaching to the main Prudential Staff Pension Scheme (PSPS) and the smaller Scottish Amicable Pensions 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 the WPSF and shareholders' funds was in the ratio 80/20. In 2005, following extensive analysis, this ratio was revised to 70/30 at 31 December 2005. Movements in the apportionment of the surplus or deficit for PSPS between the WPSF and shareholders' funds in 2006 reflects the 70/30 ratio application to movements in the carrying value of assets and liabilities as at 31 December 2005 but with service cost and contributions for ongoing service apportioned by reference to the cost allocation for activity of current employees.

For SAPS the ratio for both 2006 and 2005 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 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) Financial instruments (other than long-term business contracts classified as financial instruments under IFRS 4)
Investment classification
Upon initial recognition, financial investments are measured at fair value. Subsequently, the Group is permitted under IAS 39, 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 assets and liabilities at fair value through profit and loss – this comprises assets and liabilities 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.

Notes on the Group financial statements continued

A4: Significant accounting policies continued

(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 receivables and debt securities held by Jackson and Egg. Debt securities held by Jackson 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 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 a 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 which is 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).

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 is 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 Jackson 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, the embedded derivative is bifurcated and carried at fair value as a derivative in accordance with IAS 39.

A4: Significant accounting policies continued

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 all of 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; and
- the Group has an 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.

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.

(b) Long-term business contracts

Income statement treatment

Premiums and claims
Premium and annuity considerations for conventional with-profits policies and other protection type insurance policies 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.

For investment contracts which do not contain discretionary participating features, the accounting reflects the deposit nature of the arrangement, with premiums and claims reflected as deposits and withdrawals and taken directly to the balance sheet.

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Notes on the Group financial statements continued

A4: Significant accounting policies continued

Acquisition costs

Costs of acquiring new insurance 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 part of deferred acquisition costs (DAC), which are included as an asset in the balance sheet. The DAC asset in respect of insurance contracts 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.

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

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 for 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.

From 1 January 2005, the previous UK GAAP basis was 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.

The cost of guarantees, options and smoothing is very sensitive to the bonus, market value reduction (MVR) and investment policy the Group 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 Group 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.

A4: Significant accounting policies continued

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 2006 and 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 (i.e. contracts which contain significant insurance risk as defined under IFRS 4)
For these contracts UK GAAP has been applied, which reflects the MSB. Under this basis the following approach applies:

Other UK insurance contracts
Other UK insurance contracts that contain significant insurance risk include unit-linked, annuity and other non-profit business. For the purposes of local regulations, 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
The assets and liabilities of insurance contracts 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
The future policyholder benefit provisions for Jackson'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 Jackson, 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 2006 and 2005, 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.

Jackson 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, Jackson 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.

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.

Notes on the Group financial statements continued

A4: Significant accounting policies continued

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 Jackson 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 is consistent with the accounting for similar with-profits insurance contracts. Other 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.

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.

(c) Other assets, liabilities, income and expenditure
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 given to other factors such as potential voting rights.

The Group has consolidated some special purpose entities (SPEs), such as funds holding collateralised debt obligations (CDOs) 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.

The Group holds investments in internally and externally managed Open-ended Investment Companies (OEICs) and unit trusts. The Group's percentage ownership levels in these entities can fluctuate from day to day according to changes in the Group's and third party participation in the funds. In instances where the Group's ownership of internally managed funds declines marginally below 50 per cent and, based on historical analysis and future expectations the decline in ownership is expected to be temporary, the funds continue to be consolidated as subsidiaries under IAS 27.

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 associates' 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.

A4: Significant accounting policies continued

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 2006 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 benefit 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 value of the scheme 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 (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 performed to estimate the fair value of the awards. 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.

The Company has established trusts to facilitate the delivery of Prudential plc shares under employee incentive plans and savings-related share option schemes. None of the trusts that hold shares for employee incentive and savings plans continue to hold these shares once they are issued to employees. The cost to the Company of acquiring these treasury shares held in trusts is shown as a deduction from shareholders' equity.

Notes on the Group financial statements continued

A4: Significant accounting policies continued

Tax

The Group's UK subsidiaries each file separate tax returns. Jackson 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.

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.

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 assets and liabilities 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 amount 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.

A4: Significant accounting policies continued

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.

Acquired intangible assets

Intangible assets acquired on the purchase of a subsidiary or portfolio of contracts are valued at acquisition and carried at amortised cost. Amortisation calculated is charged on a straight-line basis over the estimated useful life of the assets. The residual values and useful lives are reviewed at each balance sheet date.

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 pounds 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.

Notes on the Group financial statements continued

A4: Significant accounting policies continued

(d) 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.

Operating profit based on longer-term investment returns

Prior to the adoption of IFRS, 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.

Under IFRS, the Group continues to use operating profit based on longer-term investment returns as a supplemental measure of its results. In determining profit on this basis the following key elements are applied to the results of the Group's shareholder-financed operations.

(i) Debt securities and equity securities

Longer-term investment returns comprise income and longer-term capital returns. For debt securities the longer-term capital returns comprise two elements. 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.

(ii) Derivative value movements

Value movements for Jackson's equity-based derivatives and variable annuity product embedded derivatives are included in operating profits based on longer-term investment returns. The inclusion of these movements is so as to broadly match with the results on the Jackson variable annuity book that pertain to equity market movements.

Other derivative value movements are excluded from operating results based on longer-term investment returns. These derivatives are primarily held by Jackson as part of a broadly-based hedging programme for features of Jackson's bond portfolio (for which value movements are booked directly to shareholders' equity rather than income statement) and product liabilities (for which US GAAP accounting does not reflect the economic features being hedged).

These key elements are of most importance in determining the operating results based on longer-term investment returns of Jackson.

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 of Jackson and other derivatives where value movements match other items in operating results based on longer-term investment returns, value movements on derivatives held by Jackson 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: Adoption of IAS 32, IAS 39 and IFRS 4 at 1 January 2005

The standards of IAS 32, IAS 39 and IFRS 4 were adopted on 1 January 2005.

The principal effects of adopting these standards arose in the Group's UK long-term business contracts, Jackson's debt securities and derivative instruments and Egg's banking assets, liabilities and derivatives positions.

The following table demonstrates the effects of adoption of IAS 32, IAS 39 and IFRS 4 on the IFRS balance sheet at 1 January 2005.

		Effect of adoption of IAS 32, IAS 39 and IFRS 4					
	At 31 Dec 2004 £m	UK insurance operations (note i) £m	Jackson (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							
Intangible assets attributable to shareholders:							
Goodwill	1,461						**1,461**
Deferred acquisition costs and acquired in-force value of long-term business	2,244	23	(456)			(433)	**1,811**
Total	3,705	23	(456)			(433)	**3,272**
Intangible assets attributable to PAC with-profits fund:							
In respect of acquired venture fund investment subsidiaries	858						**858**
Deferred acquisition costs	798	(765)				(765)	**33**
Total	1,656	(765)				(765)	**891**
Total	5,361	(742)	(456)			(1,198)	**4,163**
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	1,171		(1)	(49)		(50)	**1,121**
Total	5,875	10	66	(92)		(16)	**5,859**
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						**100**
Cash and cash equivalents	4,341						**4,341**
Total assets	180,063	(877)	872	53	68	116	**180,179**

Notes on the Group financial statements continued

A5: Adoption of IAS 32, IAS 39 and IFRS 4 at 1 January 2005 continued

	At 31 Dec 2004 £m	Effect of adoption of IAS 32, IAS 39 and IFRS 4 UK insurance operations (note i) £m	Jackson (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					8,315	8,315	**8,315**
Reflecting previous UK GAAP basis of provisioning	16,122	(7,807)			(8,315)	(16,122)	
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	145,184	(787)	(51)		0	(838)	**144,346**
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	2,350	(91)	218	(6)		121	**2,471**
Accruals and deferred income	655			(88)		(88)	**567**
Other creditors	1,009	8		(54)		(46)	**963**
Provisions	1,006						**1,006**
Other liabilities	1,175	15	229	83	76	403	**1,578**
Total other non-insurance liabilities	11,840	(68)	443	(65)	76	386	**12,226**
Total liabilities	175,437	(855)	599	81	68	(107)	**175,330**
Total equity and liabilities	180,063	(877)	872	53	68	116	**180,179**

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.

A5: Adoption of IAS 32, IAS 39 and IFRS 4 at 1 January 2005 continued

Notes 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
Under IAS 39, Jackson'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.

A6: New accounting pronouncements

The following standards, interpretations and amendments have either been effective and adopted in 2006 or have been issued but are not yet effective in 2006. This is not intended to be a complete list as only those standards, interpretations and amendments that are anticipated to have an impact upon the Group's financial statements have been discussed.

Accounting pronouncements adopted in 2006

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.

Amendment to IAS 21, 'Net Investment in a Foreign Operation'

Issued in December 2005, the amendments to IAS 21 clarify the definition of a foreign operation and the recognition of exchange difference in a net investment in a foreign operation. The amendments are effective for annual periods beginning on or after 1 January 2006.

The adoption of these aforementioned amendments did not have a material impact on the financial statements of the Group.

Accounting pronouncements not yet effective

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.

Notes on the Group financial statements continued

A6: New accounting pronouncements continued

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.

IFRS 8, 'Operating Segments'

IFRS 8 requires entities to adopt the 'management approach' to reporting the financial performance of its operating segments. The amount of each operating segment item to be reported is the measure reported to the chief operating decision maker, which in some instances will be non-GAAP. IFRS 8 will require the Group to provide an explanation of the basis on which the segment information is prepared and a reconciliation to the amount recognised in the Group's consolidated financial statements. This standard is effective for accounting periods beginning on or after 1 January 2009.

IFRIC 9, 'Reassessment of Embedded Derivatives'

IFRIC 9 will require the Group to assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when it first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case a reassessment is required. This interpretation became effective for annual periods beginning on or after 1 June 2006.

IFRIC 10, 'Interim Financial Reporting and Impairment'

IFRIC 10 addresses the apparent conflict between the requirements of IAS 34, 'Interim Financial Reporting', and those in other standards on the recognition and reversal in financial statements of impairment losses on goodwill and certain financial assets. IFRIC 10 states that any such impairment losses recognised in an interim financial statement may not be reversed in subsequent interim or annual financial statements. This interpretation became effective for annual periods beginning on or after 1 November 2006.

The Group is currently assessing the impact of the aforementioned standards, interpretations 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 from continuing operations 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.

	2006 £m	2005 £m
UK operations		
UK insurance operations (note ii)	**500**	400
M&G	**204**	163
Egg	**(145)**	44
Total	**559**	607
US operations		
Jackson (notes ii and iii)	**398**	348
Broker-dealer and fund management (including Curian losses of £8m (2005: £10m))	**10**	14
Total	**408**	362
Asian operations		
Long-term business (note ii)	**189**	195
Fund management (note iv)	**50**	12
Development expenses	**(15)**	(20)
Total	**224**	187
Other income and expenditure		
Investment return and other income	**58**	87
Interest payable on core structural borrowings	**(177)**	(175)
Corporate expenditure:		
Group Head Office	**(83)**	(70)
Asia Regional Head Office	**(36)**	(30)
Charge for share-based payments for Prudential schemes (note viii)	**(10)**	(11)
Total	**(248)**	(199)
UK restructuring costs (note ix)	**(50)**	–
Operating profit from continuing operations based on longer-term investment returns (note i)	**893**	957
Goodwill impairment charge (note v)	**–**	(120)
Short-term fluctuations in investment returns on shareholder-backed business (note vi)	**162**	211
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes (note vii)	**167**	(50)
Profit from continuing operations before tax attributable to shareholders	**1,222**	998

Notes

(i) 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 Jackson 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.

(ii) Effect of changes to assumptions, estimates 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). In particular, the operating result for UK insurance operations for 2006 has benefited from a credit of £46 million due to altered regulatory requirements, as explained in note D2(f), whilst the operating result for Asian long-term business in 2005 benefited by a net of £52 million for changes in Singapore and Taiwan as described in note D4(f).

(iii) Jackson – Summary of operating results
(a) IFRS basis operating profits include the following longer-term investment returns (net of related change in amortisation of deferred acquisition costs)

	2006 £m	2005 £m
Longer-term returns on debt securities:		
Amortisation of interest-related gains (net of related change in amortisation of deferred acquisition costs)	**38**	46
Risk margin reserve charge in respect of credit-related losses (net of related change in amortisation of deferred acquisition costs) (note b)	**(44)**	(45)
Total	**(6)**	1
Longer-term returns on equity type investments	**45**	38

Notes on the Group financial statements continued

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

Notes continued

(b) The risk margin reserve (RMR) charge for 2006 is based on an average annual RMR of 23 basis points (2005: 24 basis points) on a book value of US$43.9bn (2005: US$43.3bn)

(iv) Asian fund management business
Operating profit for the Asian fund management business of £12 million for 2005 was determined after an 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 in 2005 related to the Japan life business. There was no impairment charge for goodwill in 2006. Further details of the Group's goodwill are shown in notes H1 and H2.

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

	2006 £m	2005 £m
US operations:		
Movements in market value of derivatives (other than equity-based) used for economic hedging purposes	**34**	122
Actual less longer-term investment returns for other items	**20**	56
Asian operations	**134**	32
Other operations	**(26)**	1
	162	211

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

	2006 £m	2005 £m
Actuarial gains and losses		
Actual less expected return on scheme assets	**156**	544
Experience gains on liabilities	**18**	1
Gains (losses) on changes of assumptions for scheme liabilities	**311**	(489)
	485	56
Less: amount attributable to the PAC with-profits sub-fund	**(318)**	(58)
	167	(2)
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	**167**	(50)

(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 was altered so that a ratio of 70/30 was applied to the PSPS deficit at 31 December 2005. For 2006, the opening deficit of the PSPS scheme has been allocated in the ratios 70/30 between the with-profits fund and shareholder-backed operations. The ratio has continued to be applied to movements in the financial position that relate to opening assets and liabilities. However, the service charge and contributions for ongoing service are allocated by reference to the cost allocation for current business.

(b) As a result of the April 2005 scheme valuation and subsequent discussions, the contribution levels for future ongoing service of active members were approximately doubled. The charge of £20 million in 2005 reflected 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.

(viii) Share-based payments
The charge for share-based payments for Prudential schemes is for the SAYE and Group performance-related schemes.

(ix) UK restructuring costs are allocated as follows:

	£m
UK insurance operations	31
M&G	2
Egg	12
Unallocated corporate	5
	50

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.

2006	**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	**893**	**(257)**	**1**	**637**	**26.4p**	**26.4p**
Short-term fluctuations in investment returns on shareholder-backed business	**162**	**(40)**	**(2)**	**120**	**5.0p**	**5.0p**
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	**167**	**(50)**	**–**	**117**	**4.8p**	**4.8p**
Based on profit for the year	**1,222**	**(347)**	**(1)**	**874**	**36.2p**	**36.2p**

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	–	(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

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:

	2006 (millions)	2005 (millions)
Weighted average shares for calculation of basic earnings per share	**2,413**	2,365
Shares under option at end of year	**10**	13
Number of shares that would have been issued at fair value on assumed option exercise	**(7)**	(9)
Weighted average shares for calculation of diluted earnings per share	**2,416**	2,369

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Notes on the Group financial statements continued

B3: Dividends

	2006 £m	2005 £m
Dividends declared and paid in reporting period		
Parent company:		
Interim dividend (2006: 5.42p, 2005: 5.30p per share)	**131**	126
Final dividend for prior period (2005: 11.02p, 2004: 10.65p per share)	**267**	252
Subsidiary company payment to minority interests	**1**	2
Total	**399**	380

As a result of shares issued in lieu of dividends of £76 million (2005: £52 million), dividends paid in cash, as set out in the consolidated cash flow statement, were £323 million (2005: £328 million).

	2006 £m	2005 £m
Parent company dividends relating to reporting period:		
Interim dividend (2006: 5.42p, 2005: 5.30p per share)	**131**	126
Final dividend (2006: 11.72p, 2005: 11.02p per share)	**287**	267
Total	**418**	393

A final dividend of 11.72 pence per share was proposed by the directors on 14 March 2007. Subject to shareholders' approval, the dividend will be paid on 22 May 2007 to shareholders on the register at the close of business on 13 April 2007. The dividend will absorb an estimated £287 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	
	2006 £m	2005 £m	2006 £m	2005 £m	2006 £m	2005 £m
UK operations	**7,192**	7,193	**13,486**	7,916	**20,678**	15,109
US operations	**5,981**	5,023	**–**	–	**5,981**	5,023
Asian operations	**1,921**	1,485	**20,408**	18,457	**22,329**	19,942
Group total	**15,094**	13,701	**33,894**	26,373	**48,988**	40,074

B4: New business continued

Insurance products – new business premiums and contributions*

	Single		Regular		Annual premium and contribution equivalents	
	2006 £m	2005 £m	**2006 £m**	2005 £m	**2006 £m**	2005 £m
UK insurance operations						
Direct to customer						
Individual annuities	**816**	720	**–**	–	**82**	72
Individual pensions and life	**60**	29	**9**	11	**15**	14
Department of Work and Pensions rebate business	**161**	244	**–**	–	**16**	24
Total	**1,037**	993	**9**	11	**113**	110
Business to business						
Corporate pensions	**536**	242	**162**	146	**216**	170
Individual annuities	**264**	212	**–**	–	**26**	21
Bulk annuities	**85**	511	**–**	–	**8**	51
Total	**885**	965	**162**	146	**250**	242
Intermediated distribution						
Life	**961**	1,112	**5**	6	**101**	118
Individual annuities	**919**	995	**–**	–	**92**	100
Individual and corporate pensions	**130**	108	**22**	25	**35**	36
Total	**2,010**	2,215	**27**	31	**228**	254
Partnerships						
Life	**840**	814	**3**	3	**87**	84
Individual and bulk annuities:						
Bulk annuity reinsurance from the Scottish Amicable Insurance Fund*	**560**	–	**–**	–	**56**	–
Individual and other bulk annuities	**1,500**	1,814	**–**	–	**150**	182
Total	**2,900**	2,628	**3**	3	**293**	266
Europe						
Life	**159**	201	**–**	–	**16**	20
Total UK insurance operations	**6,991**	7,002	**201**	191	**900**	892
US operations						
Fixed annuities	**688**	788	**–**	–	**69**	79
Fixed index annuities	**554**	616	**–**	–	**55**	62
Variable annuities	**3,819**	2,605	**–**	–	**382**	261
Life	**8**	11	**17**	14	**18**	15
Guaranteed investment contracts	**458**	355	**–**	–	**46**	35
GIC – Medium Term Notes	**437**	634	**–**	–	**44**	63
Total US operations	**5,964**	5,009	**17**	14	**614**	515
Asian operations						
China	**27**	17	**36**	23	**39**	25
Hong Kong	**355**	289	**103**	83	**139**	112
India (Group's 26% interest)	**20**	4	**105**	57	**107**	57
Indonesia	**31**	42	**71**	42	**74**	46
Japan	**68**	30	**7**	4	**14**	7
Korea	**103**	29	**208**	132	**218**	135
Malaysia	**4**	9	**72**	66	**72**	67
Singapore	**357**	284	**72**	58	**108**	86
Taiwan	**92**	124	**139**	150	**148**	162
Other	**15**	9	**36**	33	**37**	34
Total Asian operations	**1,072**	837	**849**	648	**956**	731
Group total	**14,027**	12,848	**1,067**	853	**2,470**	2,138

Notes on the Group financial statements continued

B4: New business continued

Investment products – funds under management*

2006	1 Jan 2006 £m	Gross inflows £m	Redemptions £m	Market and other movements £m	**31 Dec 2006 £m**
UK operations	36,196	13,486	(7,385)	2,649	**44,946**
Asian operations	10,132	20,408	(17,876)	(411)	**12,253**
Group total	46,328	33,894	(25,261)	2,238	**57,199**

2005	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
Asian operations	8,538	18,457	(17,130)	267	10,132
Group total	37,243	26,373	(21,184)	3,896	46,328

*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.

The tables shown above are provided as an indicative volume measure of transactions undertaken in the reporting period that have the potential to generate profits for shareholders. The amounts shown are not, and not intended to be, reflective of premium income recorded in the IFRS income statement.

The tables above include a bulk annuity transaction with the Scottish Amicable Insurance Fund (SAIF) with a premium of £560 million. The transaction reflects the arrangement entered into in June 2006 for the reinsurance of non-profit immediate pension annuity liabilities of SAIF to Prudential Retirement Income Limited (PRIL), a shareholder-owned subsidiary of the Group. SAIF is a closed ring-fenced sub-fund of the PAC long-term fund established by a Court approved Scheme of Arrangement in October 1997, which is solely for the benefit of SAIF policyholders. Shareholders have no interest in the profits of this fund, although they are entitled to investment management fees on this business. The inclusion of the transaction between SAIF and PRIL as new business in the tables reflects the transfer from SAIF to Prudential shareholders' funds of longevity risk, the requirement to set aside supporting capital, and entitlement to surpluses arising on this block of business from the reinsurance arrangement. For Group reporting purposes the amounts recorded by SAIF and PRIL for the premium are eliminated on consolidation.

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 Guaranteed Investment Contracts and similar funding agreements written in US operations.

New business premiums for regular premium products are shown on an annualised basis. Department of Work and Pensions rebate business is classified as single recurrent business. Internal vesting business is classified as new business where the contracts include an open market option.

UK and Asian investment products referred to in the table for funds under management above are unit trust, mutual funds and similar types of retail fund management arrangements. These are unrelated to insurance products that are classified as 'investment contracts' under IFRS 4, as described in the preceding paragraph, although similar IFRS recognition and measurement principles apply to the acquisition costs and fees attaching to this type of business. US investment products are no longer included in the table above as they are assets under administration rather than funds under management.

In previous periods new business premiums for intermediated distribution of UK insurance operations have included Department of Work and Pensions (DWP) rebate business for SAIF. As shareholders have no interest in SAIF, these are now excluded from the table above with comparatives restated accordingly. The amounts of new SAIF DWP rebate business written were £60 million for 2006, and £83 million for 2005.

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 the UK, the 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 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. Note I8 includes details of the agreement in January 2007 to sell Egg Banking plc.

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.

2006	**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	**201,937**	**9,498**	**5,564**	**3,672**	**(4,151)**	**216,520**
Consolidated total liabilities	**(196,651)**	**(9,206)**	**(3,922)**	**(5,272)**	**4,151**	**(210,900)**
Segment assets by geographical segment						
UK						**165,103**
US						**39,695**
Asia						**15,873**
Intra-group eliminations						**(4,151)**
Total assets per balance sheet						**216,520**

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	192,944	10,752	3,208	2,768	(2,236)	207,436
Consolidated total liabilities	(187,662)	(10,374)	(1,597)	(4,673)	2,236	(202,070)
Segment assets by geographical segment						
UK						154,900
US						41,700
Asia						13,072
Intra-group eliminations						(2,236)
Total assets per balance sheet						207,436

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 2006.

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Notes on the Group financial statements continued

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									
Intangible assets attributable to shareholders:									
Goodwill	–	1,153	–	1,153	16	172	–	–	1,341
Deferred acquisition costs and acquired in-force value of long-term business contracts	167	6	–	173	1,712	612	–	–	2,497
Total	167	1,159	–	1,326	1,728	784	–	–	3,838
Intangible assets attributable to PAC with-profits fund:									
In respect of acquired venture fund investment subsidiaries	830	–	–	830	–	–	–	–	830
Deferred acquisition costs	31	–	–	31	–	–	–	–	31
	861	–	–	861	–	–	–	–	861
Total (notes H1 and H2)	1,028	1,159	–	2,187	1,728	784	–	–	4,699
Other non-investment and non-cash assets (notes G1 and H3 to H6)	4,733	278	342	5,353	1,671	656	2,917	(4,151)	6,446
Investments of long-term business, banking and other operations (notes G1,H7 and H8)	138,537	2,904	8,247	149,688	36,164	13,749	240	–	199,841
Held for sale assets (note H9)	463	–	–	463	–	–	–	–	463
Cash and cash equivalents (note H10)	1,979	852	909	3,740	132	684	515	–	5,071
Total assets	**146,740**	**5,193**	**9,498**	**161,431**	**39,695**	**15,873**	**3,672**	**(4,151)**	**216,520**

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
Equity and liabilities									
Equity									
Shareholders' equity (note H11)	1,263	1,383	292	2,938	2,713	1,437	(1,600)	–	5,488
Minority interests	79	52	–	131	1	–	–	–	132
Total equity	1,342	1,435	292	3,069	2,714	1,437	(1,600)	–	5,620
Liabilities									
Banking customer accounts (note G1)	–	–	5,554	5,554	–	–	–	–	5,554
Policyholder liabilities and unallocated surplus of with-profits funds:									
Insurance contract liabilities (note H12)	80,323	–	–	80,323	30,184	12,706	–	–	123,213
Investment contract liabilities with discretionary participation features (note G1)	28,665	–	–	28,665	–	68	–	–	28,733
Investment contract liabilities without discretionary participation features (note G1)	11,453	–	–	11,453	1,562	27	–	–	13,042
Unallocated surplus of with-profits funds (reflecting application of 'realistic' basis provisions for UK regulated with-profits funds (notes D2(d)(ii) and H12)	13,511	–	–	13,511	–	88	–	–	13,599
Total policyholder liabilities and unallocated surplus of with-profits funds	133,952	–	–	133,952	31,746	12,889	–	–	178,587
Core structural borrowings of shareholder-financed operations (note H13):									
Subordinated debt (other than Egg)	–	–	–	–	–	–	1,538	–	1,538
Other	–	–	–	–	127	–	947	–	1,074
	–	–	–	–	127	–	2,485	–	2,612
Egg subordinated debt (note H13)	–	–	451	451	–	–	–	–	451
Total	–	–	451	451	127	–	2,485	–	3,063
Operational borrowings attributable to shareholder-financed operations (notes G1 and H13)	11	4	2,819	2,834	743	–	2,032	–	5,609
Borrowings attributable to with-profits funds (notes G1 and H13)	1,776	–	–	1,776	–	–	–	–	1,776
Other non-insurance liabilities (notes G1, H4, H9, H14 and H15)	9,659	3,754	382	13,795	4,365	1,547	755	(4,151)	16,311
Total liabilities	145,398	3,758	9,206	158,362	36,981	14,436	5,272	(4,151)	210,900
Total equity and liabilities	**146,740**	**5,193**	**9,498**	**161,431**	**39,695**	**15,873**	**3,672**	**(4,151)**	**216,520**

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Notes on the Group financial statements continued

B5: Group balance sheet continued

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

	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									
Intangible assets attributable to shareholders:									
Goodwill	–	1,153	–	1,153	16	172	–	–	1,341
Deferred acquisition costs and acquired in-force value of long-term contracts	199	6	–	205	1,634	566	–	–	2,405
Total	199	1,159	–	1,358	1,650	738	–	–	3,746
Intangible assets attributable to PAC with-profits fund:									
In respect of acquired venture fund investment subsidiaries	679	–	–	679	–	–	–	–	679
Deferred acquisition costs	35	–	–	35	–	–	–	–	35
Total	714	–	–	714	–	–	–	–	714
Total (notes H1 and H2)	913	1,159	–	2,072	1,650	738	–	–	4,460
Other non-investment and non-cash assets (notes G1 and H3 to H6)	4,457	256	280	4,993	1,888	566	1,059	(2,236)	6,270
Investments of long-term business, banking and other operations (notes G1, H7 and H8)	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 (note H10)	1,195	26	725	1,946	202	504	934	–	3,586
Total assets	**138,556**	**2,824**	**10,752**	**152,132**	**41,700**	**13,072**	**2,768**	**(2,236)**	**207,436**

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
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 (notes D2(d)(ii) and H12)	11,245	–	–	11,245	–	85	–	–	11,330
Total policyholder liabilities and unallocated surplus of with-profits funds	127,421	–	–	127,421	31,981	10,913	–	–	170,315
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)	–	–	451	451	–	–	–	–	451
Total	–	–	451	451	145	–	2,594	–	3,190
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, H14 and H15)	7,984	1,424	237	9,645	5,518	871	607	(2,236)	14,405
Total liabilities	137,320	1,426	10,374	149,120	38,729	11,784	4,673	(2,236)	202,070
Total equity and liabilities	**138,556**	**2,824**	**10,752**	**152,132**	**41,700**	**13,072**	**2,768**	**(2,236)**	**207,436**

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Notes on the Group financial statements continued
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. The risk management of the Group has been given additional focus by the creation in 2005 of a new 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 Group's risk framework, including the Group and business unit level risk committees, is included in the risk management section of the Group's operating and financial review.

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 evaluate opportunities and risks against 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 these reviews are reported to the Audit Committee together with confirmation that the processes described above as required by the Group Risk Framework were in place throughout the period covered by the report. The businesses also confirm that they 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, with all significant issues arising from the audit reported to the Group Audit Committee.

The Group's internal control framework includes detailed procedures set out 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, together with 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 discusses 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 67 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 2006, 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 76 per cent of the Group's IFRS basis shareholders' funds at 31 December 2006 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 has also entered into a US$2 billion net investment hedge (see note G3). Net of the currency position arising from these instruments some 43 per cent of the Group's shareholders' funds are 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 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 surrender charges, reduces the liquidity risk. The Group maintains committed borrowing and securities lending facilities.

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(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 Jackson, 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 Jackson 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 Jackson 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 taken by Prudential 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, the 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.

Notes on the Group financial statements continued

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 Jackson to calculate projections to test Jackson's ability to run off its liabilities with assets equal to statutory reserves in a number of specified future economic scenarios. If Jackson 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

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

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 for with-profits contracts of UK regulated entities and disclosures of the UK Standard FRS 27 from 1 January 2005. An explanation of the provisions under FRS 27 is provided in note D2.

Under the previously applied GAAP, UK GAAP, the assets and liabilities of contracts are reported in accordance with the MSB of reporting as set out in the ABI SORP.

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 primarily by Prudential Retirement Income Limited, Prudential Pensions Limited, and other categories of non-participating UK business;
- Jackson – 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.

Investment contracts

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.

Contracts of the Group, which are classified as investment contracts that do not contain discretionary participation features, whose assets and liabilities were 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 – GICs and funding agreements
  – minor amounts of 'annuity certain' contracts; and
- Prudential Corporation Asia – minor amounts for a number of small categories of business.

The accounting for the contracts of UK insurance operations and Jackson's GICs and funding agreements are considered in turn below:

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

Deferred acquisition costs

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. The amortisation profile is either on a straight-line basis or, if more appropriate, a further deferral of income recognition is applied.

Sterling reserves

Prudent provisions established for possible future expenses not covered by future margins at a policy level reflecting the regulatory approach in the UK are not permitted under IFRS 4.

Notes on the Group financial statements continued

D1: Group overview continued

(ii) Jackson – GICs and funding arrangments

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 framework that is used for internal business management. The economic capital methodology seeks to apply a single yardstick to assess and quantify all risks attaching to the Group's insurance business and associated capital requirements.

Prudential's internal Group economic capital requirement is defined as the minimum amount of capital that the Group needs to hold in order to remain economically solvent over a 25-year horizon, given a target probability of insolvency appropriate for AA-rated debt. The target confidence level is based on historic default rates for AA-rated debt, and varies over the time horizon of the projection. The economic capital requirement is calculated in respect of existing contractual and discretionary liabilities only.

For the purposes of calculating Group economic capital, Group economic solvency is defined as the position where both: (a) the capital balance of the parent company is positive, and (b) all business units are solvent on the applicable local regulatory basis. This definition of solvency allows the Group's capital position to be assessed on an economic basis while taking into account the actual regulatory constraints at the business unit level.

The Group economic capital position is calculated using the Group Solvency Model (GSM) – an integrated stochastic asset/liability model of the Group economic solvency position. Projected economic scenarios in the GSM are generated using a stochastic economic scenario generator that captures all the correlations between different asset classes and geographies.

The Group regularly determines the level of capital required to cover the risks to its existing contractual and discretionary insurance liabilities on an economic basis and its internal target solvency level. This level of required capital is determined after allowance for diversification across risk and geographies and the capturing of future shareholders' transfers from the business units. This level is then compared with available capital on an equivalent basis (i.e. GAAP based shareholders' equity after eliminating goodwill and including subordinated debt capital and valuation differences). The required capital is then analysed into its contributing parts by risk type namely asset/liability matching, credit risk, underwriting, persistency and operational risk.

The largest risk exposure on a diversified basis, credit risk, reflects the relative size of the exposure to Jackson, 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 framework 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), D4(b) and D4(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 2006 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). Jackson'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).

D1: Group overview continued

(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 present value of future expected distributable earnings of in-force long-term insurance business. The latter item when added to the net assets 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 use of best estimate assumptions to project future cash flows arising from the contracts.

The business covered by the EEV basis results includes both investment contracts as well as insurance contracts (as defined under IFRS 4). Investment contracts form a relatively small part of the Group's long-term business as demonstrated by the carrying value of policyholder liabilities shown in the Group balance sheet.

The projected cash flows are those expected to arise under the contracts such as those arising from premiums, claims and expenses after appropriate allowance for 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 the Group's internal target for economic capital subject to it meeting 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.

The 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.

The present value of the future distributable earnings 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.

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 margin of 50 basis points (2005: 50 basis points) has been added to the risk margin derived for market risk to cover the non-diversifiable non-market risks associated with the business. For the UK shareholder-backed annuity business an additional margin of 100 basis points was used (2005: 100 basis points).

Product level betas are calculated each year. They are combined with the most recent product mix to produce appropriate betas 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.

Notes on the Group financial statements continued

D1: Group overview continued

(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

- 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 indexed 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 2005 and to a much lesser extent in 2006 reflecting a reduced level of projected statutory transfers from the PAC with-profits sub-fund. However, in any given year, the statutory transfer recognised in IFRS profits is only marginally affected by altered persistency trends.

Jackson is sensitive to lapse risk. However, Jackson 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, other insurable events 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 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 2002 to 2006, 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 £15.9 billion. Indicatively it is to be expected that of the Group's policyholder liabilities (excluding unallocated surplus) at 31 December 2006 of £165 billion, the amounts likely to be paid in 2007 will be of a similar magnitude.

D2: UK insurance operations

(a) Summary balance sheet at 31 December 2006

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, PRIL, 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			UK insurance operations	
	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	**Total 2006 £m**	Total 2005 £m
Assets									
Intangible assets attributable to shareholders:									
Deferred acquisition costs and acquired in-force value of long-term business contracts	–	–	–	–	–	167	167	**167**	199
	–	–	–	–	–	167	167	**167**	199
Intangible assets attributable to PAC with-profits fund:									
In respect of acquired venture fund investment subsidiaries	–	830	–	830	–	–	–	**830**	679
Deferred acquisition costs	5	26	–	26	–	–	–	**31**	35
	5	856	–	856	–	–	–	**861**	714
Total	5	856	–	856	–	167	167	**1,028**	913
Other non-investment and non-cash assets	320	2,530	292	2,822	482	1,109	1,591	**4,733**	4,457
Investments of long-term business and other operations:									
Investment properties	1,437	10,174	385	10,559	393	2,040	2,433	**14,429**	12,670
Financial investments:									
Loans and receivables	207	666	212	878	43	–	43	**1,128**	1,130
Equity securities and portfolio holdings in unit trusts	7,509	40,876	365	41,241	20	11,476	11,496	**60,246**	58,526
Debt securities	4,306	16,795	13,801	30,596	12,669	5,890	18,559	**53,461**	49,452
Other investments	211	1,955	186	2,141	37	72	109	**2,461**	2,688
Deposits	530	3,998	355	4,353	549	1,380	1,929	**6,812**	6,797
Total investments	14,200	74,464	15,304	89,768	13,711	20,858	34,569	**138,537**	131,263
Held for sale assets	–	463	–	463	–	–	–	**463**	728
Cash and cash equivalents	147	827	123	950	30	852	882	**1,979**	1,195
Total assets	**14,672**	**79,140**	**15,719**	**94,859**	**14,223**	**22,986**	**37,209**	**146,740**	138,556

Notes on the Group financial statements continued

D2: UK insurance operations continued

	Scottish Amicable Insurance Fund (note ii) £m	PAC with-profits sub-fund (note i) Excluding Prudential Annuities Limited £m	Prudential Annuities Limited (note iii) £m	Total (note iv) £m	Other funds and subsidiaries Prudential Retirement Income Limited £m	Other non-profit unit-linked and other business (note v) £m	Total £m	UK insurance operations **Total 2006 £m**	Total 2005 £m
Equity and liabilities									
Equity									
Shareholders' equity	–	–	–	–	971	292	1,263	**1,263**	1,141
Minority interests	24	55	–	55	–	–	–	**79**	95
Total equity	24	55	–	55	971	292	1,263	**1,342**	1,236
Liabilities									
Policyholder liabilities and unallocated surplus of with-profits funds:									
Insurance contract liabilities	13,393	32,830	13,379	46,209	12,327	8,394	20,721	**80,323**	79,231
Investment contract liabilities with discretionary participation features	737	27,928	–	27,928	–	–	–	**28,665**	26,443
Investment contract liabilities without discretionary participation features	–	12	–	12	–	11,441	11,441	**11,453**	10,502
Unallocated surplus of with-profits funds (reflecting application of 'realistic' provisions for UK regulated with-profits funds)	–	11,886	1,625	13,511	–	–	–	**13,511**	11,245
Total	14,130	72,656	15,004	87,660	12,327	19,835	32,162	**133,952**	127,421
Operational borrowings attributable to shareholder-financed operations	–	–	–	–	–	11	11	**11**	17
Borrowings attributable to with-profits funds	112	1,664	–	1,664	–	–	–	**1,776**	1,898
Other non-insurance liabilities	406	4,765	715	5,480	925	2,848	3,773	**9,659**	7,984
Total liabilities	14,648	79,085	15,719	94,804	13,252	22,694	35,946	**145,398**	137,320
Total equity and liabilities	**14,672**	**79,140**	**15,719**	**94,859**	**14,223**	**22,986**	**37,209**	**146,740**	138,556

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 £19,835 million for the non-profit unit-linked and other business is £17,679 million for unit-linked business.

(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.

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D2: UK insurance operations continued

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

Within the balance sheet of UK insurance operations at 31 December 2006, there are policyholder liabilities of £74.1 billion (2005: £73.2 billion) and unallocated surplus of £13.5 billion (2005: £11.2 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 £47 million at 31 December 2006 (2005: £52 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 minimum investment returns, surrender values or annuities 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 non-profit sub-fund 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 2006, £29.0 billion (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 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-profits 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.

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 four per cent per annum.

The Group's main exposure to guaranteed annuities in the UK is through SAIF and a provision of £561 million was held in SAIF at 31 December 2006 (2005: £619 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' equity.

Notes on the Group financial statements continued

D2: UK insurance operations continued

(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 credit life and protection 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 or surviving partner 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

The 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, economic assumptions and where applicable, persistency.

For with-profits business written in the WPSF or SAIF, a market consistent valuation is performed (as described in section (ii) below). Additional assumptions required are for persistency and the management actions under which the fund is managed. Assumptions used for a 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 experience 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 yields on nominal gilts and index-linked gilts.

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 except for the PAL and PRIL annuity business where the internal rate of return of the assets backing the liabilities 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.

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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. The policyholder liabilities of the WPSF are accounted for under FRS 27.

The provisions have been determined on a basis consistent with the detailed methodology included in regulations contained in the FSA's rules for the determination of 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 and 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 employed 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 is retained in adverse investment conditions, thereby avoiding the creation of unreasonable minimum capital requirements. The management actions assumed are consistent with the Group's management policy for with-profits funds and the Group's 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 recent experience analysis.

(iii) Annuity business

The contract liabilities for PAL and PRIL are based on the FSA regulatory solvency basis. The valuation is then modified for IFRS 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 rates used for discounting claim payments are derived from the yields on the assets held with an allowance for default and mismatching risk.

Notes on the Group financial statements continued

D2: UK insurance operations continued

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		PRIL	
2006	Males	Females	Males	Females
In payment	106% – 126% PNMA00 (C = 2000) with medium cohort improvement table with a minimum annual improvement of 1.25%	84% – 117% PNFA00 (C = 2000) with 75% of medium cohort improvement table with a minimum annual improvement of 0.75%	99% – 114% PNMA00 (C = 2000) with medium cohort improvement table with a minimum annual improvement of 1.25%	85% – 103% PNFA00 (C = 2000) 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

	PAL		PRIL	
2005	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%	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%
In deferment	AM92 minus 4 years	AF92 minus 4 years	AM92 minus 4 years	AF92 minus 4 years

	PAL		PRIL	
2004	Males	Females	Males	Females
In payment	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%	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 expenses and 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.

(e) Reinsurance

The Group's UK insurance business cedes only minor amounts of business outside the Group. During 2006, reinsurance premiums for externally ceded business were £58 million (2005: £82 million) and reinsurance recoverable insurance assets were £510 million (2005: £750 million) in aggregate. The gains and losses recognised in profit and loss for these contracts were immaterial.

D2: UK insurance operations continued

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

2006

For with-profits business, there was no significant change in assumptions in 2006.

There was no change in mortality assumptions for PAL in 2006 which had a material effect on the measurement of the insurance liabilities. Liabilities for PAL were increased by £47 million for the effect of change of assumptions for renewal expenses. As PAL is owned by the WPSF, this change had no effect on shareholder profit.

In 2006, the FSA made regulatory changes for UK regulated shareholder-backed non-participating business. These changes were proposed in the consultative paper CP06/16 and confirmed in December 2006 policy statement PS06/14.

The changes to the FSA rules allow insurance liabilities for this business to incorporate more realism. In particular this is achieved by:

- setting technical provisions for expenses not directly attributable to one particular contract at a homogenous risk group level and not, as previously, at an individual contract level for all non-profit business; and
- recognising the economic effect of making a prudent lapse rate assumption. Previously, no lapses were assumed.

Under IFRS 4, the effect of this change is accounted for as a change in estimate and there is a consequent increase in operating profit based on longer-term investment returns of £46 million.

In addition to the £46 million credit described above, a charge of £4 million was recognised in 2006 for the effect of change of assumption for renewal and termination expenses mainly in respect of PAC.

2005

For with-profits business the only significant change for 2005 was an altered basis of recognising liabilities and unallocated surplus for SAIF. This was 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 were 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 2005 for the effect of change of assumption for renewal expenses, which relates to an increase in ongoing future pension scheme contributions as described in section B1, was 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 comprised amounts in respect of PAC (£35 million charge), Prudential Holborn Life (£2 million credit) and PRIL (£3 million charge).

Notes on the Group financial statements continued

D2: UK insurance operations continued

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

At 31 December 2006, the EEV basis value of in-force business of 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 £4,835 million (2005: £4,274 million). This value has been determined after applying the principles of valuation described in note D1 and the following key assumptions.

	2006 %	2005 %
Risk discount rate for in-force business at the start of the year	**8.0**	7.7
Pre-tax expected long-term nominal rates of investment return:		
UK equities	**8.6**	8.1
Overseas equities	**8.6 to 9.3**	8.1 to 8.75
Property	**7.1**	6.4
Gilts	**4.6**	4.1
Corporate bonds	**5.3**	4.9
Expected long-term rate of inflation	**3.1**	2.9
Post-tax expected long-term nominal rate of return for the with-profits sub-fund		
Pensions business (where no tax applies)	**7.5**	7.1
Life business	**6.6**	6.3

The sensitivity of the value of in-force business and net worth to changes in key assumptions is as follows:

	£m	£m
Economic assumptions:		
Discount rates – 1% increase	**(480)**	(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 (note)	**55**	69
– 1% decrease (note)	**(70)**	(99)
Equity/property yields – 1% rise	**382**	297
Equity/property market values – 10% fall	**(502)**	(480)
Non-economic assumptions:		
Maintenance expenses – 10% decrease	**33**	33
Lapse rates – 10% decrease	**75**	68
Mortality and morbidity – 5% decrease in base rates (i.e. increased longevity)	**(87)**	(62)

Note
2005 comparatives have been adjusted to reflect refinements to the methodology in UK insurance operations, for the effect of interest rate movements.

(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 are relatively minor 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 represents the surplus. The effects for 2006 and 2005 are demonstrated in note D5.

D2: UK insurance operations continued

(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 matches the expected duration of the liabilities under the contracts. Assuming close matching, the impact of short-term asset value movements as a result of interest rate movements will broadly offset changes in the value 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;
- the extent to which expected future mortality experience gives rise to changes in the measurement of liabilities; and
- changes in renewal expense levels.

A decrease in assumed mortality rates of one per cent would decrease gross profits by approximately £34 million (2005: £33 million). A decrease in credit default assumptions of five basis points would increase gross profits by £64 million (2005: £65 million). A decrease in renewal expenses (excluding investment management expenses) of five per cent would increase gross profits by £14 million (2005: £12 million). The effect on profits would be approximately symmetrical for changes in assumptions 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 and the non-profit sub-fund) 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-profits 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.

The tables below show the carrying value of the policyholder liabilities. Separately, 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 tables below also show the maturity profile of the cash flows used for 2006 and 2005 for that purpose for insurance contracts, as defined by IFRS, i.e. those containing significant insurance risk, and investment contracts, which do not.

Notes on the Group financial statements continued

D2: UK insurance operations continued

2006	With-profits business			Annuity business (Insurance contracts)			Other		
	Insurance contracts £m	Investment contracts £m	Total £m	PAL £m	PRIL £m	Total £m	Insurance contracts £m	Investment contracts £m	Total £m
Policyholder liabilities	**46,223**	**28,677**	**74,900**	**13,379**	**12,327**	**25,706**	**8,394**	**11,441**	**19,835**
	%	%	%	%	%	%	%	%	%
Expected maturity:									
0 to 5 years	**47**	**23**	**36**	**32**	**30**	**31**	**32**	**37**	**34**
5 to 10 years	**28**	**22**	**26**	**24**	**23**	**24**	**24**	**23**	**23**
10 to 15 years	**13**	**17**	**15**	**18**	**17**	**18**	**18**	**14**	**16**
15 to 20 years	**6**	**15**	**10**	**12**	**12**	**12**	**12**	**13**	**13**
20 to 25 years	**3**	**13**	**7**	**7**	**8**	**7**	**7**	**5**	**7**
Over 25 years	**3**	**10**	**6**	**7**	**10**	**8**	**7**	**8**	**7**

2005	With-profits business			Annuity business (Insurance contracts)			Other		
	Insurance contracts £m	Investment contracts £m	Total £m	PAL £m	PRIL £m	Total £m	Insurance contracts £m	Investment contracts £m	Total £m
Policyholder liabilities	47,435	26,443	73,878	14,068	8,324	22,392	9,404	10,502	19,906
	%	%	%	%	%	%	%	%	%
Expected maturity:									
0 to 5 years	48	25	39	32	29	31	33	45	36
5 to 10 years	29	24	27	24	22	23	25	24	25
10 to 15 years	13	18	15	17	17	17	18	14	17
15 to 20 years	6	14	9	12	12	12	14	8	12
20 to 25 years	3	11	6	7	8	8	6	5	6
Over 25 years	1	8	4	8	12	9	4	4	4

Notes

(i) The cash flow projections of expected benefit payments used in the maturity profile table above are from value of in-force business and exclude the value of future new business, including vesting of internal pension contracts.

(ii) Benefit payments do not reflect the pattern of bonuses and shareholder transfers in respect of the with-profits business.

(iii) Investment contracts under Other comprise certain unit-linked and similar contracts accounted for under IAS 39 and IAS 18.

(iv) For business with no maturity term included within the contracts, for example with-profits investment bonds such as Prudence Bond, an assumption is made as to likely duration based on prior experience.

D3: US operations

(a) Summary balance sheet at 31 December 2006

	Long-term business				US operations	
	Variable annuity separate account assets and liabilities* £m	Fixed annuity, GIC and other business* £m	Total £m	Broker-dealer and fund management £m	**Total 2006 £m**	Total 2005 £m
Assets						
Intangible assets attributable to shareholders:						
Goodwill	–	–	–	16	**16**	16
Deferred acquisition costs and acquired in-force value of long-term business contracts	–	1,712	1,712	–	**1,712**	1,634
Total	–	1,712	1,712	16	**1,728**	1,650
Other non-investment and non-cash assets	–	1,588	1,588	83	**1,671**	1,888
Investments of long-term business and other operations:						
Investment properties	–	20	20	–	**20**	41
Financial investments:						
Loans and receivables	–	3,254	3,254	–	**3,254**	3,577
Equity securities and portfolio holdings in unit trusts	11,367	343	11,710	–	**11,710**	8,847
Debt securities	–	20,146	20,146	–	**20,146**	24,290
Other investments	–	542	542	28	**570**	825
Deposits	–	457	457	7	**464**	380
Total investments	11,367	24,762	36,129	35	**36,164**	37,960
Cash and cash equivalents	–	99	99	33	**132**	202
Total assets	**11,367**	**28,161**	**39,528**	**167**	**39,695**	41,700
Equity and liabilities						
Equity						
Shareholders' equity	–	2,656	2,656	57	**2,713**	2,969
Minority interests	–	1	1	–	**1**	2
Total equity	–	2,657	2,657	57	**2,714**	2,971
Liabilities						
Policyholder liabilities:						
Insurance contract liabilities	11,367	18,817	30,184	–	**30,184**	30,479
Investment contract liabilities without discretionary participation features (GIC and annuity certain)	–	1,562	1,562	–	**1,562**	1,502
Total	11,367	20,379	31,746	–	**31,746**	31,981
Core structural borrowings of shareholder-financed operations	–	127	127	–	**127**	145
Operational borrowings attributable to shareholder-financed operations	–	743	743	–	**743**	1,085
Other non-insurance liabilities	–	4,255	4,255	110	**4,365**	5,518
Total liabilities	11,367	25,504	36,871	110	**36,981**	38,729
Total equity and liabilities	**11,367**	**28,161**	**39,528**	**167**	**39,695**	41,700

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

Notes on the Group financial statements continued

D3: US operations continued

Summary policyholder liabilities (net of reinsurance) and reserves at 31 December 2006

The policyholder liabilities, net of reinsurers' share of £427 million (2005: £520 million) reflect balances in respect of the following:

	2006 £m	2005 £m
Policy reserves and liabilities on non-linked business:		
Reserves for future policyholder benefits and claims payable	**935**	971
Deposits on investment contracts (as defined under US GAAP)	**17,690**	20,702
Guaranteed investment contracts	**1,327**	1,214
Unit-linked (variable annuity) business	**11,367**	8,574
	31,319	31,461

In addition to the policyholder liabilities above, Jackson 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 £2,552 million (2005: £3,267 million) and are included in 'other non-insurance liabilities' in the balance sheet above.

(b) Products and guarantees

Jackson provides long-term savings and retirement products to retail and institutional customers throughout the US. Jackson offers fixed annuities (interest-sensitive, fixed indexed and immediate annuities), variable annuities (VA), life insurance and institutional products.

(i) Fixed annuities

Interest-sensitive annuities

At 31 December 2006, interest-sensitive fixed annuities accounted for 31 per cent (2005: 36 per cent) of policy and contract liabilities of Jackson. 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 Jackson 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. Jackson 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 Jackson'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 (2005: 1.5 per cent to 5.5 per cent) depending on the jurisdiction of issue and the date of issue, with 80 per cent (2005: 73 per cent) of the fund at three per cent or less. The average guarantee rate is 3.1 per cent (2005: 3.3 per cent).

Approximately 35 per cent (2005: 29 per cent) of the interest-sensitive fixed annuities Jackson wrote in 2006 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 indexed annuities

Fixed indexed annuities accounted for seven per cent (2005: seven per cent) of Jackson's policy and contract liabilities at 31 December 2006. Fixed indexed annuities vary in structure, but generally are deferred annuities that enable policyholders to obtain a portion of an equity-linked return (based on participation rates and caps) but provide a guaranteed minimum return. These guaranteed minimum rates are generally set at three per cent.

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

Immediate annuities

At 31 December 2006, immediate annuities accounted for two per cent (2005: two per cent) of Jackson'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 Jackson'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.

D3: US operations continued

(ii) Variable annuities

At 31 December 2006, VAs accounted for 38 per cent (2005: 32 per cent) of Jackson's policy and contract liabilities. VAs are deferred annuities that have the same tax advantages and payout options as interest-sensitive and fixed indexed annuities.

The primary differences between VAs and interest-sensitive or fixed indexed 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 on the fixed account is borne by Jackson through guaranteed minimum fixed rates of return. At 31 December 2006, approximately 13 per cent (2005: 19 per cent) of VA funds were in fixed accounts.

Jackson issues VA contracts where it contractually guarantees to the contractholder 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)). Jackson hedges these risks using equity options and futures contracts as described in note D3(c).

(iii) Life insurance

Jackson's life insurance products accounted for 10 per cent (2005: nine per cent) of Jackson's policy and contract liabilities at 31 December 2006. The products offered include variable universal life insurance, term life insurance and interest-sensitive life insurance.

(iv) Institutional products

Jackson's institutional products consist of GICs, funding agreements (including agreements issued in conjunction with Jackson's participation in the US Federal Home Loan Bank programme) and medium-term note funding agreements. At 31 December 2006, institutional products accounted for 12 per cent of policy and contract liabilities (2005: 14 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. Jackson agrees 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 one per cent (2005: one per cent) of 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, Jackson agrees to pay a rate of interest, which may be fixed or floating, to the holders of the trust instruments.

(c) Risk management

Jackson's main exposures to market risk are through its exposure to interest rate risk and equity risk. Approximately 89 per cent (2005: 88 per cent) of its general account investments support interest-sensitive and fixed indexed annuities, life business and surplus and 11 per cent (2005: 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.

Jackson 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 Jackson has acquired or incurred.

Jackson generally uses free-standing derivative instruments for hedging purposes. Additionally, certain liabilities, primarily trust instruments supported by funding agreements, fixed indexed annuities, certain GMWB variable annuity features and reinsured GMIB variable annuity features contain embedded derivatives as defined by IAS 39, 'Financial Instruments: Recognition and Measurement'. Jackson does not account for such derivatives as either fair value or cash flow hedges as might be permitted if the 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.

Notes on the Group financial statements continued

D3: US operations continued

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 Jackson 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 Jackson and their purpose are as follows:

- interest rate swaps 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 Jackson locks in the forward interest rate differential between a swap and the corresponding US Treasury security. The forwards are held as a hedge of corporate spreads;
- 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. Jackson 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;
- equity index futures contracts and equity index call and put options are used to hedge Jackson's obligations associated with its issuance of fixed indexed immediate and deferred annuities and certain VA guarantees. These annuities and guarantees contain embedded options which are fair valued for financial reporting purposes;
- total return swaps in which Jackson 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 Jackson's foreign currency denominated funding agreements supporting trust instrument obligations.

As noted above, Jackson is exposed to equity risk through the options embedded in the fixed indexed liabilities and GMDB and GMWB guarantees included in certain VA benefits. 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 Jackson's operations. Jackson 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, Jackson's free-standing derivatives would decrease in value. However, over time, this movement would be broadly offset by increased separate account fees and reserve decreases, net of the related changes to amortisation of deferred acquisition costs. Due to the nature of the free-standing and embedded derivatives, this hedge, while highly effective on an economic basis, may not completely mute the immediate impact of the market movements as the free-standing derivatives reset immediately while the hedged liabilities reset more slowly (see note (d) for further details on the valuation of the guarantees) and fees are recognised prospectively. It is estimated that an immediate increase in the equity markets of 10 per cent would result in a net accounting charge of up to £20 million, excluding the impact on future separate account fees. The actual impact on financial results would vary contingent upon the volume of new product sales and lapses, changes to the derivative portfolio, correlation of market returns and various other factors including volatility, interest rates and elapsed time.

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 indexed business. Jackson hedges the equity return risk on fixed indexed 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, Jackson's investment advisor, PPM America, provides the designation for the purposes of disclosure below.

D3: US operations continued

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 2006 and 2005:

	2006 Carrying value		2005 Carrying value	
	£m	**% of total**	£m	% of total
NAIC designation:				
1	**4,631**	**40**	5,852	39
2	**5,850**	**51**	7,622	51
3	**817**	**7**	1,183	8
4	**249**	**2**	320	2
5	**22**	**0**	30	0
6	**–**	**–**	–	–
	11,569	**100**	15,007	100

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

	2006 Carrying value		2005 Carrying value	
	£m	**% of total**	£m	% of total
NAIC designation:				
1	**861**	**35**	1,368	43
2	**1,345**	**54**	1,471	46
3	**212**	**9**	299	9
4	**40**	**2**	51	2
5	**–**	**–**	–	–
6	**–**	**–**	11	0
	2,458	**100**	3,200	100

The following table shows the quality of residential and commercial mortgage-backed securities:

	2006 £m (unless otherwise stated)	2005 £m (unless otherwise stated)
Residential mortgage-backed securities (included within debt securities)		
Total residential mortgage-backed securities	**2,827**	2,303
Residential mortgage-backed securities rated AAA or equivalent by a nationally recognised statistical ratings organisation (including Standard & Poor's, Moody's and Fitch):		
Amount	**1,750**	2,002
Percentage of total	**61.9%**	86.9%
Residential mortgage-backed securities rated NAIC 1:		
Amount	**2,824**	2,300
Percentage of total	**99.9%**	99.9%
Commercial mortgage-backed securities (included within debt securities)		
Total commercial mortgage-backed securities	**1,155**	1,385
Commercial mortgage-backed securities rated by a nationally recognised statistical ratings organisation (including Standard & Poor's, Moody's and Fitch):		
Amount	**1,090**	1,385
Percentage of total	**94.4%**	100.0%
Commercial mortgage-backed securities rated investment grade:		
Amount	**1,076**	1,364
Percentage of total	**93.2%**	98.5%

Notes on the Group financial statements continued

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 previously applied UK GAAP basis. Accordingly, and consistent with the basis explained in note A4, in the case of Jackson the carrying values of insurance assets and liabilities are consolidated into the Group accounts based on US GAAP.

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 generally 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 Jackson 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 life of the contract based on total expected assessments. At 31 December 2006, the GMDB liability was valued using a series of deterministic investment performance scenarios, a mean investment return of 8.4 per cent (2005: 8.4 per cent) and assumptions for lapse, mortality and expense that are the same as those used in amortising the 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 2006 and 2005 are consistent with those used for calculating the GMDB liability.

Jackson 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 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, Jackson 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 Jackson's contracts are in most circumstances not explicitly valued, 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 standards SFAS 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 Jackson outside the Group is on term life insurance, direct and assumed accident and health business and GMIB variable annuity guarantees. In 2006, the premiums for such ceded business amounted to £66 million (2005: £78 million). Net commissions received on ceded business and claims incurred ceded to external reinsurers totalled £12 million and £53 million, respectively, during 2006 (2005: £13 million and £54 million respectively). There were no deferred gains or losses on reinsurance contracts in either 2006 or 2005. The reinsurance asset for business ceded outside the Group was £427 million (2005: £520 million).

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

2006

The operating profit based on longer-term investment returns of £408 million for US operations for 2006 has been determined after taking account of several changes of assumptions during the year. Generally, assumptions were modified in 2006 to conform to more recent experience. These changes included revisions to the assumptions regarding utilisation of free partial withdrawal options, resulting in a decrease in Deferred Acquisition Costs (DAC) of £12 million. In addition, several smaller changes relating to lapse rates, mortality rates and other assumptions, resulted in an increase of £6 million in DAC. Combined with other minor modifications, the resulting net impact of all changes during the year was a decrease in pre-tax profits of £7 million.

2005

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 DAC. Combined with other minor modifications, the resulting net impact of all changes during the year was a decrease in pre-tax profits of £7 million.

Notes on the Group financial statements continued

D3: US operations continued

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

At 31 December 2006, 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 £1,320 million (2005: £1,251 million). This value has been determined after applying the principles of valuation described in note D1. The key assumptions in these projections are the risk discount rates, which are 8.4 per cent (2005: 8.0 per cent) for variable annuity business and 5.6 per cent (2005: 5.2 per cent) for other business, and the expected ultimate 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 the value of in-force business and net worth to changes in key assumptions is as follows:

	2006 £m	2005 £m
Economic assumptions:		
Discount rates – 1% increase	**(127)**	(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	**(190)**	(144)
– 1% decrease	**116**	55
Equity/Property yields – 1% rise	**46**	42
Equity/Property market values – 10% fall	**(58)**	(55)
Non-economic assumptions:		
Maintenance expenses – 10% decrease	**32**	36
Lapse rates – 10% decrease	**110**	90
Mortality and morbidity – 5% decrease in base rates (i.e. increased longevity)	**75**	90

Notes
2005 comparatives have been adjusted to reflect the effect of equity falls where the impact of associated hedging activity on variable annuity business is now included.

(h) Sensitivity of IFRS basis profit 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 2006, the rates were US$1.84 (2005: US$1.82) and US$1.96 (2005: 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 £42 million (2005: £48 million) and £247 million (2005: £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 Jackson, industry experience and future expectations. A detailed analysis of actual experience is measured by internally developed mortality and persistency studies. For variable annuity business, the key assumption is the expected long-term level of equity market returns, which for 2006 and 2005 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.

D3: US operations continued

- 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 Jackson are relatively insensitive to changes in insurance risk.

(iii) Exposure to interest rate risk

Notwithstanding the market risk exposure described in note 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 Jackson 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 notes 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 2006 and 2005 is as follows:

	2006		2005 (note (i))	
	Fixed annuity and other business (including GICs and similar contracts) £m	**Variable annuity £m**	Fixed annuity and other usiness (including GICs and similar contracts) £m	Variable annuity £m
Policyholder liabilities	**20,379**	**11,367**	23,407	8,574
	%	%	%	%
Expected maturity:				
0 to 5 years	**53**	**48**	52	47
5 to 10 years	**26**	**30**	26	31
10 to 15 years	**11**	**13**	12	13
15 to 20 years	**5**	**6**	6	6
20 to 25 years	**3**	**2**	3	2
Over 25 years	**2**	**1**	1	1

Note
(i) The presentation of the 2005 maturity profile has been altered to a discounted basis from the previously published undiscounted basis to conform to the current year's presentation.

Notes on the Group financial statements continued

D4: Asian operations

(a) Summary balance sheet at 31 December 2006

	With-profits business £m	Unit-linked assets and liabilities £m	Other £m	**2006 Total £m**	2005 Total £m
Assets					
Intangible assets attributable to shareholders:					
Goodwill	–	–	172	**172**	172
Deferred acquisition costs and acquired in-force value of long-term business contracts	–	–	612	**612**	566
Total	–	–	784	**784**	738
Other non-investment and non-cash assets	100	28	528	**656**	566
Investments of long-term business and other operations:					
Investment properties	30	–	11	**41**	39
Financial investments:					
Loans and receivables	418	–	486	**904**	1,105
Equity securities and portfolio holdings in unit trusts	3,102	3,179	617	**6,898**	4,959
Debt securities	2,025	759	2,620	**5,404**	4,742
Other investments	35	45	11	**91**	45
Deposits	93	82	236	**411**	374
Total investments	5,703	4,065	3,981	**13,749**	11,264
Cash and cash equivalents	220	41	423	**684**	504
Total assets	**6,023**	**4,134**	**5,716**	**15,873**	13,072
Equity and liabilities					
Equity					
Shareholders' equity	–	–	1,437	**1,437**	1,288
Liabilities					
Policyholder liabilities and unallocated surplus of with-profits funds:					
Insurance contract liabilities	5,317	4,134	3,255	**12,706**	10,726
Investment contract liabilities with discretionary participation features	68	–	–	**68**	80
Investment contract liabilities without discretionary participation features	27	–	–	**27**	22
Unallocated surplus of with-profits funds	88	–	–	**88**	85
Total	5,500	4,134	3,255	**12,889**	10,913
Other non-insurance liabilities	523	–	1,024	**1,547**	871
Total liabilities	6,023	4,134	4,279	**14,436**	11,784
Total equity and liabilities	**6,023**	**4,134**	**5,716**	**15,873**	13,072

Summary policyholder liabilities (net of reinsurance) and unallocated surplus at 31 December 2006

The policyholder liabilities (net of reinsurance of £8 million (2005: £8 million)) and unallocated surplus shown in the table above reflect the following balances:

	2006 £m	2005 £m
With-profits and other non-linked business	**8,659**	8,122
Unallocated surplus of Asian operations	**88**	85
Unit-linked business	**4,134**	2,698
	12,881	10,905

D4: Asian operations continued

At 31 December 2006, the policyholder liabilities (net of reinsurance) and unallocated surplus for Asian operations of £12.9 billion (2005: £10.9 billion) comprised the following:

	2006 £m	2005 £m
Singapore	**4,355**	3,938
Hong Kong	**3,045**	2,156
Taiwan	**2,249**	2,050
Malaysia	**895**	763
Japan	**572**	631
Other countries	**1,765**	1,367
Total Asian operations	**12,881**	10,905

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

(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 Asian operations also offer health, disability, critical illness and accident coverage to supplement its core life products.

The terms and conditions of the contracts written by 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 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 endowment products offer savings and/or 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 in note D2(b) in respect of UK business broadly apply to similar types of participating contracts written in the 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 rate 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 on 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 funds and their estates.

Notes on the Group financial statements continued

D4: Asian operations continued

The most significant book of non-participating business in the 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 note (h) below.

Whole of 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 2006 of £226 million and £316 million respectively (2005: £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 Japanese 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.

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

The Asian operations sell 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 note (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 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 Asian 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 two per cent (2005: two per cent) trend towards 5.5 per cent (2005: 5.5 per cent) at 31 December 2013 (2005: 2012).

(e) Reinsurance

The Asian businesses cede only minor amounts of business outside the Group with immaterial effects on reported profit. During 2006, reinsurance premiums for externally ceded business were £47 million (2005: £37 million) and the reinsurance assets were £8 million (2005: £8 million) in aggregate.

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

2006

There are no changes of assumptions that had a material impact on the 2006 results of Asian operations.

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D4: Asian operations continued

2005

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 for 2004 and earlier, 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 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 note (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.

Consistent with the application of US GAAP for Taiwanese insurance contracts under IFRS 4, this write-off resulted from a premium deficiency as defined under paragraphs 35-37 of SFAS 60, 'Accounting and Reporting by Insurance Enterprises' (SFAS 60), and a resulting unlocking of actuarial assumptions in accordance with paragraph 21 of SFAS 60.

Under the standard liability adequacy testing required by SFAS 60, the net amount for the present value of future payments for benefits and claims less present value of future premiums, determined using revised assumptions based on actual and anticipated experience, i.e. the best estimate amount, has been compared against the balance sheet liability for policy benefits less unamortised acquisition costs.

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 2006, the EEV basis value of in-force business of the Asian operations, after taking account of the cost of encumbered capital and the cost of the time value of financial options and guarantees was £1,628 million (2005: £1,226 million). The most significant businesses in Asia are in Hong Kong, Malaysia, Singapore and Taiwan. These businesses account for 75 per cent (2005: 77 per cent) of the total value of business in force for the Asian operations. These EEV basis in-force values have been determined after applying the principles of valuation described in section D1 and the following key assumptions for the four most significant businesses.

	2006			2005		
	Risk discount rate (in-force business) ** %	**Expected long-term rate of inflation %**	**Government bond yield %**	Risk discount rate (in-force business)** %	Expected long-term rate of inflation %	Government bond yield %
Hong Kong*	**6.8**	**2.25**	**4.7**	6.15	2.25	4.8
Malaysia	**9.2**	**3.0**	**7.0**	9.0	3.0	7.0
Singapore	**6.9**	**1.75**	**4.5**	6.8	1.75	4.5
Taiwan	**9.3**	**2.25**	**5.5**	9.4	2.25	5.5

* Hong Kong business is predominantly US dollar denominated.

** Cash rates are used in setting the risk discount rates.

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 2006 were 8.7 per cent, 9.3 per cent and 12.8 per cent respectively (2005: 8.6 per cent, 9.3 per cent and 12.8 per cent respectively).

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

Notes on the Group financial statements continued

D4: Asian operations continued

The sensitivity of the value of in-force business and net worth to changes in key assumptions is as follows:

	2006 £m	2005 £m
Economic assumptions:		
Discount rates – 1% increase	**(271)**	(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	**42**	49
– 1% decrease	**(115)**	(126)
Equity/Property yields – 1% rise	**154**	136
Equity/Property market values – 10% fall	**(99)**	(75)
Non-economic assumptions:		
Maintenance expenses – 10% decrease	**45**	45
Lapse rates – 10% decrease	**93**	87
Mortality and morbidity – 5% decrease in base rates (i.e. increased longevity)	**77**	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 (as described in note (h)(ii) below).

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

(i) Currency translation

Consistent with the Group's accounting policies, the profits of the Asian operations are translated at average exchange rates and shareholders' equity at the closing rate for the reporting period. For 2006, 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 £33 million (2005: £23 million) and £116 million (2005: £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 Asian with-profits 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 Asian operations is primarily driven by charges related to invested funds. For the 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 of life business written in Taiwan.

The in-force business of the 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 eight per cent to current levels of around two 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 cost of funding in-force negative spread in Taiwan is around £40 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 period. For 2005, it was projected that rates of return for Taiwanese bond yields would trend from the then current levels of some two per cent to 5.5 per cent by 31 December 2012. For 2006, it has been assumed that the long-term bond rate will be attained one year later, i.e. by 31 December 2013.

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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 2007 and the target date for attainment of the long-term bond yield deferred to 31 December 2014, the premium reserve, net of deferred acquisition costs, would be broadly sufficient. If interest rates were to remain at current levels in 2008 with a further one year delay in the progression period, then some level of write-off of deferred acquisition costs may be necessary. However, the amount of the charge based on current in-force business, which is estimated at £70-90 million, is sensitive to the previously mentioned variables.

Furthermore, the actual amount of any write-off would be affected by the impact of new business written between 31 December 2006 and the future reporting dates to the extent that the business is taken into account as part of the liability adequacy testing calculations for the portfolio of contracts.

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 altered, the carrying value of the deferred acquisition costs and policyholder liabilities would potentially be affected.

At 31 December 2006, if the assumed long-term bond yield applied had been reduced by 0.5 per cent from 5.5 per cent to 5.0 per cent and continued to apply the same progression period to 31 December 2013, by assuming bond yields increase from current levels in equal annual instalments to the long-term rate, the premium reserve, net of deferred acquisition costs, would have been insufficient and there would have been a charge of some £60 million to the income statement. The impact of reducing the long-term rate by a further 0.5 per cent to 4.5 per cent would have increased this charge by some £160 million. The primary reason for the lower level of charge for the initial 0.5 per cent reduction is the current level of margins in the liability adequacy calculation. The effects of additional 0.5 per cent reductions in the assumed long-term rate below 4.5 per cent would be of a similar or slightly higher level to the £160 million noted previously. 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 Japanese life business exposures described in note (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:

	2006 £m	2005 £m
Policyholder liabilities	**12,801**	10,828

	%	%
Expected maturity:		
0 to 5 years	**22**	23
5 to 10 years	**20**	25
10 to 15 years	**16**	19
15 to 20 years	**13**	12
20 to 25 years	**10**	8
Over 25 years	**19**	13

Notes on the Group financial statements continued

D5: Capital position statement for life assurance businesses

(a) Summary statement

The Group's capital position for life assurance businesses with reconciliations to shareholders' equity is shown below. Available capital for each fund or group of companies is determined by reference to local regulation at 31 December 2006 and 2005.

31 December 2006	SAIF £m	WPSF (note i) £m	Total PAC with-profits fund £m	Other UK life assurance subsidiaries and funds (note ii) £m	Jackson £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 total £m
Group shareholders' equity											
Held outside long-term funds:											
Net assets	–	–	–	612	2,656	1,176	4,444	230	292	(1,519)	3,447
Goodwill	–	–	–	–	–	111	111	1,153	–	77	1,341
Total	–	–	–	612	2,656	1,287	4,555	1,383	292	(1,442)	4,788
Held in long-term funds (note iii)	–	–	–	700	–	–	700	–	–	–	700
Total Group shareholders' equity	–	–	–	1,312	2,656	1,287	5,255	1,383	292	(1,442)	5,488
Adjustments to regulatory basis											
Unallocated surplus of with-profits funds (note v)	–	13,511	13,511	–	–	88	13,599				
Shareholders' share of realistic liabilities	–	(4,000)	(4,000)	–	–	–	(4,000)				
Deferred acquisition costs of non-participating business and goodwill not recognised for regulatory reporting purposes	(5)	(26)	(31)	(146)	(1,712)	(673)	(2,562)				
Jackson surplus notes (note iv)	–	–	–	–	127	–	127				
Adjustment from IAS 19 basis pension surplus attributable to WPSF to pension liability for regulatory purposes (note vii)	–	(244)	(244)	–	–	–	(244)				
Inadmissible assets of WPSF	–	(256)	(256)	–	–	–	(256)				
Other adjustments to restate these amounts to a regulatory basis (with SAIF and the WPSF on a Peak 2 realistic basis) (note v)	5	(297)	(292)	(263)	1,012	(136)	321				
Total adjustments	0	8,688	8,688	(409)	(573)	(721)	6,985				
Total available capital resources of life assurance businesses on local regulatory bases	**0**	**8,688**	**8,688**	**903**	**2,083**	**566**	**12,240**				

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D5: Capital position statement for life assurance businesses continued

31 December 2006	SAIF £m	WPSF note (i) £m	Total PAC with-profits fund £m	Other UK subsidiaries and funds (note ii) £m	Jackson £m	Asian life assurance subsidiaries £m	Total life assurance operations £m
Policyholder liabilities							
With-profits liabilities of UK regulated with-profits funds:							
Insurance contracts	**13,162**	**31,925**	**45,087**	**–**	**–**	**2,659**	**47,746**
Investment contracts (with discretionary participating features)	**737**	**27,928**	**28,665**	**–**	**–**	**68**	**28,733**
Total	**13,899**	**59,853**	**73,752**	**–**	**–**	**2,727**	**76,479**
Other liabilities:							
Insurance contracts:							
With-profits liabilities of non-UK regulated funds	**–**	**–**	**–**	**–**	**–**	**2,658**	**2,658**
Unit-linked, including variable annuity	**–**	**2,039**	**2,039**	**7,766**	**11,367**	**4,134**	**25,306**
Other life assurance business	**231**	**12,245**	**12,476**	**12,955**	**18,817**	**3,255**	**47,503**
Investment contracts without discretionary participation features (principally unit-linked and similar contracts in the UK and GIC liabilities of Jackson) (note vi)	**–**	**12**	**12**	**11,441**	**1,562**	**27**	**13,042**
Total	**231**	**14,296**	**14,527**	**32,162**	**31,746**	**10,074**	**88,509**
Total policyholder liabilities shown in the consolidated balance sheet	**14,130**	**74,149**	**88,279**	**32,162**	**31,746**	**12,801**	**164,988**

Notes on the Group financial statements continued

D5: Capital position statement for life assurance businesses continued

31 December 2005	SAIF £m	WPSF (note i) £m	Total PAC with-profits fund £m	Other UK life assurance subsidiaries and funds (note ii) £m	Jackson £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 total £m
Group shareholders' equity											
Held outside long-term funds:											
Net assets	–	–	–	640	2,899	1,034	4,573	245	303	(1,826)	3,295
Goodwill	–	–	–	–	–	111	111	1,153	–	77	1,341
Total	–	–	–	640	2,899	1,145	4,684	1,398	303	(1,749)	4,636
Held in long-term funds (note iii)	–	–	–	558	–	–	558	–	–	–	558
Total Group shareholders' equity	–	–	–	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)	–	11,245	11,245	–	–	85	11,330				
Shareholders' share of 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)				
Jackson surplus notes (note iv)	–	–	–	–	145	–	145				
Part of IAS 19 basis pension deficit attributable to WPSF not recognised for regulatory purposes (note vii)	–	211	211	–	–	–	211				
Inadmissible assets of WPSF	–	(20)	(20)	–	–	–	(20)				
Other adjustments to restate these amounts to a regulatory basis (with SAIF and the WPSF on a Peak 2 realistic basis) (note v)	6	45	51	(271)	837	(41)	576				
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				

D5: Capital position statement for life assurance businesses continued

31 December 2005	SAIF £m	WPSF (note i) £m	Total PAC with-profits fund £m	Other UK subsidiaries and funds (note ii) £m	Jackson £m	Asian life assurance subsidiaries £m	Total life assurance operations £m
Policyholder liabilities							
With-profits liabilities of UK regulated with-profits funds:							
Insurance contracts	13,043	32,557	45,600	–	–	2,053	47,653
Investment contracts (with discretionary participating features)	751	25,692	26,443	–	–	80	26,523
Total	13,794	58,249	72,043	–	–	2,133	74,176
Other liabilities:							
Insurance contracts:							
With-profits liabilities of non-UK regulated funds	–	–	–	–	–	2,492	2,492
Unit-linked, including variable annuity	–	2,125	2,125	7,629	8,574	2,698	21,026
Other life assurance business	968	12,810	13,778	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 Jackson) (note vi)	–	–	–	10,502	1,502	22	12,026
Total	968	14,935	15,903	28,230	31,981	8,695	84,809
Total policyholder liabilities shown in the consolidated balance sheet	14,762	73,184	87,946	28,230	31,981	10,828	158,985

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 life assurance subsidiaries.

(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 Jackson 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 the principal reconciling item is deferred tax related to deferred acquisition costs of £599 million (2005: £568 million).

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

(vii) In determining the IAS 19 adjustment for the purposes of this table the surplus (deficit) in the Group's main pension scheme used for the calculation includes amounts for investments in Prudential insurance policies (see note I1).

(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.

Notes on the Group financial statements continued

D5: Capital position statement for life assurance businesses continued

(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 £8.7 billion (2005: £8.0 billion) represents the excess of assets over liabilities on the FSA 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 £1.9 billion (2005: £2.4 billion) at 31 December 2006.

The FSA's basis of setting the RCM is to target a level broadly equivalent to a Standard & Poor's credit rating of BBB and to judge 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-profits policies.

As noted in section D2(d)(ii), PAC 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, PAC expects changes to regular bonus rates to be gradual over time and changes are not expected to exceed one 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 PAC 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.

Other UK life assurance subsidiaries and funds

The available capital of £903 million (2005: £759 million) reflects the excess of regulatory basis assets over liabilities of the subsidiaries and funds, before deduction of the capital resources requirement of £809 million (2005: £718 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

The regulatory framework for Jackson 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 Jackson shown above of £2,083 million (2005: £2,257 million) reflects US regulatory basis assets less liabilities excluding asset valuation reserves. The asset valuation reserve is designed to provide for future credit-related losses on debt securities and losses on equity investments. Available capital includes the effect of the interest maintenance reserve, which is designed by state regulators to defer recognition of non-credit related realised capital gains and losses and to recognise them rateably in the future.

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

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D5: Capital position statement for life assurance businesses continued

(iii) Asian operations

The available capital shown above of £566 million (2005: £570 million) represents the excess of local regulatory basis assets over liabilities before deduction of required capital of £211 million (2005: £149 million). These amounts have been determined applying the local regulations in each of the operations.

At the country level, the businesses in Asia are subject to 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 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 four 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 four per cent of reserves plus a specified percentage of sums at risk. There is an overriding minimum capital requirement of 100 million Malaysian Ringgits.

(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 2006 is provided in the operating and financial review section of the Group's 2006 Annual Report.

(c) Movements in total available capital

Total available capital for the Group's life assurance operations has changed during 2006 as follows:

	WPSF (note i) £m	SAIF (note ii) £m	Other UK subsidiaries and funds (note iv) £m	Jackson (note iii) £m	Asian life assurance subsidiaries £m	Group total £m
Available capital at 31 December 2005	**7,979**	**–**	**759**	**2,257**	**570**	**11,565**
Changes in assumptions	61	–	(3)	–	(2)	56
Changes in management policy	–	–	–	–	–	–
Changes in regulatory requirements	–	–	80	–	–	80
New business and other factors	648	–	67	(174)	(2)	539
Available capital at 31 December 2006	**8,688**	**–**	**903**	**2,083**	**566**	**12,240**

Notes on the Group financial statements continued

D5: Capital position statement for life assurance businesses continued

Detail on the movement for 2005 is as follows:

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

Notes

(i) WPSF

The £648 million increase in available capital in 2006 for new business and other factors incorporates the effects of the strong investment returns in 2006 and the improved outlook for future investment returns.

The increase in available capital in 2005, shown in the format as previously published, arises as follows:

	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 in 2005 reflects the impact of FSA actuarial guidance note GN 45 as explained in note D2(f).

(iii) Jackson

The decrease of £174 million in 2006 reflects an underlying increase of £100 million (applying the 2006 year end exchange rate of 1.96) and £274 million of exchange translation loss.

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

(iv) Other UK life assurance subsidiaries and funds

The increase in available capital in 2006 from changes in regulatory requirements of £80 million is primarily due to regulatory changes for UK regulated shareholder-backed non-participating business from the FSA's policy statement PS06/14 confirmed in December 2006. The changes allow liabilities for this business to incorporate more economic realism. Additional details are shown in note D2.

The effect from the changes in assumptions of valuation interest rates on insurance liabilities is broadly matched by the corresponding effect on assets leaving no significant impact on the available capital.

(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-profits 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 it 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 Jackson, capital retention is maintained at a level consistent with an appropriate rating by Standard & Poor's. Currently Jackson is rated AA. Jackson 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 Jackson's statutory surplus or statutory net gain from operations for the prior year require prior regulatory approval.

D5: Capital position statement for life assurance businesses continued

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-profits 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 Singapore and Malaysian businesses may, in general, remit dividends to the UK, 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.

(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 the UK, Jackson 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, the 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 Jackson for its interest-sensitive and fixed indexed 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 which 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.

(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 their obligation to maintain the capital position of long-term funds generally, having to contribute to SAIF is remote.

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Notes on the Group financial statements continued

E: Banking operations

The Group undertakes banking operations almost wholly through its subsidiary, Egg Banking plc. Financial information in respect of Egg Banking plc, together with amounts in respect of its former parent Egg plc and its associate IfOnline, have been included in this note. Note I6 shows details of the purchase of the minority interests in Egg plc in 2006. Note I8 includes details of the agreement in January 2007 to sell Egg Banking plc and its subsidiaries.

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 from that of the Group consolidated income statement and balance sheet; however, total (loss) profit 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

The (loss) profit included in the Group consolidated income statement in respect of banking operations is as follows:

	Note	**2006 £m**	2005 £m
Interest income		**783**	893
Interest expense		**(453)**	(581)
Net interest income		**330**	312
Fee and commission income		**153**	223
Fee and commission expense		**(23)**	(23)
Other operating income		**8**	16
Operating income		**468**	528
General administrative expenses		**(192)**	(216)
Impairment losses on loans and cash advances to customers	E5	**(384)**	(241)
Other operating expenses		**(37)**	(27)
Operating (loss) profit based on longer-term investment returns before restructuring costs		**(145)**	44
Restructuring costs (part of £50m for Group)		**(12)**	–
Short-term fluctuations in investment returns		**7**	–
(Loss) profit before tax		**(150)**	44
Tax attributable to shareholders' profits		**45**	1
(Loss) profit from continuing operations after tax		**(105)**	45
Discontinued operations (net of tax)	F6	**–**	3
(Loss) profit for the year		**(105)**	48

Of the (loss) profit for the year in 2006 and 2005, a loss of £2 million and a profit of £9 million, respectively, are attributable to minority interests in Egg.

Discontinued operations above relate to Egg France and Funds Direct 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 in respect of banking operations are as follows:

	2006 £m	2005 £m
Assets		
Cash and balances with central banks	**6**	7
Loans and advances to banks	**903**	718
Securities purchased under agreement to resell	**–**	200
Loans and advances to customers	**6,193**	7,430
Investment securities	**1,976**	2,117
Derivative financial instruments	**78**	50
Other assets	**342**	230
Total assets	**9,498**	10,752
Liabilities		
Deposits by banks	**2,220**	2,452
Customer accounts	**5,554**	5,830
Debt securities issued	**599**	1,404
Derivative financial instruments	**154**	77
Other liabilities	**228**	160
Subordinated liabilities	**451**	451
Total liabilities	**9,206**	10,374
Equity		
Shareholders' equity	**292**	303
Minority interests	**–**	75
Total equity	**292**	378
Total equity and liabilities	**9,498**	10,752

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: the retail credit committee is responsible for retail credit risk, the wholesale credit committee is responsible for wholesale credit risk, the operational risk committee is responsible for operational risk and the asset and liability committee (ALCO) is responsible 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.

Notes on the Group financial statements continued

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 liquidity 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 2006	**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	**6**	**–**	**–**	**–**	**–**	**6**
Loans and advances to banks	**876**	**–**	**–**	**2**	**25**	**903**
Loans and advances to customers	**1**	**2,725**	**42**	**1,338**	**2,087**	**6,193**
Investment securities	**466**	**696**	**176**	**266**	**372**	**1,976**
Derivative financial instruments	**61**	**–**	**17**	**–**	**–**	**78**
Other assets	**68**	**159**	**41**	**74**	**–**	**342**
Total assets	**1,478**	**3,580**	**276**	**1,680**	**2,484**	**9,498**
Liabilities						
Deposits by banks	**18**	**–**	**516**	**1,686**	**–**	**2,220**
Customer accounts	**5,427**	**3**	**68**	**56**	**–**	**5,554**
Debt securities issued	**–**	**–**	**553**	**46**	**–**	**599**
Derivative financial instruments	**56**	**–**	**–**	**98**	**–**	**154**
Other liabilities	**117**	**68**	**43**	**–**	**–**	**228**
Subordinated liabilities	**–**	**–**	**–**	**–**	**451**	**451**
Total liabilities	**5,618**	**71**	**1,180**	**1,886**	**451**	**9,206**
Net liquidity gap	**(4,140)**	**3,509**	**(904)**	**(206)**	**2,033**	**292**

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	–	3,343	40	1,421	2,626	7,430
Investment securities	157	439	633	352	536	2,117
Derivative financial instruments	–	–	50	–	–	50
Other assets	3	4	91	125	7	230
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
Derivative financial instruments	77	–	–	–	–	77
Other liabilities	8	34	118	–	–	160
Subordinated liabilities	–	–	–	–	451	451
Total liabilities	5,909	50	1,026	2,938	451	10,374
Net liquidity gap	(4,906)	3,786	(212)	(1,035)	2,745	378

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 2006 and 2005. 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.

	2006 £m	2005 £m
Balance at the beginning of the year	**335**	250
Amounts written off	**(201)**	(161)
New and additional provisions	**384**	241
Transition adjustment to reflect adoption of IAS 39 at 1 January 2005	**–**	5
Balance at the end of the year	**518**	335

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 are provided below:

	2006 £m		2005 £m	
Assets				
Debt securities available-for-sale*	**1,935**	**5.3%**	2,046	4.6%
Loans and receivables	**7,096**	**9.0%**	8,148	7.5%
	9,031		10,194	
Liabilities				
Banking customer accounts	**5,554**	**4.9%**	5,830	4.3%
Core structural borrowings of shareholder-financed operations	**451**	**6.2%**	451	8.5%
Operational borrowings attributable to shareholder-financed operations	**2,819**	**5.4%**	3,856	4.5%
	8,824		10,137	

* Egg has also classified £41 million (2005: £71 million) of debt securities as fair value through profit and loss.

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 2006, Egg held £357 million of assets and £1,751 million of liabilities with foreign currency exposure (2005: £539 million and £2,640 million respectively).

Notes on the Group financial statements continued

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.

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 2006 and 2005:

	2006 £m	2005 £m
UK	**18,132**	18,840
Rest of Europe	**244**	399
Other	**243**	380
Total*	**18,619**	19,619

*This includes £9,475 million (2005: £9,104 million) of off-balance sheet items, which mainly relate to unutilised credit limits on credit cards.

The following is a breakdown of the credit risk borne by Egg for financial assets and off-balance sheet items at 31 December 2006 and 2005:

	2006 £m	2005 £m
Loans and advances to banks	**903**	718
Securities purchased under agreement to resell	**–**	200
Investment securities	**1,970**	2,117
Loans and advances to customers	**6,711**	7,765
Allowances for impairment losses on loans and advances to customers	**(518)**	(335)
Fair value of derivative assets	**78**	50
Off-balance sheet items (including unutilised credit limits on credit cards)	**9,475**	9,104
Total credit risk net of allowances and provisions	**18,619**	19,619

At 31 December 2006, Egg had certain credit-related commitments in the form of unused credit limits on credit cards of £9,458 million (2005: £9,061 million) and pre-approved but unused borrowing limits on mortgages and personal loans of £8 million and £9 million respectively (2005: £14 million and £29 million respectively) which are included in off-balance sheet items above. 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, 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 2006, this was estimated at £8.7 billion (2005: £10.9 billion) of which £3.9 billion (2005: £5.7 billion) related to derivative financial instruments and £1.8 billion (2005: £2.3 billion) to credit default swaps. Egg also has significant credit exposure in asset-backed security products which totalled approximately £403 million at 31 December 2006 (2005: £496 million). 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 of repurchase agreements was £nil and £5.2 million at 31 December 2006 and 2005, respectively. Collateral in respect of over-the-counter derivative transactions was £29.3 million and £30.9 million at 31 December 2006 and 2005, respectively. See note G4 where amounts relating 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 years ended 31 December 2006 and 2005 are as follows:

	2006 £m	2005 £m
Revenue		
Long-term business	**34,197**	39,296
Banking	**914**	1,115
Broker-dealer and fund management	**1,080**	895
Unallocated corporate	**38**	98
Intra group revenue eliminated on consolidation	**(284)**	(279)
Total revenue, net of reinsurance per income statement	**35,945**	41,125
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	**(32,162)**	(36,997)
Banking	**(1,064)**	(1,071)
Broker-dealer and fund management	**(797)**	(741)
Unallocated corporate	**(135)**	(450)
Intra group charges eliminated on consolidation	**284**	279
Total charges per income statement	**(33,874)**	(38,980)
Segment results – revenue less charges (continuing operations)		
Long-term business	**2,035**	2,299
Banking	**(150)**	44
Broker-dealer and fund management	**283**	154
Unallocated corporate	**(97)**	(352)
Profit before tax*	**2,071**	2,145
Tax attributable to policyholders' returns	**(849)**	(1,147)
Profit before tax attributable to shareholders	**1,222**	998
Tax attributable to shareholders' profits	**(347)**	(241)
Profit from continuing operations after tax	**875**	757
Segment results – discontinued operations		
Banking	**–**	3
Profit for the year	**875**	760

* 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.

Within segment results above, the share of post-tax profit of associates that are equity accounted for of £1 million (2005: £nil) is allocated 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 £12,130 million (2005: £12,745 million) of non-cash expenses other than depreciation and amortisation 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.

Notes on the Group financial statements continued

F1: Segmental information continued

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	2006 £m	2005 £m
UK	**22,126**	30,688
US	**8,562**	6,912
Asia	**5,541**	3,804
Intra group revenue	**(284)**	(279)
Total revenue per income statement	**35,945**	41,125

F2: Revenue

	2006 £m	2005 £m
Long-term business premiums		
Insurance contract premiums	**13,805**	13,583
Investment contracts with discretionary participation feature premiums	**1,249**	1,366
Inwards reinsurance premiums	**1,103**	276
Less: reinsurance premiums ceded	**(171)**	(197)
Earned premiums, net of reinsurance	**15,986**	15,028
Realised and unrealised gains and losses on securities at fair value through profit and loss	**6,887**	14,640
Realised losses on available-for-sale securities, previously recognised directly in equity	**(7)**	(22)
Interest (note i)	**6,609**	5,896
Dividends	**3,666**	2,731
Other investment income	**749**	768
Investment income	**17,904**	24,013
Fee income from investment contract business, fund management, banking and broker-dealer services	**1,024**	926
Income from consolidated venture investments of the PAC with-profits funds	**1,031**	1,158
Other income	**2,055**	2,084
Total revenue	**35,945**	41,125

Note
(i) 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

	2006 £m	2005 £m
Acquisition costs (note i)	**1,238**	1,413
Staff and pension costs (see note I1)	**723**	991
Administrative and operating costs (note ii)	**3,282**	3,148
Total acquisition costs and other operating expenditure	**5,243**	5,552

Notes
(i) Acquisition costs in 2006 comprise amounts related to insurance contracts of £1,165 million (2005: £1,307 million), and investment contracts and investment management contracts of £73 million (2005: £106 million). These costs include amortisation of £299 million (2005: £392 million) and £6 million (2005: £9 million) respectively.

(ii) Administrative and operating costs include total depreciation and amortisation expense amounting to £516 million (2005: £541 million). Of this amount, £305 million (2005: £401 million) relates to amortisation of deferred acquisition costs of insurance contracts and investment management contracts, which is primarily borne by the long-term business segment. Of the remainder of the depreciation and amortisation charge of £211 million (2005: £140 million), £156 million (2005: £101 million) relates to long-term business, £44 million (2005: £28 million) to banking, £8 million (2005: £8 million) to fund management and £3 million (2005: £3 million) to central companies.

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

Finance costs consist of £177 million (2005: £175 million) interest on core debt of the parent company and related finance subsidiaries and Jackson surplus notes and of £33 million (2005: £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:

	2006 £m	2005 £m
Current tax expense:		
Corporation tax	**645**	722
Adjustments in respect of prior years	**(38)**	(209)
Benefit from a previously unrecognised tax loss, tax credit or temporary difference from a prior period	**–**	(2)
Total current tax	**607**	511
Deferred tax arising from:		
Origination and reversal of temporary differences	**556**	870
Benefit from a previously unrecognised tax loss, tax credit or temporary difference from a prior period	**33**	5
Write-down or reversal of a previous write-down of a deferred tax asset	**–**	2
Total deferred tax	**589**	877
Total tax expense	**1,196**	1,388

The total tax expense arises as follows:

	2006 £m	2005 £m
Current tax expense:		
UK	**334**	339
Foreign	**273**	172
	607	511
Deferred tax expense:		
UK	**319**	780
Foreign	**270**	97
	589	877
Total	**1,196**	1,388

The total deferred tax expense arises as follows:

	2006 £m	2005 £m
Unrealised gains and losses on investments	**236**	599
Short-term timing differences	**156**	263
Capital allowances	**4**	13
Balances relating to investment and insurance contracts	**198**	3
Unused tax losses	**(5)**	(1)
Deferred tax expense	**589**	877

In 2006, a deferred tax credit of £41 million (2005: £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 £548 million in the Group's net deferred tax liability (2005: £784 million).

In 2006, there is no tax relating to discontinued operations (2005: £nil) (see note F6).

Notes on the Group financial statements continued

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:

	2006 £m	2005 £m
Profit before tax	**2,071**	2,145
Tax attributable to policyholders' returns	**(849)**	(1,147)
Profit before tax attributable to shareholders	**1,222**	998
Tax attributable to shareholders' profits:		
Tax expense	**(1,196)**	(1,388)
Less: tax attributable to policyholders' returns	**849**	1,147
Tax attributable to shareholders' profits	**(347)**	(241)
Profit from continuing operations after tax	**875**	757

(ii) Overview

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:

	2006			2005		
	Attributable to shareholders £m	Attributable to policyholders* £m	Total £m	Attributable to shareholders £m	Attributable to policyholders* £m	Total £m
Profit before tax	**1,222**	**849**	**2,071**	998	1,147	2,145
Taxation charge:						
Expected tax rate	**31%**	**100%**	**59%**	35%	100%	70%
Expected tax charge	**(374)**	**(849)**	**(1,223)**	(353)	(1,147)	(1,500)
Variance from expected tax charge (note v(ii))	**27**	**–**	**27**	112	–	112
Actual tax charge	**(347)**	**(849)**	**(1,196)**	(241)	(1,147)	(1,388)
Average effective tax rate	**28%**	**100%**	**58%**	24%	100%	65%

* For the column entitled 'Attributable to policyholders', the 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 and unit-linked policies.

Due to the requirements of the financial reporting standards IAS 1 and IAS 12, the profit before tax and tax charge reflect the aggregate of amounts that are attributable to shareholders and policyholders.

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 total 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. This feature arises from the basis of taxation applied to life and pension business, principally in the UK, but with similar bases applying in certain Asian operations, and is explained in note (iii) below.

Furthermore, the basis of preparation of Prudential's financial statements incorporates the additional feature that, as permitted under IFRS 4, the residual equity of the Group's with-profits funds, i.e. unallocated surplus, is recorded as a liability with transfers to and from that liability reflected in pre-tax profits. This gives rise to anomalous effective tax rates for profits attributable to policyholders (as described in note (iv) below).

In meeting the reconciliation requirements set out in paragraph 81(c) of IAS 12, the presentation shown in this disclosure note seeks to ensure that the explanation of the relationship between tax expense and accounting profit draw properly the distinction between the elements of the profit and tax charge that are attributable to policyholders and shareholders as explained below in notes (iv) and (v), respectively. The shareholder elements are the components of the profit and tax charge that are of most direct relevance to investors, and it is this aspect that the IAS 12 requirement is seeking to explain for companies that do not need to account for both with-profits and unit-linked funds, where tax is borne by the Company on the policyholders' behalf and which is not contemplated by IFRS requirements.

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F5: Tax continued

(iii) Basis of taxation for UK life and pension business

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 referrable to pension business, and some other less significant classes of business, is exempt from taxation, but tax is charged on the profit that shareholders derive from writing such business at the corporate rate of tax. The rules for taxing life insurance business are more complex. Initially, the UK regime seeks to tax the regulatory basis investment return less management expenses (I-E) on this business as it arises. However, in determining the actual tax charge, a calculation of the shareholder profits for taxation purposes from writing life insurance business also has to be made and compared with the I-E profit.

If the shareholder profit is higher than the I-E amount, then relief for expenses in the I-E calculation has to be restricted until the I-E profit equals the shareholder profit. If on the other hand, the 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, as defined for taxation purposes by reference to the Company's regulatory returns (rather than IFRS basis results), 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.

It is to be noted that the calculations described are determined using data from the regulatory basis returns rather than the IFRS basis results. The differences between the regulatory and accounting bases are significant and complex.

(iv) Profits attributable to policyholders and related tax

As noted above, it is necessary under IFRS requirements to include the total tax charge of the Company (both policyholder and shareholder elements) in the tax charge disclosed in the income statement.

For with-profits business, total pre-tax profits reflect the aggregate of profits attributable to policyholders and shareholders. However, amounts attributable to the equity of with-profits funds are carried in the liability for unallocated surplus. Also, as described in note (iii), UK with-profits 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. The statutory transfer represents 10 per cent of the actuarially determined surplus for the year that is attributable to shareholders.

For SAIF similar transfers are made. However, in the case of SAIF, a net nil balance is derived, reflecting the lack of shareholder interest in the financial performance of the fund (other than through investment management arrangements).

The accounting anomaly that arises under IFRS is that due to the fact that the net of tax profit attributable to with-profits policyholders is zero, the Company's presentation of pre-tax profit attributable to policyholders reflects an amount that is the mirror image of the tax charge attributable to policyholders.

For unit-linked business, pre-tax profits also reflect the aggregate of profits attributable to policyholders and shareholders. The pre-tax profits attributable to policyholders represent fees earned that are used to pay tax borne by the Company on policyholders' behalf. The net of tax profit attributable to policyholders for unit-linked business is thus zero.

The combined effect of these features is such that providing a reconciliation of the tax charge attributable to policyholders to an expected charge based on the standard corporate rate of tax on IFRS basis profits attributable to policyholders is not relevant.

In summary, for accounting purposes, in all cases and for all reporting periods, the apparent effective rate for profit attributable to policyholders and unallocated surplus is 100 per cent. However, it is to be noted that the 100 per cent rate does not reflect a rate paid on the profits attributable to policyholders. It instead 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 and IFRS requirements in respect of reporting of all pre-tax profits and all tax charges irrespective of policyholder or shareholder economic interest.

Notes on the Group financial statements continued

F5: Tax continued

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

2006	UK insurance operations £m	Jackson £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 (note iii)	**469**	**398**	**175**	**(149)**	**893**
Short-term fluctuations in investment returns	**(43)**	**53**	**134**	**18**	**162**
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	**0**	**0**	**0**	**167**	**167**
Total	**426**	**451**	**309**	**36**	**1,222**
Expected tax rate (note i):					
Operating profit based on longer-term investment returns (note iii)	**30%**	**35%**	**25%**	**30%**	**31%**
Short-term fluctuations in investment returns	**30%**	**35%**	**25%**	**30%**	**28%**
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	**30%**	**35%**	**25%**	**30%**	**30%**
Total	**30%**	**35%**	**25%**	**30%**	**31%**
Expected tax charge based on expected tax rates:					
Operating profit based on longer-term investment returns (note iii)	**(141)**	**(139)**	**(44)**	**45**	**(279)**
Short-term fluctuations in investment returns	**13**	**(19)**	**(33)**	**(6)**	**(45)**
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	**0**	**0**	**0**	**(50)**	**(50)**
Total	**(128)**	**(158)**	**(77)**	**(11)**	**(374)**
Variance from expected tax charge (note ii):					
Operating profit based on longer-term investment returns (note iii)	**23**	**5**	**(10)**	**4**	**22**
Short-term fluctuations in investment returns	**(4)**	**3**	**5**	**1**	**5**
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	**0**	**0**	**0**	**0**	**0**
Total	**19**	**8**	**(5)**	**5**	**27**
Actual tax charge:					
Operating profit based on longer-term investment returns (note iii)	**(118)**	**(134)**	**(54)**	**49**	**(257)**
Short-term fluctuations in investment returns	**9**	**(16)**	**(28)**	**(5)**	**(40)**
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	**0**	**0**	**0**	**(50)**	**(50)**
Total	**(109)**	**(150)**	**(82)**	**(6)**	**(347)**
Actual tax rate: operating profit	**25%**	**34%**	**31%**	**33%**	**29%**
: total	**26%**	**33%**	**27%**	**17%**	**28%**

F5: Tax continued

2005	UK insurance operations £m	Jackson £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 (note iii)	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)	0	3	(33)	(50)
Total	416	526	210	(154)	998
Expected tax rate (note i):					
Operating profit based on longer-term investment returns (note iii)	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%	35%	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 (note iii)	(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	0	10	16
Total	(125)	(184)	(54)	10	(353)
Variance from expected tax charge (note ii):					
Operating profit based on longer-term investment returns (note iii)	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	0	(1)
Total	(3)	8	(8)	115	112
Actual tax charge:					
Operating profit based on longer-term investment returns (note iii)	(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	0	10	15
Total	(128)	(176)	(62)	125	(241)
Actual tax rate: operating profit	29%	35%	36%	(344)%	19%
: total	31%	33%	30%	(81)%	24%

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 result. In 2005, the expected tax rate on total profits of 35 per cent was due to the inclusion of a goodwill impairment charge of £120 million which is not allowable for tax. In 2006, no goodwill impairment charge has been booked, and the expected tax rate on total profits of 31 per cent is lower in part due to this, and additionally due to the Asian long-term business (which is subject to lower tax rates than the UK and US) being a greater proportion of Group results.

Notes on the Group financial statements continued

F5: Tax continued

Notes continued
(ii) Variances from expected tax charge for results attributable to shareholders
For 2006, the principal variances arise from differences between the standard corporation tax rate and actual rates due to a number of factors, including:

(a) The tax credit arising from relief for excess expenses in respect of the shareholder-backed protection business.

(b) Prior year adjustments arising from routine revisions of tax returns.

For 2005, 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 (HMRC) at amounts below those previously provided. The settlements related to a range of issues affecting both shareholder and policyholder taxes. Many of the issues had been in dispute for several years. The principal issues resolved were as follows:

Firstly, HMRC had disputed the deductibility of commissions paid on credit life (protection) insurance. Prudential's treatment of the commissions was consistent with industry practice. At the start of 2005 it looked likely that the dispute would only be settled through litigation. However, it proved possible to negotiate a settlement acceptable to both parties.

Secondly, in 2000 Prudential transferred the insurance business previously carried on by two M&G subsidiaries into another subsidiary, Scottish Amicable Life (SAL). In 2002, Prudential transferred the entire business of SAL (including the old M&G business) into Prudential Assurance Company Limited. Both of these transactions were conducted under a statutory framework, which included obtaining High Court approval. The transactions were complex, leading to a difference in views between HMRC and Prudential as to the correct tax treatment of the transactions. These differences were resolved through a negotiated settlement.

(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.

(iii) For 2006, operating profit based on longer-term investment returns is net of attributable restructuring costs and development expenses. In 2005, operating profit based on longer-term investment returns is net of development expenses.

F6: Discontinued operations

	2006 £m	2005 £m
Profit generated by discontinued operations		
Revenue	–	1
Expenses	–	2
Pre-tax profit on results of discontinued operations	–	3
Taxation	–	0
Post-tax profit on results of discontinued operations	–	3
Post-tax profit from discontinued operations	–	3

In the year ended 31 December 2005, discontinued operations comprised of Egg France and Funds Direct, both of which are included within banking operations in the segment analysis. The £3 million post-tax profit reported is comprised of £4 million from the release of surplus provision on the completion of the exit process from France, by Egg, partially offset by £1 million losses incurred by Funds Direct which was sold by Egg in October 2005.

For the purposes of the 2006 financial statements, Egg is reported as part of continuing operations. Note I8 provides details of the agreement to sell Egg after the balance sheet date.

G: Financial assets and liabilities

G1: Financial instruments – designation and fair values

The Group designates all financial assets as either fair value through profit and loss, available-for-sale, or as loans and receivables. 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.

2006	**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	**–**	**–**	**7,759**	**7,759**	**7,759**
Equity securities and portfolio holdings in unit trusts	**78,892**	**–**	**–**	**78,892**	**78,892**
Debt securities (note i)	**59,812**	**21,907**	**–**	**81,719**	**81,719**
Loans and receivables	**–**	**–**	**11,573**	**11,573**	**12,093**
Other investments (note ii)	**5,401**	**–**	**–**	**5,401**	**5,401**
Accrued investment income	**–**	**–**	**1,900**	**1,900**	**1,900**
Other debtors	**–**	**–**	**1,052**	**1,052**	**1,052**
	144,105	**21,907**	**22,284**	**188,296**	

2006	**Fair value through profit and loss £m**	**Amortised cost £m**	**IFRS 4 £m**	**Total carrying value £m**	**Fair value £m**
Financial liabilities					
Banking customer accounts	**–**	**5,554**	**–**	**5,554**	**5,554**
Core structural borrowings of shareholder-financed operations (note iii and note H13)	**–**	**3,063**	**–**	**3,063**	**3,297**
Operational borrowings attributable to shareholder-financed operations (note H13)	**–**	**5,609**	**–**	**5,609**	**5,609**
Borrowings attributable to with-profits funds (note H13)	**553**	**1,223**	**–**	**1,776**	**1,798**
Obligations under funding, securities lending and sale and repurchase agreements	**–**	**4,232**	**–**	**4,232**	**4,229**
Net asset value attributable to unit holders of consolidated unit trust and similar funds	**2,476**	**–**	**–**	**2,476**	**2,476**
Investment contracts with discretionary participation features (note iii)	**–**	**–**	**28,733**	**28,733**	**–**
Investment contracts without discretionary participation features	**11,480**	**1,562**	**–**	**13,042**	**13,035**
Accruals and deferred income	**–**	**517**	**–**	**517**	**517**
Other creditors	**–**	**1,398**	**–**	**1,398**	**1,398**
Other liabilities (including derivatives)	**663**	**989**	**–**	**1,652**	**1,652**
	15,172	**24,147**	**28,733**	**68,052**	

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 i)	56,814	25,657	–	82,471	82,471
Loans and receivables	–	–	13,245	13,245	14,268
Other investments (note ii)	3,879	–	–	3,879	3,879
Accrued investment income	–	–	1,791	1,791	1,791
Other debtors	–	–	1,305	1,305	1,305
	132,678	25,657	23,968	182,303	

Notes on the Group financial statements continued

G1: Financial instruments – designation and fair values continued

2005	Fair value through profit and loss £m	Amortised cost £m	IFRS 4 £m	Total 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)	–	3,190	–	3,190	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, securities 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 iii)	–	–	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	919	–	1,770	1,770
	12,899	25,725	26,523	65,147	

Notes

(i) As at 31 December 2006, £624 million (2005: £450 million) of convertible bonds were included in debt securities and £279 million (2005: £311 million) were included in borrowings.

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

(iii) 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.

Determination of fair value

The fair values of the Group's quoted investments are based on current bid prices. If the market for a financial investment of the Group is not active, the Group establishes fair value by using quotations from independent third parties, such as brokers, or by using valuation techniques. The fair value of investments valued using a valuation technique at 31 December 2006 was £4,548 million (31 December 2005: £4,947 million). 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, 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.

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 determined using quotations from independent third parties or valued internally using standard market practices. In accordance with the Group's risk management framework, all internally generated valuations are subject to independent assessment against external counterparties' valuations.

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.

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G1: Financial instruments – designation and fair values continued

Use of valuation techniques

Valuation techniques – UK

Of the financial investments that are not quoted on active markets, assets with a fair value at 31 December 2006 of £3,959 million (2005: £3,729 million) were held by UK operations. £3,563 million (2005: £3,466 million) of this amount related to assets held by with-profits operations and £396 million (2005: £263 million) related to assets held by the shareholder-backed UK annuity subsidiary Prudential Retirement Income Limited (PRIL). 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 Group's Fair Value Committees which comprise members who are independent of the fund managers involved in the day-to-day trading in these assets.

The total amount of the change in fair value estimation 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 2006 was a loss of £63 million (2005: a gain of £82 million) for the with-profits fund investments. Changes in values of assets of the with-profits funds are reflected in policyholder liabilities and unallocated surplus. Due to the liability accounting treatment of unallocated surplus, changes in values of securities held by with-profits funds have no direct effect on the profit or loss or shareholders' equity.

The total amount of the change in fair value estimation using valuation techniques, including those based on assumptions not wholly supported by observable market prices or rates, recognised in the profit and loss account in 2006 and which was attributable to shareholders, was a loss of £12 million (2005: a gain of £11 million) for the PRIL investments.

Valuation techniques – US

The other financial investments which are not quoted on active markets were assets held by Jackson that had a fair value of £589 million (2005: £1,218 million).

The US operations of Prudential had two groups of assets which were valued using valuation techniques – derivatives that are accounted for under IAS 39 on a fair value through profit and loss basis and securities held by the Piedmont trust entity, an 80 per cent Jackson held static trust formed as a result of a securitisation of asset-backed securities in 2003 that are accounted for on an available-for-sale basis. As at 31 December 2006, the fair value of the derivative and Piedmont assets valued using valuation techniques was £184 million and £405 million, respectively (2005: £518 million and £700 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.

Significant estimates and judgements 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 2006 totalled £372 million, a difference of £33 million (2005: £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 for the year ended 31 December 2006 was £2,775 million (2005: £2,662 million).

The interest expense on financial liabilities not at fair value through profit and loss for the year ended 31 December 2006 was £890 million (2005: £893 million).

Notes on the Group financial statements continued

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 is analysed between those exposed to fair value interest rate risk, cash flow interest rate risk and those with no direct interest rate risk exposure:

2006	**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	**4,872**	**2,887**	**–**	**7,759**
Debt securities	**55,504**	**26,215**	**–**	**81,719**
Loans and receivables	**4,521**	**7,052**	**–**	**11,573**
Other investments (including derivatives)	**292**	**2,601**	**2,508**	**5,401**
	65,189	**38,755**	**2,508**	**106,452**
Financial liabilities				
Banking customer accounts	**–**	**5,554**	**–**	**5,554**
Core structural borrowings of shareholder-financed operations	**3,063**	**–**	**–**	**3,063**
Operational borrowings attributable to shareholder-financed operations	**2,282**	**3,320**	**7**	**5,609**
Borrowings attributable to with-profits funds	**1,486**	**219**	**71**	**1,776**
Obligations under funding, securities lending and sale and repurchase agreements	**851**	**3,381**	**–**	**4,232**
Investment contracts without discretionary participation features	**1,562**	**–**	**11,480**	**13,042**
Other liabilities (including derivatives)	**393**	**379**	**880**	**1,652**
	9,637	**12,853**	**12,438**	**34,928**

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	3,190	–	–	3,190
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)	276	380	1,114	1,770
	7,446	16,478	11,751	35,675

G2: Market risk continued

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

	2006		2005	
	Amount £m	Weighted average interest rate %	Amount £m	Weighted average interest rate %
Term to maturity:				
Less than 1 year	–	–	16	11.9
1 to 5 years	**2**	**8.9**	58	5.4
5 to 10 years	**55**	**6.9**	52	7.4
10 to 15 years	**19**	**6.7**	27	7.4
15 to 20 years	–	–	9	5.3
Over 20 years	**7**	**6.5**	5	5.6
	83		167	

Of the above commitments £39 million (2005: £104 million) relates to US operations, £9 million (2005: £32 million) relates to the banking operations, £16 million (2005: £31 million) relates to Asian operations and £19 million (2005: £nil) relates to the UK operations.

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:

	2006		2005	
	Balance of financial instruments not at fair value through profit and loss £m	Range of effective interest rates applicable as at 31 Dec 2006 %	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	**7,759**	**2.4 – 5.4**	7,627	1.6 – 5.4
Debt securities	**21,907**	**5.2 – 17.8**	25,657	4.0 – 8.0
Loans and receivables:				
Mortgage loans	**4,421**	**3.7 – 10.7**	4,928	2.3 – 7.6
Policy loans	**819**	**3.0 – 8.8**	865	3.0 – 9.0
Other loans	**6,333**	**6.7 – 11.0**	7,452	4.5 – 10.5
	41,239		46,529	
Liabilities				
Banking customer accounts (note E2)	**5,554**	**0.9 – 5.5**	5,830	1.6 – 5.0
Core structural borrowings of shareholder-financed operations (note H13)	**3,063**	**5.5 – 9.4**	3,191	5.5 – 9.4
Operational borrowings attributable to shareholder-financed operations (note H13)	**5,609**	**5.9 – 8.2**	6,432	2.2 – 6.5
Borrowings attributable to with-profits funds	**1,223**	**3.0 – 7.6**	1,339	6.0 – 10.0
Obligations under funding, stocklending and sale and repurchase agreements	**4,232**	**2.6 – 6.2**	4,529	2.4 – 8.0
Investment contracts without discretionary participation features	**1,562**	**2.0 – 8.2**	1,502	2.0 – 8.2
Other liabilities (including derivatives)	**989**	**0.0 – 0.0**	918	0.0 – 0.0
	22,232		23,741	

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

Notes on the Group financial statements continued

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G2: Market risk continued

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:

2006	**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	**7,656**	**33**	**19**	**–**	**–**	**51**	**–**	**7,759**
Debt securities	**3,395**	**14,712**	**19,227**	**10,121**	**8,395**	**25,333**	**536**	**81,719**
Loans and receivables	**2,905**	**2,803**	**3,168**	**743**	**716**	**350**	**888**	**11,573**
Other investments (including derivatives)	**2,615**	**209**	**129**	**106**	**5**	**237**	**2,100**	**5,401**
	16,571	**17,757**	**22,543**	**10,970**	**9,116**	**25,971**	**3,524**	**106,452**
Financial liabilities								
Banking customer accounts (note E2)	**5,498**	**56**	**–**	**–**	**–**	**–**	**–**	**5,554**
Core structural borrowings of shareholder-financed operations (note H13)	**150**	**248**	**250**	**536**	**313**	**803**	**763**	**3,063**
Operational borrowings attributable to shareholder-financed operations (note H13)	**3,135**	**1,793**	**521**	**–**	**–**	**160**	**–**	**5,609**
Borrowings attributable to with-profits funds (note H13)	**33**	**331**	**541**	**–**	**19**	**57**	**795**	**1,776**
Obligations under funding, stocklending and sale and repurchase agreements	**4,232**	**–**	**–**	**–**	**–**	**–**	**–**	**4,232**
Other liabilities (including derivatives)	**1,033**	**301**	**19**	**39**	**7**	**125**	**128**	**1,652**
	14,081	**2,729**	**1,331**	**575**	**339**	**1,145**	**1,686**	**21,886**

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 (note E2)	5,790	40	–	–	–	–	–	5,830
Core structural borrowings of shareholder-financed operations (note H13)	–	399	249	–	857	820	865	3,190
Operational borrowings attributable to shareholder-financed operations (note H13)	2,440	3,040	–	139	–	813	–	6,432
Borrowings attributable to with-profits funds (note H13)	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	71	30	68	130	119	1,770
	13,894	4,044	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 2006, the Group held 16 per cent (2005: 18 per cent) and 15 per cent (2005: 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 90 per cent (2005: 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 14 per cent (2005: 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 (note G3 below).

The amount of exchange gains recognised in the income statement in 2006, except for those arising on financial instruments measured at fair value through profit and loss, is £73 million (2005: £152 million). This constitutes £107 million (2005: £134 million) gains on Medium-Term Notes (MTN) liabilities and £34 million of net losses (2005: £18 million net gains), mainly arising on investments of the PAC with-profits fund. The gains on MTN liabilities are fully offset by value movements on cross-currency swaps, which are measured at fair value through profit and loss.

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 2006 were as follows:

2006	**UK insurance operations £m**	**US £m**	**Banking operations £m**	**Other operations £m**	**Total £m**
Derivative assets	**476**	**254**	**78**	**90**	**898**
Derivative liabilities	**(268)**	**(92)**	**(154)**	**(149)**	**(663)**
	208	**162**	**(76)**	**(59)**	**235**

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.

Notes on the Group financial statements continued

G3: Derivatives and hedging continued

The notional amount of the derivatives, distinguishing between UK insurance, US, banking and other operations was as follows:

	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	
As at 31 December 2006	**Asset £m**	**Liability £m**	**Asset £m**	**Liability £m**	**Asset £m**	**Liability £m**
Cross-currency swaps*	**579**	**499**	**537**	**26**	**348**	**360**
Equity index call options	**–**	**–**	**583**	**12**	**–**	**–**
Swaptions	**1,125**	**–**	**13,540**	**11,751**	**–**	**–**
Futures	**2,306**	**2,463**	**–**	**274**	**–**	**–**
Forwards*	**12,614**	**12,465**	**–**	**–**	**383**	**376**
Inflation swaps	**1,109**	**1,109**	**–**	**–**	**–**	**–**
Credit default swaps	**–**	**–**	**–**	**–**	**1,787**	**–**
Single stock options	**–**	**6**	**–**	**–**	**–**	**–**
Credit derivatives	**–**	**–**	**–**	**18**	**–**	**–**
Put options	**–**	**–**	**2,708**	**–**	**–**	**–**
FTSE swap	**–**	**–**	**–**	**–**	**49**	**49**
Total return swaps	**895**	**833**	**230**	**65**	**–**	**–**
Interest rate swaps	**2,976**	**3,388**	**2,407**	**1,988**	**3,117**	**3,117**

	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	
As at 31 December 2005	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 £754 million (2005: £2,761 million) and £1,743 million (2005: £2,692 million) respectively, forward currency contracts assets and liabilities with notional amounts of £443 million (2005: £501 million) and £63 million (2005: £167 million) respectively, interest rate swaps of £1,856 million (2005: £1,310 million) and £1,856 million (2005: £1,310 million) respectively and inflation swap liabilities with notional amounts of £150 million (2005: £nil).

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 note D3 for use of derivatives by the Group's US operations.

The Group uses various interest rate derivative instruments such as interest rate swaps to reduce exposure to interest rate volatility.

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.

G3: Derivatives and hedging continued

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. During 2006, the Group entered into a transaction to extend the term of the interest rate swap in this hedging relationship from 30 years to 50 years. In addition, the Group entered into a US$300 million fair value hedge in June 2006 to hedge the interest exposure on its US$300 million, 6.5 per cent perpetual subordinated capital securities.

Jackson has had a collar fair value hedge in place since 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 using interest rate and cross currency interest rate swaps, with the effective part of any gain or loss on the swaps recognised directly in equity. As at 31 December 2006, the notional amount of this cash flow hedge was £1,711 million (2005: £2,296 million). The cash flows are periodically updated based on the underlying banking portfolios. The net movement on ineffective positions of cash flow hedges recognised in the income statement in 2006 was a loss of £nil (2005: £0.2 million)

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 three-month period 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 forward currency contracts were renewed throughout 2006. The forward currency contracts in place at 31 December 2006 expire in March 2007.

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 Jackson. The carrying value of the subordinated capital securities was £763 million (2005: £865 million) as at 31 December 2006. The foreign exchange gain of £110 million (2005: loss of £78 million) on translation of the borrowings to pounds sterling at the balance sheet date is recognised in the translation reserve in shareholders' equity.

The net investment hedges were 100 per cent effective.

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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 2006, the Group had lent £11,418 million (2005: £10,594 million) (of which £7,592 million (2005: £8,250 million) was lent by the PAC with-profits fund) of securities and held collateral under such agreements of £11,814 million (2005: £11,112 million) (of which £7,934 million (2005: £8,657 million) was held by the PAC with-profits fund).

At 31 December 2006, 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 of £1,435 million (2005: £1,214 million), together with accrued interest.

Collateral and pledges under derivative transactions

At 31 December 2006, the Group had pledged £263 million (2005: £403 million) for liabilities and held collateral of £212 million (2005: £193 million) in respect of over-the-counter derivative transactions.

Securitisation

During 2006, 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 (2005: £2.8 billion). The noteholders in securitisations from this vehicle have a proportional interest in each account balance in the trust. As at 31 December 2006, the value of this interest was £2.3 billion (2005: £2.3 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 2006, impairment losses of £416 million (2005: £278 million) were recognised. These were mainly for loans and advances to customers in Egg and available-for-sale securities held by Jackson.

Impairment losses recognised on available-for-sale securities amounted to £24 million (2005: £24 million). Of this amount, 76 per cent (2005: 28 per cent) has been recorded on structured asset-backed securities, primarily due to reduced cash flow expectations on such securities that are collateralised by diversified pools of primarily below investment grade securities. 22 per cent (2005: 53 per cent) of the losses related to the impairment of fixed maturity securities of two (2005: five) individual corporate issuers, reflecting deteriorating business outlook of the companies concerned.

The impairment losses have been recorded in 'acquisition costs and other operating expenditure' in the income statement.

In 2006, the Group realised gross losses on sales of available-for-sale securities of £58 million (2005: £29 million). 30 per cent (2005: 38 per cent) of these losses related to the disposal of fixed maturity securities of six (2005: five) individual issuers, which were disposed of to rebalance the portfolio in the US operations.

The effect of those reasonably likely changes in the key assumptions underlying the estimates that underpin the assessment of whether impairment has taken place depends on the factors described in note A3. A key indicator of whether such impairment may arise in future, and the potential amounts at risk, is the profile of gross unrealised losses for fixed maturity and equity securities accounted for on an available-for-sale basis by reference to the time periods by which the securities have been held continuously in an unrealised loss position and by reference to the maturity date of the securities concerned.

G5: Impairment of financial assets continued

For 2006, the difference between the carrying value and book cost of equity securities in gross unrealised loss position was £(1) million (2005: £(1) million). The following table shows the amounts of gross unrealised losses for fixed maturity securities classified as available-for-sale under IFRS in an unrealised loss position for the time periods indicated as at 31 December 2006 and 31 December 2005.

2006	**Not rated £m**	**Non-investment grade £m**	**Investment grade £m**	**Total £m**
Less than 6 months	**(1)**	**(1)**	**(14)**	**(16)**
6 months to 1 year	**(3)**	**(1)**	**(10)**	**(14)**
1 year to 2 years	**(24)**	**(10)**	**(135)**	**(169)**
2 years to 3 years	**(5)**	**0**	**(9)**	**(14)**
3 years to 4 years	**(5)**	**0**	**(35)**	**(40)**
4 years to 5 years	**0**	**0**	**0**	**0**
5 years to 6 years	**(2)**	**(1)**	**0**	**(3)**
	(40)	**(13)**	**(203)**	**(256)**

2005	Not rated £m	Non-investment grade £m	Investment grade £m	Total £m
Less than 6 months	(17)	(10)	(99)	(126)
6 months to 1 year	(8)	(9)	(40)	(57)
1 year to 2 years	(8)	(5)	(15)	(28)
2 years to 3 years	(6)	0	(42)	(48)
3 years to 4 years	0	0	0	0
4 years to 5 years	(3)	(1)	0	(4)
5 years to 6 years	0	0	0	0
	(42)	(25)	(196)	(263)

The following table shows the amount of gross unrealised losses for fixed maturity securities classified as available-for-sale under IFRS in an unrealised loss position by maturity date of the securities as at 31 December 2006 and 31 December 2005.

	2006 £m	2005 £m
Less than 1 year	**(1)**	0
1 to 5 years	**(29)**	(23)
5 to 10 years	**(113)**	(126)
More than 10 years	**(51)**	(41)
Mortgage-backed securities and other debt securities	**(62)**	(73)
Total	**(256)**	(263)

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H: Other information on balance sheet items

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H1: Intangible assets attributable to shareholders

(a) Goodwill

	2006 £m	2005 £m
Cost		
At 1 January	**1,461**	1,466
Disposals (including, for 2005, goodwill of held for sale venture investment subsidiaries – see note H9)	**–**	(5)
At 31 December	**1,461**	1,461
Aggregate impairment		
At 1 January	**(120)**	(5)
Impairment losses in the year recognised in the profit and loss	**–**	(120)
Write-offs related to disposals and discontinued operations	**–**	5
At 31 December	**(120)**	(120)
Net book amount at 31 December	**1,341**	1,341

During 2005, the acquired goodwill of the Japanese life company was tested for impairment and a charge of £120 million was 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 to CGUs of the Group's goodwill attributable to shareholders is shown below:

	2006 £m	2005 £m
M&G	**1,153**	1,153
Other	**188**	188
	1,341	1,341

'Other' represents goodwill amounts allocated across CGUs in Asia and US operations. These goodwill amounts are not individually material.

Assessment of whether goodwill may be impaired

With the exception of M&G, the goodwill attributable to shareholders 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 note 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.

H1: Intangible assets attributable to shareholders continued

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 five 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.

Japanese life company
As noted above, the entire goodwill relating to the Japanese life operation of £120 million was deemed to be impaired in 2005 following impairment testing carried out. 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 five per cent was applied to the projected cash flows. On the basis of the results of this exercise, all goodwill held in relation to the Japanese business was written off in 2005.

(b) Deferred acquisition costs and acquired in-force value of long-term business contracts attributable to shareholders

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.

Other intangible assets in the Group consolidated balance sheet attributable to shareholders consist of:

	2006 £m	2005 £m
Deferred acquisition costs (DAC) related to insurance contracts as classified under IFRS 4	**2,315**	2,200
Deferred acquisition costs related to investment management contracts, including life assurance contracts classified as financial instruments and investment management contracts under IFRS 4	**110**	104
	2,425	2,304
Present value of acquired in-force policies for insurance contracts as classified under IFRS 4	**66**	92
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	**6**	9
	72	101
Total of deferred acquisition costs and acquired in-force value of long-term business contracts	**2,497**	2,405

Deferred acquisition costs related to insurance contracts attributable to shareholders

The movement in deferred acquisition costs relating to insurance contracts attributable to shareholders is as follows:

	£m
Deferred acquisition costs at 1 January 2005	1,620
Additions	495
Amortisation	(388)
Impairment	(21)
Exchange differences	173
Change in shadow DAC	321
Deferred acquisition costs at 31 December 2005	2,200
Deferred acquisition costs at 1 January 2006	**2,200**
Additions	**623**
Amortisation	**(299)**
Exchange differences	**(290)**
Change in shadow DAC	**81**
Deferred acquisition costs at 31 December 2006	**2,315**

In 2005, deferred acquisition costs of £21 million relating to the Taiwanese life assurance operation were impaired. See note D4(f) for further details.

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H1: Intangible assets attributable to shareholders continued

Deferred acquisition costs related to investment management contracts attributable to shareholders

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 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 charges	(7)
At 31 December 2005	104
At 1 January 2006	
Gross amount	118
Accumulated amortisation	(14)
Net book amount	104
Year ended 31 December 2006	
Opening net book amount	**104**
Additions (through internal development)	**36**
Amortisation	**(6)**
Other charges	**(24)**
Closing net book amount	**110**
At 31 December 2006	
Gross amount	**130**
Accumulated amortisation	**(20)**
Net book amount	**110**

Present value of acquired in-force business of long-term business contracts attributable to shareholders

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 previously 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 is 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.

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.

H1: Intangible assets attributable to shareholders continued

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.

	Insurance contracts £m	Investment management £m
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)
At 31 December 2005	92	9
At 1 January 2006		
Cost	233	12
Accumulated amortisation	(141)	(3)
Net book amount	92	9
Year ended 31 December 2006		
Opening net book amount	**92**	**9**
Exchange differences	**(4)**	**0**
Amortisation charge	**(22)**	**(3)**
Closing net book amount	**66**	**6**
At 31 December 2006		
Cost	**220**	**12**
Accumulated amortisation	**(154)**	**(6)**
Net book amount	**66**	**6**

H2: Intangible assets attributable to the PAC with-profits fund

(a) Goodwill and other acquired intangible assets in respect of acquired venture fund investment subsidiaries

	Goodwill £m	Other acquired intangible assets £m	Total £m
Carrying value at 1 January 2006	**419**	**260**	**679**
Additions	**336**	**139**	**475**
Amortisation charge	**–**	**(41)**	**(41)**
Disposals (including held for sale subsidiaries)	**(168)**	**(115)**	**(283)**
At 31 December 2006	**587**	**243**	**830**

In the 2005 financial statements the following details were included:

- at 1 January 2005, goodwill in respect of acquired venture fund investment subsidiaries was £784 million;
- during 2005, acquisitions amounted to £151 million and disposals (including held for sale subsidiaries) amounted to £328 million; and
- at 31 December 2005, the goodwill and other acquired intangible assets in respect of PAC with-profits fund were £607 million and £nil respectively.

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H2: Intangible assets attributable to the PAC with-profits fund continued

In 2006, certain reclassifications were made to goodwill and other acquired intangible assets as explained in note I11. This resulted in the altered opening balances for goodwill and other acquired intangible assets as shown in the table above.

All goodwill figures shown above reflect the cost. These have no impairment losses or other write-offs.

All goodwill additions relate to the UK and the long-term business segments. Additional details on the acquisitions are provided in note I6.

The recoverable amount for the venture fund investment subsidiaries 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.

(b) Deferred acquisition costs

	2006 £m	2005 £m
At 1 January	**35**	33
Additions	**2**	6
Amortisation	**(6)**	(4)
At 31 December	**31**	35

These costs relate to non-participating business written by the PAC with-profits sub-fund. No deferred acquisition costs are established for the participating business.

H3: Reinsurers' share of policyholder liabilities

	2006 £m	2005 £m
Insurance contract liabilities	**878**	1,203
Claims outstanding	**67**	75
	945	1,278

The movement on reinsurers' share of insurance contract liabilities is as follows:

	2006 £m	2005 £m
At 1 January	**1,203**	919
Amount included in income statement	**(265)**	242
Foreign exchange translation differences	**(60)**	42
At 31 December	**878**	1,203

H4: Tax assets and liabilities

Assets

Of the £404 million (2005: £231 million) current tax recoverable, the majority is expected to be recovered in one year or less.

Deferred tax asset

	2006 £m	2005 £m
Unrealised losses on investments	**83**	84
Balances relating to investment and insurance contracts	**439**	317
Short-term timing differences	**472**	258
Capital allowances	**18**	91
Unused deferred tax losses	**–**	5
	1,012	755

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 2006 results and balance sheet position at 31 December 2006, the possible tax benefit of approximately £333 million (2005: £333 million), which may arise from capital losses valued at approximately £1.7 billion (2005: £1.7 billion), is sufficiently uncertain that it has not been recognised. In addition, a potential deferred tax asset of £71 million (2005: £67 million), which may arise from trading losses of approximately £245 million (2005: £237 million), is sufficiently uncertain that it has not been recognised.

Liabilities

Of the £1,303 million (2005: £962 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

	2006 £m	2005 £m
Unrealised gains on investments	**2,346**	1,907
Balances relating to investment and insurance contracts	**613**	554
Short-term timing differences	**916**	536
Capital allowances	**7**	80
	3,882	3,077

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

	2006 £m	2005 £m
Accrued investment income		
Interest receivable	**1,331**	1,235
Other	**569**	556
	1,900	1,791
Other debtors		
Premiums receivable:		
From policyholders	**200**	230
From intermediaries	**12**	10
From reinsurers	**22**	21
Other	**818**	1,044
	1,052	1,305
Total	**2,952**	3,096

Of the £2,952 million (2005: £3,096 million) of accrued investment income and other debtors, £800 million (2005: £992 million) is expected to be settled after one year or more.

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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 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 1 January 2006				
Cost	279	175	1,082	1,536
Accumulated depreciation	(37)	–	(589)	(626)
Net book amount	242	175	493	910
Year ended 31 December 2006				
Opening net book amount	**242**	**175**	**493**	**910**
Exchange differences	**(8)**	**–**	**(8)**	**(16)**
Depreciation charge	**(6)**	**–**	**(139)**	**(145)**
Additions	**4**	**36**	**134**	**174**
Arising on acquisition of subsidiaries	**–**	**–**	**40**	**40**
Disposals	**(25)**	**–**	**(73)**	**(98)**
Reclassification from held for investment	**–**	**268**	**–**	**268**
Closing net book amount	**207**	**479**	**447**	**1,133**
At 31 December 2006				
Cost	**241**	**479**	**1,127**	**1,847**
Accumulated depreciation	**(34)**	**–**	**(680)**	**(714)**
Net book amount	**207**	**479**	**447**	**1,133**

Of the above net book amounts, £102 million (2005: £125 million) of Group occupied property and £261 million (2005: £269 million) of tangible assets are attributable to consolidated venture investment subsidiaries of the PAC with-profits fund at 31 December 2006. All additions arising on acquisition of subsidiaries relate to acquisitions of venture investment subsidiaries of the PAC with-profits fund.

Capital expenditure: property, plant and equipment by primary segment

	2006 £m	2005 £m
Long-term business	**153**	124
Banking	**12**	28
Broker-dealer and fund management	**6**	6
Unallocated corporate	**3**	2
	174	160

Capital expenditure: property, plant and equipment by secondary segment

	2006 £m	2005 £m
UK	**134**	117
US	**15**	14
Asia	**25**	29
	174	160

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:

	2006 £m	2005 £m
At 1 January	**13,180**	13,303
Additions:		
Resulting from acquisitions	**1,185**	844
Resulting from expenditure capitalised	**51**	56
Resulting from acquisitions through business combinations	**2**	22
Disposals	**(398)**	(1,224)
Net gains from fair value adjustments	**813**	720
Net foreign exchange differences	**(42)**	24
Transfers to held for sale assets	**(32)**	(552)
Transfers to development properties	**(268)**	(13)
At 31 December	**14,491**	13,180

The income statement includes the following items in respect of investment properties:

	2006 £m	2005 £m
Rental income from investment properties	**744**	765
Direct operating expenses (including repairs and maintenance expenses) arising from investment properties:		
That generated rental income during the year	**118**	133
That did not generate rental income during the year	**8**	7
Total direct operating expenses	**126**	140

Investment properties of £4,990 million (2005: £4,463 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:

	2006 £m	2005 £m
Future minimum lease payments at 31 December	**400**	564
Future finance charges on finance leases	**(325)**	(450)
Present value of minimum lease payments	**75**	114
Future minimum lease payments are due as follows:		
Less than 1 year	**4**	12
1 to 5 years	**15**	23
Over 5 years	**381**	529
	400	564
The present values of these minimum lease payments are:		
Less than 1 year	**3**	11
1 to 5 years	**15**	22
Over 5 years	**57**	81
	75	114

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 2006 amounted to £11 million (2005: £21 million). Contingent rents recognised as income in the year amounted to £33 million (2005: £46 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:

	2006 £m	2005 £m
Less than 1 year	**658**	702
1 to 5 years	**2,382**	2,535
Over 5 years	**6,135**	7,005
	9,175	10,242

The total minimum future rentals to be received on non-cancellable sub-leases for land and buildings for the year ended 31 December 2006 are £2,651 million (2005: £4,006 million).

Notes on the Group financial statements continued

H8: Investments in associates and joint ventures

Investments in associates

The Group had three associates at 31 December 2006 (2005: one) that are accounted for using the equity method. The Group acquired two new associates in 2006, a 30 per cent interest in Apollo Education and Training Organisation Vietnam and a 25 per cent interest in OYO Developments Limited, which are included in the summarised financial information below. IfOnline Group Limited (IfOnline), a company whose principal activity is mortgage intermediation, was held by the Group in both 2006 and 2005.

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

During the year, IfOnline issued further shares to its shareholders which diluted the Group's holding to 28.8 per cent (2005: 38.6 per cent) of the total issued share capital. Total share capital comprises 29.9 per cent of the ordinary share capital, 96.0 per cent of the preference share capital, a £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.

A summary of the movements in investments in associates accounted for using the equity method in 2006 and 2005 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 2005	4	(6)	(2)	7	5
Share of profit for the year after tax	–	0	0	–	0
Balance at 31 December 2005	4	(6)	(2)	7	5
Acquisitions	0	0	0	0	0
Share of profit for the year after tax	–	1	1	–	1
Balance at 31 December 2006	4	(5)	(1)	7	6

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 2006 and 2005 is as follows:

	2006 £m	2005 £m
Financial position		
Total assets (excluding goodwill)	**4**	1
Total liabilities	**(5)**	(3)
Net assets	**(1)**	(2)
Results of operations		
Revenue	**3**	2
Profit in the year	**1**	0

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 2006 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 (2005: £2 billion) at 31 December 2006.

The aggregate assets of these associates are approximately £7 billion (2005: £9 billion). Aggregate liabilities, excluding liabilities to unit holders and shareholders for unit trusts and OEICs, are approximately £3 billion (2005: £3 billion). Fund revenues, with revenue arising in unit trusts and OEICs deemed to constitute the investment return for these vehicles, were approximately £0.4 billion (2005: £2 billion) and net profit in the year, excluding unit trusts and OEICs where all investment returns accrue to unit holders or shareholders respectively, was approximately £0.2 billion (2005: £0.1 billion).

H8: Investments in associates and joint ventures continued

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
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
Prudential BSN Takaful Berhad	49	General and life insurance	Malaysia

CITIC Prudential Fund Management Company Limited and Prudential ICICI Asset Management Company Limited were 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 six 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. Prudential BSN Takaful Berhad is a new joint venture in 2006.

In January 2006, the Group sold its 50 per cent interest in Marlborough Stirling Mortgage Services Limited for £2.9 million. The profit on sale before tax of £1.7 million is included in investment income in the consolidated income statement.

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:

	2006 £m	2005 £m
Financial position		
Current assets	**91**	233
Non-current assets	**638**	281
Total assets	**729**	514
Current liabilities	**(47)**	(30)
Non-current liabilities	**(467)**	(272)
Total liabilities	**(514)**	(302)
Net equity	**215**	212
Results of operations		
Revenues	**265**	156
Expenses	**(273)**	(161)
Net loss	**(8)**	(5)

There are several minor service agreements in place between the joint ventures and the Group. During 2006, the aggregate amount of the transactions was £4 million and the balance outstanding as at 31 December 2006 was £3.2 million.

During 2006, ICICI Prudential Life Insurance Company Limited invested its own capital of £1.4 million into the joint venture to fund the operational needs of the business.

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.

Notes on the Group financial statements continued

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 2006, one venture subsidiary, Pharmacia Diagnostics, was classified as held for sale. The disposal of this subsidiary was completed on 18 January 2007. There were two venture subsidiaries at 31 December 2005 that were classified as held for sale; Upperpoint Distribution Limited and Taverner Hotel Group Pty Ltd. The sale of these venture subsidiaries was completed in 2006.

Gains on disposal of held for sale assets and liabilities are recorded in 'investment income' within the income statement.

Major classes of assets and liabilities held for sale are as follows:

	2006 £m	2005 £m
Assets		
Goodwill	**138**	16
Intangible assets	**112**	–
Property, plant and equipment	**48**	21
Other assets	**105**	139
Investment properties	**60**	552
Non-current assets held for sale	**463**	728
Liabilities		
Other liabilities	**64**	42
Borrowings	**323**	104
Non-current liabilities held for sale	**387**	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:

	2006 £m	2005 £m
Cash	**3,908**	2,380
Cash equivalents	**1,163**	1,206
Total cash and cash equivalents	**5,071**	3,586

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 £437 million and £263 million in 2006 and 2005, 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 £220 million (2005: £170 million) (divided into 4,000,000,000 (2005: 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 have been issued. A summary of the ordinary shares in issue is set out below:

	2006 £m	2005 £m
Share capital and share premium		
Ordinary share capital: 2,444m (2005: 2,387m)		
Shares issued	**122**	119
Share premium	**1,822**	1,564
Reserves		
Retained earnings	**3,640**	3,236
Translation reserve	**(125)**	173
Available-for-sale and hedging reserves	**29**	102
Total shareholders' equity	**5,488**	5,194

H11: Shareholders' equity: share capital, share premium and reserves continued

Share capital and share premium

	Number of ordinary shares	Share capital £m	Share premium £m
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
2006			
Issued shares of 5p each fully paid:			
At the beginning of the year	**2,386,784,266**	**119**	**1,564**
Shares issued under share option schemes	**2,953,552**	**–**	**15**
Shares issued in lieu of cash dividends	**12,940,993**	**1**	**75**
Shares issued in respect of acquisition of Egg minority interests	**41,633,614**	**2**	**243**
Transfer to retained earnings in respect of shares issued in lieu of cash dividends	**–**	**–**	**(75)**
At end of the year	**2,444,312,425**	**122**	**1,822**

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.

At 31 December 2006, there were options outstanding under Save As You Earn schemes to subscribe for 10,722,274 (2005: 12,503,956) shares at prices ranging from 266 pence to 715 pence (2005: 266 pence to 715 pence) and exercisable by the year 2013 (2012). In addition, there are 4,113,481 (2005: 4,668,534) conditional options outstanding under the RSP and 1,623,637 (2005: nil) under the GPSP exercisable at nil cost within a 10-year period.

The cost of own shares of £79 million as at 31 December 2006 (2005: £97 million) 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. At 31 December 2006, 7.5 million (2005: 10.7 million) Prudential plc shares with a market value of £52 million (2005: £59 million) were held in such trusts. In 2006, the Company purchased 2.3 million (2005: 1.4 million) shares in respect of employee incentive plans at a cost of £15 million (2005: £6 million). The maximum number of shares held in the year was 10.7 million which was at the beginning of the year. Of this total, 4.8 million (2005: 5.7 million) shares were held in trusts under employee incentive plans.

Of the total shares held in trust, 2.7 million (2005: 5 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 303 pence (2005: 286 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 2006 was 4.9 million (2005: 5 million) and the cost of acquiring these shares of £26 million (2005: £26 million) is included in cost of own shares. The market value of these shares as at 31 December 2006 was £34 million (2005: £28 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 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.

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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
At 1 January 2005	103,582	8,315
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	11,330
At 1 January 2006	**120,436**	**11,330**
Income and expense included in the income statement	**7,811**	**2,296**
Foreign exchange translation differences	**(5,034)**	**(27)**
At 31 December 2006	**123,213**	**13,599**

H13: Borrowings

Core structural borrowings of shareholder-financed operations

	2006 £m	2005 £m
Central companies		
Subordinated debt:		
€500m 5.75% Subordinated Notes 2021 (note i)	**335**	341
£435m 6.125% Subordinated Notes 2031	**427**	426
US$1,000m 6.5% Perpetual Subordinated Capital Securities (note ii)	**484**	554
US$250m 6.75% Perpetual Subordinated Capital Securities (note iii)	**125**	142
US$300m 6.5% Perpetual Subordinated Capital Securities (notes iii and iv)	**154**	169
€20m Medium Term Subordinated Notes 2023 (note v)	**13**	14
	1,538	1,646
Other debt:		
£150m 9.375% Guaranteed Bonds 2007	**150**	150
£249m 5.5% Bonds 2009 (note vi)	**248**	249
£250m 5.875% Bonds 2029	**249**	249
£300m 6.875% Bonds 2023	**300**	300
	947	948
Total central companies	**2,485**	2,594
US operations		
US$250m 8.15% Surplus Notes 2027 (note vii)	**127**	145
Egg		
£200m 6.875% Subordinated Notes 2021	**201**	201
£250m 7.5% Subordinated Notes 2013	**250**	250
	451	451
Total	**3,063**	3,190

Notes

(i) The €500 million 5.75 per cent borrowings have been swapped into borrowings of £333 million with interest payable at six month £Libor plus 0.962 per cent.

(ii) Interest on the US$1,000 million 6.5 per cent borrowings has been swapped into floating rate payments at three month US$Libor plus 0.80 per cent.

(iii) This debt is exchangeable into preference shares at Prudential's option.

(iv) Interest on the US$300 million 6.5 per cent borrowings has been swapped into floating rate payments at three month US$Libor plus 0.0225 per cent.

(v) The €20 million Medium Term Subordinated Notes were issued at 20-year Euro Constant Maturity Swap (capped at 6.5 per cent). These have been swapped into borrowings of £14 million with interest payable at three month £Libor plus 1.2 per cent.

(vi) In February 2006, £1.3 million of the original bond issue of £250 million was redeemed.

H13: Borrowings continued

Notes continued
(vii) These Surplus Notes are unsecured and subordinated to all present and future indebtedness, policy claims and other creditor claims of the US operations.

(viii) Maturity analysis
The following table sets out the maturity analysis of the Group's core structural borrowings:

	2006 £m	2005 £m
Less than 1 year	150	–
1 to 2 years	–	150
2 to 3 years	248	–
3 to 4 years	–	249
4 to 5 years	–	–
Over 5 years	2,665	2,791
Total	3,063	3,190

Operational borrowings attributable to shareholder-financed operations

	2006 £m	2005 £m
Borrowings in respect of short-term fixed income securities programmes		
Commercial paper	2,017	1,461
Floating Rate Notes 2007	5	–
Medium-Term Notes 2010	10	11
	2,032	1,472
Non-recourse borrowings of investment subsidiaries managed by PPM America		
Non-recourse borrowings of investment subsidiaries (notes i and iii)	76	133
Non-recourse borrowings of Piedmont and CDO funds (notes ii and iii)	667	952
	743	1,085
Borrowings in respect of banking operations (note iv)	2,819	3,856
Other borrowings		
Bank loans and overdrafts	9	11
Obligations under finance leases	6	8
	15	19
Total	5,609	6,432

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 5.93 per cent and 4.48 per cent at 31 December 2006 and 31 December 2005 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 £2,220 million (2005: £2,452 million) and unsubordinated debt securities issued by Egg of £599 million (2005: £1,404 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:

	2006 £m	2005 £m
Less than 1 year	3,135	2,440
1 to 2 years	533	1,055
2 to 3 years	946	523
3 to 4 years	266	1,013
4 to 5 years	48	449
Over 5 years	681	952
Total	5,609	6,432

Notes on the Group financial statements continued

H13: Borrowings continued

Borrowings attributable to with-profits funds

	2006 £m	2005 £m
Non-recourse borrowings of venture fund investment subsidiaries	**926**	988
£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)	**750**	810
Total	**1,776**	1,898

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:

	2006 £m	2005 £m
Less than 1 year	**33**	39
1 to 2 years	**12**	74
2 to 3 years	**–**	40
3 to 4 years	**319**	62
4 to 5 years	**–**	133
Over 5 years	**1,412**	1,550
Total	**1,776**	1,898

H14: Provisions and contingencies

Provisions

	2006 £m	2005 £m
Provision in respect of defined benefit pension schemes (note I1):		
(Surplus) deficit, gross of deferred tax, based on scheme assets held, including investments in Prudential insurance policies:		
Attributable to PAC with-profits fund (i.e. absorbed by the liability for unallocated surplus)	**(73)**	329
Attributable to shareholder-financed operations (i.e. to shareholders' equity)	**8**	214
	(65)	543
Add back: investments in Prudential insurance policies	**287**	253
Provision after elimination of investments in Prudential insurance policies and matching policyholder liability from Group balance sheet	**222**	796
Other provisions (see below)	**242**	176
Total provisions	**464**	972

Analysis of other provisions:

	2006 £m	2005 £m
At 1 January	**176**	181
Charged to income statement:		
Additional provisions	**172**	85
Unused amounts reversed	**(13)**	(25)
Used during the year	**(89)**	(63)
Exchange differences	**(4)**	(2)
At 31 December	**242**	176
Comprising:		
Legal provisions	**11**	11
Restructuring provisions	**76**	41
Other provisions	**155**	124
	242	176

Of the other provisions balance, £55 million (2005: £74 million) is expected to be settled within one year. Employer contributions expected to be paid into defined benefit pension schemes within one year are shown in note I1.

H14: Provisions and contingencies continued

Legal provisions

The legal provisions of £11 million (2005: £11 million) relate predominantly to Jackson. Jackson 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 2006, an additional provision of £3 million was made, £2 million was paid and there was a £1 million exchange gain.

Restructuring provisions

Restructuring provisions of £76 million (2005: £41 million) comprise £72 million (2005: £30 million) relating to restructuring activity of UK insurance operations, £4 million (2005: £1 million) relating to Egg and £nil (2005: £10 million) relating to closure costs in Japan.

UK restructuring

In 2004 and 2005, Prudential implemented restructurings relating to document management review, streamlining operations, and the relocation of activities to an offshore base in India. In December 2005, the Group announced an initiative for UK insurance operations to work more closely with Egg and M&G and in the process facilitate the realisation of substantial annualised pre-tax cost savings and opportunities for revenue synergies.

At 1 January 2005, a provision of £49 million was brought forward, and during 2005 an additional £1 million was provided, £11 million of unused provision was released, and £9 million was paid.

During 2006, an additional provision of £75 million was provided, £4 million of unused provision was released, and £29 million was paid.

Egg restructuring

At 1 January 2005, a provision of £17 million was brought forward relating to Egg's withdrawal from the French market, of which £16 million was used during 2005. In 2006, as a result of the UK and Egg initiative described above, a provision of £11 million was set up, of which £8 million was used.

Japan restructuring

In 2005, Japan closed its Financial Advisor distribution channel. A £10 million provision was set up relating to closure and redundancy costs, which was used during 2006.

Other provisions

Other provisions of £155 million (2005: £124 million) include provisions of £134 million (2005: £94 million) relating to staff benefit schemes. During 2006, another £78 million was provided, £7 million of unused provision was released, and £31 million was paid. In 2005, a provision of £77 million was brought forward, an additional £27 million was provided and £10 million was paid. Other provisions also include £18 million (2005: £19 million) relating to various onerous contracts where, in 2006, an additional £1 million was provided and £2 million was used. In 2005, £29 million was brought forward, £6 million was released and £4 million was used. The remaining provisions of £3 million (2005: £11 million) include VAT provisions.

Contingencies and related obligations

Litigation

In addition to the legal proceedings relating to Jackson 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.

Notes on the Group financial statements continued

H14: Provisions and contingencies continued

The table below summarises the change in the pension mis-selling provision for the years ended 31 December 2006 and 2005. 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.

	2006 £m	2005 £m
Balance at beginning of year	**331**	487
Change arising from adoption of FRS 27	**–**	(109)
Changes to actuarial assumptions and method of calculation	**108**	(28)
Discount unwind	**15**	14
Redress to policyholders	**(48)**	(21)
Payment of administrative costs	**(5)**	(12)
Balance at end of year	**401**	331

The pension mis-selling provision is included within the liabilities in respect of investment contracts with discretionary participation features under IFRS 4.

The liability accounting for the contracts which are the subject of the mis-selling provision is reflected in two elements, namely the core policyholder liability determined on the basis applied for other contract liabilities and the mis-selling provision. The overall liability for these contracts remains appropriate in the context of the accounting for policyholder liabilities that determines the calculation of both elements. However, the constituent elements are reallocated and remeasured for the changes arising from the application of the realistic Peak 2 basis of liabilities for the core policyholder liability, as reflected in the IFRS policy improvement to apply the UK GAAP standard FRS 27 as described in section A4.

The change arising from the adoption of FRS 27 in 2005 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 periodically 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.

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.

H14: Provisions and contingencies continued

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 programme 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) which were transferred into SAIF. At 31 December 2006, provisions of £5 million (2005: £6 million) in SAL and £45 million (2005: £50 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 2006 Prudential Assurance's main with-profits fund paid compensation of £11 million (2005: £24 million) in respect of mortgage endowment products mis-selling claims and at 31 December 2006 held a provision of £60 million (2005: £63 million) in respect of further compensation. The movement in this provision has no impact on the Group's profit before tax.

In May 2006, the Group introduced a deadline for both Prudential and Scottish Amicable mortgage endowment complaints. Impacted customers have three years to lodge a mis-selling complaint in line with the time limit prescribed by the FSA and the ABI.

Guaranteed annuities

Prudential Assurance used to sell guaranteed annuity products in the UK and at 31 December 2006 held a provision of £47 million (2005: £52 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 2006 a provision of £561 million (2005: £619 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

Inherited estate of the PAC long-term fund

The assets of the main with-profits fund within the long-term fund of PAC comprise the amounts that it 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 PAC's long-term insurance 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.

PAC believes that it would be beneficial if there were greater clarity as to the status of the inherited estate. As a result, PAC has announced that it has begun a process to determine whether it can achieve that clarity through a reattribution of the inherited estate. As part of this process a Policyholder Advocate has been nominated to represent policyholders' interests. This nomination does not mean that a reattribution will occur.

Given the size of the Group's with-profits business any proposal is likely to be time consuming and complex to implement and is likely to involve a payment to policyholders from shareholders' funds. If a reattribution is completed the inherited estate will continue to provide working capital for the long-term insurance fund.

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.

Notes on the Group financial statements continued

H14: Provisions and contingencies continued

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 Jackson to be £9 million at 31 December 2006 (2005: £11 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.

Jackson has commitments for future payments related to equity index call options totalling £0.3 million at 31 December 2006 (2005: £3 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. The final payment is due in 2007.

At 31 December 2006, Jackson has unfunded commitments of £174 million (2005: £227 million) related to its investments in limited partnerships and of £38 million (2005: £104 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

	2006 £m	2005 £m
Creditors arising from direct insurance and reinsurance operations	**521**	474
Interest payable	**90**	61
Derivative liabilities	**663**	851
Other items	**378**	384
Total	**1,652**	1,770

I: Other notes

I1: Staff and pension plans

(a) Staff and employment costs

The average number of staff employed by the Group during the year were:

	2006	2005
Business operations:		
UK operations	**10,914**	10,708
US operations	**2,863**	2,588
Asian operations	**12,114**	9,652
Venture investment subsidiaries of the PAC with-profits fund	**8,898**	8,713
Total	**34,789**	31,661

The costs of employment were:

	2006 £m	2005 £m
Business operations:		
Wages and salaries	**825**	799
Social security costs	**65**	64
Other pension costs (see below)	**72**	77
Pension actuarial gains credited to income statement	**(469)**	(155)
	(397)	(78)
Venture investment subsidiaries of the PAC with-profits fund (see below)	**230**	206
Total	**723**	991

Other pension costs comprises £45 million (2005: £54 million) relating to defined benefit schemes and £27 million (2005: £23 million) relating to defined contribution schemes. Of the defined contribution scheme costs, £14 million (2005: £13 million) related to overseas defined contribution schemes. The £45 million (2005: £54 million) comprises £29 million (2005: £43 million) charge on an economic basis, reflecting the total assets of the schemes, and a further £16 million (2005: £11 million) charge to adjust for amounts invested in Prudential insurance policies to arrive at the IAS 19 basis charge. The £469 million (2005: £155 million) of actuarial gains comprises £485 million (2005: £171 million) of actuarial gains on an economic basis and £16 million (2005: £16 million) actuarial losses for amounts invested in Prudential insurance policies. The derivation of these amounts is shown in note (b)(i)7 below.

Of the £230 million (2005: £206 million) costs of employment for venture investment subsidiaries, £189 million (2005: £169 million) relates to wages and salaries, £27 million (2005: £31 million) relates to social security costs and £14 million (2005: £6 million) relates to pension costs.

(b) Pension plans

(i) Defined benefit plans

1. Summary

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). 88 per cent (2005: 90 per cent) of the liabilities of the Group defined benefit schemes are accounted for within PSPS.

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.

As at 31 December 2006, the shareholders' share of the surplus for PSPS and the deficits of the other schemes amounted to an £8 million deficit net of related tax relief (2005: £153 million deficit). These amounts are determined after including amounts invested by PSPS and the M&G scheme in Prudential policies as explained later in this note.

Defined benefit schemes in the UK are generally required to be subject to full actuarial valuation every three years to assess the appropriate level of funding for schemes having regard to their commitments. These valuations include assessments of the likely rate of return on the assets held within the separate trustee administered funds. PSPS was last actuarially valued as at 5 April 2005 and this valuation demonstrated the scheme to be 94 per cent funded, with a shortfall of actuarially determined assets to liabilities of six per cent, representing a deficit of £243 million.

Notes on the Group financial statements continued

I1: Staff and pension plans continued

The finalisation of the valuation as at 5 April 2005 was accompanied by changes to the basis of funding for the scheme. For 2006 and future years, deficit funding amounts designed to eliminate the actuarial deficit over a 10-year period have been and are being made. Total contributions to the Scheme for deficit funding and employer's contributions for ongoing service for current employees are expected to be of the order of £70-75 million per annum over a 10-year period. However, in the calendar year 2006, total contributions were £137 million. This amount reflects an increased level of current contributions for ongoing service and deficit funding backdated to 6 April 2005. These amounts compared to total contributions in 2005 of £19 million.

Under IAS 19 the basis of valuation differs markedly from the full triennial valuation basis. In particular, IAS 19 requires assets of the scheme to be valued at their market value at the year end, while pension liabilities are required to be discounted at a rate consistent with the current rate of return on a high quality corporate bond. As a result, the difference between IAS 19 basis assets and liabilities can be volatile. For those schemes such as PSPS, which hold a substantial proportion of their assets in equity investments, the volatility can be particularly significant. The economic basis (including investments of PSPS and the M&G scheme in Prudential policies as assets) for 2006, a £28 million (2005: £21 million) pre-tax shareholder charge to operating results based on longer-term returns arises. In addition, outside the operating result, but included in total profits is a pre-tax shareholder credit of £167 million (2005: £32 million) for net actuarial gains.

In addition, also on the economic basis, the PAC with-profits sub-fund was charged £1 million (2005: £22 million) for the aggregate of service cost and net finance income and benefited by £318 million (2005: £139 million) for its share of net actuarial gains on the scheme assets and liabilities. As shareholder profits for the PAC with-profits sub-fund reflects the surplus for distribution, these amounts are effectively absorbed by an increased charge in the income statement for the transfer to the liability for unallocated surplus.

The actuarial gains primarily represent the difference between actual and expected investment returns for the schemes and the reduction in liabilities caused by an increase in the discount rate caused by increases in corporate bond returns.

In 2006, the PSPS asset allocation was altered away from equity investments such that at 31 December 2006 the market value of equities for the Group's defined benefit schemes represented 31 per cent (2005: 52 per cent) of the total asset value whilst the bond portfolio accounted for 43 per cent (2005: 34 per cent). The asset allocation is shown in note 5.

Surpluses and deficits on the Group's defined benefit schemes are apportioned to the PAC life fund and shareholders' funds based on estimates of employees' service between them. At 31 December 2005, the deficit on the PSPS was apportioned in the ratio 70/30 between the life fund and shareholder-backed operations. This ratio was determined following extensive analysis of the source of the cumulative funding for the scheme to that date.

This basis has been applied for 2006 to the asset and liability movements relating to the position at 1 January 2006, and also to the deficit funding paid in the year. However, the IAS 19 service cost for the year and employer contributions for ongoing service of current employees, have been apportioned in the ratio relevant to current activity. Reflecting these two elements, at 31 December 2006, the total share of the surplus on PSPS and the deficit on the smaller Scottish Amicable scheme attributable to the PAC with-profits fund amounted to a net surplus of £66 million net of related tax relief.

The discussions with the Scheme Trustee also led to an altered expectation in 2005 as to future discretionary increases. Previously, it had been the custom to award discretionary increases by reference to inflation levels. From 2005 it was intended that discretionary increases will in most circumstances not exceed 2.5 per cent.

2. Corporate Governance

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.

I1: Staff and pension plans continued

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.

3. Assumptions

The actuarial assumptions used in determining benefit obligations and the net periodic benefit costs for the years ended 31 December were as follows:

	2006 %	2005 %
Discount rate	**5.2**	4.8
Rate of increase in salaries	**5.0**	4.8
Rate of increase of pensions in payment for inflation:		
Guaranteed (maximum 5%)	**3.0**	2.8
Guaranteed (maximum 2.5%)*	**2.5**	2.5
Discretionary*	**2.5**	2.5
Expected returns on plan assets	**5.9**	6.1

* 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 are 3.0 per cent in 2006 (2005: 2.8 per cent).

The change of assumption for discretionary increases first applied in 2005 following 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.

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 tables used for PSPS at 31 December 2006 were:

Male: 100 per cent PMA92 with CMIR17 improvements to the valuation date and medium cohort improvements in future; and

Female: 100 per cent PFA92 with CMIR17 improvements to the valuation date and medium cohort improvements in future.

The assumed life expectancies on retirement at age 60, based on the mortality table used was:

	Years	
	Male	Female
Retiring today	25.0	28.1
Retiring in 15 years' time	26.1	29.1

The mean term of the current PSPS liabilities is around 20 years.

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 2006, applying the principles prescribed by IAS 19.

4. Summary financial position

The Group liability in respect of defined benefit pension schemes is as follows:

	2006 £m	2005 £m
Economic position:		
Surplus (deficit), gross of deferred tax, based on scheme assets held, including investments in Prudential insurance policies:		
Attributable to the PAC with-profits fund (i.e. absorbed by the liability for unallocated surplus)	**73**	(329)
Attributable to shareholder-financed operations (i.e. to shareholders' equity)	**(8)**	(214)
Economic surplus (deficit) – as explained in note 5 below	**65**	(543)
Add back: investments in Prudential insurance policies (offset on consolidation in the Group financial statements against insurance liabilities)	**(287)**	(253)
Provision included in balance sheet under IAS 19 – as explained in note 7 below	**(222)**	(796)

The following disclosures explain the economic position and IAS 19 basis of accounting after eliminating investment in Prudential insurance policies on consolidation.

Notes on the Group financial statements continued

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I1: Staff and pension plans continued

5. Group economic financial position

The economic financial position of the deferred benefit pension schemes reflects the total assets of the schemes including investments in Prudential policies. This is to be contrasted with the IAS 19 basis assets of the PSPS and M&G schemes, as consolidated into the Group balance sheet, which exclude investments in Prudential insurance policies which on the financial statement presentation are offset against policyholder liabilities.

(i) The surplus or deficits on the PSPS and Scottish Amicable schemes are partially attributable to the PAC with-profits fund; and

(ii) The M&G pension scheme has invested £161 million at 31 December 2006 (2005: £147 million) in Prudential insurance policies. Additionally, the PSPS scheme has invested £126 million at 31 December 2006 (2005: £106 million) in Prudential insurance policies. As required by IFRS, this amount of scheme asset is eliminated against the policyholder liability and hence, for the purposes of preparing the consolidated balance sheet, the IAS 19 basis net pension liability is £287 million (2005: £253 million) lower than the 'economic basis' surplus of £65 million (2005: 'economic basis' deficit of £543 million).

On the 'economic basis', after including the underlying assets represented by the investments in Prudential insurance policies as scheme assets, the assets of the schemes at 31 December were:

	2006		2005	
	£m	**%**	£m	%
Equities	**1,628**	**31**	2,543	52
Bonds	**2,259**	**43**	1,663	34
Properties	**638**	**12**	590	12
Cash	**750**	**14**	79	2
Total value of assets	**5,275**	**100**	4,875	100

The present value of the liabilities of the four schemes at 31 December 2006 was £5,210 million (2005: £5,418 million). The resulting scheme surplus or deficit arising from the excess of assets over liabilities or vice versa at 31 December 2006 comprised surplus of £73 million (2005: deficit of £329 million) attributable to the PAC with-profits fund and deficit of £8 million (2005: deficit of £214 million) attributable to shareholder operations.

The movements in the deficit on the 'economic basis' between scheme assets and liabilities were:

	2006 £m	2005 £m
Current service cost	**(69)**	(65)
Contributions	**152**	29
Other finance income	**40**	22
Actuarial gains	**485**	171
Net decrease	**608**	157

I1: Staff and pension plans continued

Estimated pension scheme liability attributable to shareholder operations – economic basis

Movements on the pension scheme deficits (determined on the 'economic basis'), to the extent attributable to shareholder operations are as follows:

2006	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 PSPS of deficit allocation (note ii) £m	Contributions paid by shareholder operations £m	At end of year £m
Gross of tax deficit	**(214)**	**(28)**	**167**	**–**	**67**	**(8)**
Related deferred tax	**61**	**9**	**(50)**	**–**	**(20)**	**0**
Net of tax deficit	**(153)**	**(19)**	**117**	**–**	**47**	**(8)**
2005						
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)

Notes

(i) Charge to operating results (based on longer-term investment returns)
This comprises:

	2006 £m	2005 £m
Current service cost	**(69)**	(65)
Finance income (expense):		
Interest on pension scheme liabilities	**(255)**	(257)
Expected return on pension scheme assets	**295**	279
	40	22
Total charge net of finance income	**(29)**	(43)
Less: amount attributable to PAC with-profits fund	**1**	22
Charge to operating results, based on longer-term investment returns, attributable to shareholders	**(28)**	(21)

(ii) Actuarial and other gains and losses
This comprises:

	2006 £m	2005 £m
Actual less expected return on pension scheme assets	**156**	544
Experience gains on scheme liabilities	**18**	1
Changes in assumptions underlying the present value of scheme liabilities	**311**	(374)
Total actuarial and other gains	**485**	171
Less: amount attributable to PAC with-profits fund	**(318)**	(139)
Actuarial gains attributable to shareholders	**167**	32
Add: additional loss on change of estimate of allocation of opening 2005 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	**167**	(31)

Since shareholder profits in respect of the PAC with-profits fund 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.

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.

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I1: Staff and pension plans continued

Estimated pension scheme surplus (deficit) attributable to PAC with-profits fund – economic basis

Movements on the pension scheme surplus (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			
2006	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 surplus (deficit)	**(329)**	**(1)**	**318**	**–**	**85**	**73**
Related deferred tax	**33**	**0**	**(32)**	**–**	**(8)**	**(7)**
Net of tax surplus (deficit)	**(296)**	**(1)**	**286**	**–**	**77**	**66**
2005						
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)

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.

6. Movement in 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:

2006	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	**4,622**	**253**	**4,875**		**4,875**
Present value of benefit obligation, beginning of year				**(5,418)**	**(5,418)**
	4,622	**253**	**4,875**	**(5,418)**	**(543)**
Service cost – current charge only				**(69)**	**(69)**
Interest cost				**(255)**	**(255)**
Expected return on plan assets	**279**	**16**	**295**		**295**
Employee contributions	**1**	**1**	**2**	**(2)**	**–**
Employer contributions	**148**	**4**	**152**		**152**
Actuarial gains	**140**	**16**	**156**	**329**	**485**
Benefit payments	**(202)**	**(3)**	**(205)**	**205**	**–**
Fair value of plan assets, end of year	**4,988**	**287**	**5,275**		**5,275**
Present value of benefit obligation, end of year				**(5,210)**	**(5,210)**
Economic basis surplus					**65**

I1: Staff and pension plans continued

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 policies	(99)	99	–		–
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)	–
Employer contributions	25	4	29		29
Actuarial and other gains*	528	16	544	(373)	171
Benefit payments	(192)	(3)	(195)	195	–
Fair value of plan assets, end of year	4,622	253	4,875		4,875
Present value of benefit obligation, end of year				(5,418)	(5,418)
Economic basis deficit					(543)

*Including £115 million credit for past service costs as described above.

7. IAS 19 basis financial position as consolidated

The IAS 19 basis net pensions deficit can be summarised as follows:

	2006 £m	2005 £m	2004 £m
Fair value of plan assets, end of year	**4,988**	4,622	4,092
Present value of funded benefit obligation	**(5,023)**	(5,228)	(4,777)
Funded status	**(35)**	(606)	(685)
Present value of unfunded obligations (M&G scheme)*	**(187)**	(190)	(140)
Provision recognised in the balance sheet	**(222)**	(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.

	2006 £m	2005 £m
Components of net periodic pension cost		
Current service cost	**(69)**	(65)
Interest cost	**(255)**	(257)
Expected return on assets – economic basis	**295**	279
Less: expected return on investments of scheme assets in Prudential insurance policies	**(16)**	(11)
Expected return on assets – IAS 19 basis**	**279**	268
Pension cost charge (as referred to in note I1(a))	**(45)**	(54)
Actuarial gains – economic basis	**485**	171
Less: actuarial gains on investments of scheme assets in Prudential insurance policies	**(16)**	(16)
Actuarial gains – IAS 19 basis (as referred to in note I1(a))	**469**	155
Net periodic pension credit (included within acquisition and other operating expenditure in the income statement)	**424**	101

**In determining the expected return on plan assets for 2006, the 6.1 per cent rate shown above has been applied to the opening assets.

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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:

	2006		2005		2004	
	£m	**%**	£m	%	£m	%
Plan assets (IAS 19 basis)						
Equity	**1,432**	**29**	2,376	51	2,516	61
Bonds	**2,185**	**44**	1,593	35	993	24
Properties	**621**	**12**	575	12	520	13
Cash	**750**	**15**	78	2	63	2
Total	**4,988**	**100**	4,622	100	4,092	100

	2006 %	2005 %
Long-term expected rate of return		
Equity	**7.5**	7.1
Bonds	**4.8**	4.5
Properties	**6.8**	6.4
Cash	**5.0**	4.5
Weighted average long-term expected rate of return	**5.9**	6.1

The expected rates of return have been determined by reference to long-term expectations, the carrying value of the assets and equity and other market conditions at the balance sheet date.

The actual return on plan assets was £419 million (2005: £796 million) on an IAS 19 basis.

None of the scheme assets included shares in Prudential plc or property occupied by the Prudential Group.

	2006 £m	2005 £m	2004 £m
Fair value of plan assets, end of year (IAS 19 basis)	**4,988**	4,622	4,092
Present value of the benefit obligation, end of year	**(5,210)**	(5,418)	(4,917)
Plan assets in deficit of benefit obligation	**(222)**	(796)	(825)
Experience adjustments on plan liabilities	**18**	1	(17)
Percentage of plan liabilities at 31 December	**(0.35)%**	(0.02)%	0.35%
Experience adjustments on plan assets (IAS 19 basis)	**140**	527	112
Percentage of plan assets at 31 December	**2.81%**	11.42%	2.74%

Total employer contributions expected to be paid into the Group defined benefit schemes for the year ending 31 December 2007 amounts to £93 million (2006: £85 million).

8. Sensitivity of PSPS financial position to key variables

The table below shows the sensitivity of the PSPS liabilities at 31 December 2006 of £4,607 million to changes in discount rates, inflation rates and mortality assumptions.

Assumption	Change in assumption	Impact on scheme liabilities on IAS 19 basis
Discount rate	Decrease by 0.2% from 5.2% to 5.0%	Increase scheme liabilities by 3.6%
Discount rate	Increase by 0.2% from 5.2% to 5.4%	Decrease scheme liabilities by 3.4%
Rate of inflation	Decrease by 0.2% from 3.0% to 2.8% with consequent reduction in salary increases	Decrease scheme liabilities by 1.3%
Mortality rates	Reduce rates from 100% of table to 95%	Increase liabilities by 1.2%

I1: Staff and pension plans continued

9. Transfer value of PSPS scheme

At 31 December 2006, it is estimated that the assets of the scheme are broadly sufficient to cover the liabilities of PSPS on a 'buyout' basis including an allowance for expenses. The 'buyout' basis refers to a basis that might apply in the circumstance of a transfer to another appropriate financial institution. In making this assessment it has been assumed that a more conservative investment strategy applies together with a more prudent allowance for future mortality improvements and no allowance for discretionary pension increases.

(ii) Other pension plans

The Group operates various defined contribution pension schemes including schemes in Jackson, Egg and Asia. As noted earlier, the cost of the Group's contributions to these schemes in 2006 was £27 million (2005: £23 million).

I2: Share-based payments

(a) Relating to Prudential plc shares

The Group maintains 10 main share award and share option plans relating to Prudential plc shares, which are described below.

In the year ended 31 December 2006, two new incentive plans were created and approved by shareholders at the Annual General Meeeting. The Group Performance Share Plan (GPSP) and the Business Unit Performance Plan (BUPP) were established and directors were authorised to implement these schemes in the UK and other countries in which Prudential operates.

The GPSP is the new incentive plan in which all executive directors and other senior executives within the Group can participate. This scheme was established as a replacement for the Restricted Share Plan (RSP) under which no further awards could be made after March 2006. Awards are granted either in the form of a nil cost option, conditional right over shares, or such other form that shall confer to the participant an equivalent economic benefit, with a vesting period of three years. The performance condition for the initial awards was on the basis that Total Shareholder Return (TSR) outperformed an index comprising of peer companies. This approach is more robust than a rank-based approach and ensures that maximum vesting is only achieved if the Company outperforms the average comparator performance by a significant margin. Outperformance would be measured on a compound basis and vesting of the awards between each performance point is on a straight-line sliding scale basis. Participants would be entitled to the value of reinvested dividends that would have accrued on the shares that vest.

The RSP was, until March 2006, the Group's long-term incentive plan for executive directors and other senior executives designed to provide rewards linked to shareholder return. Each year participants were granted a conditional option to receive a number of shares. There was a deferment period of three years at the end of which the award vested to an extent that depended 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 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.

No rights were granted in the RSP if the Company's 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 BUPP is an incentive plan created to provide a common framework under which awards would be made to the Chief Executives of Prudential UK & Europe insurance operations, Jackson and Prudential Corporation Asia, being a replacement to the existing incentive plans for these individuals. The plan is an incentive to promote ownership and encourage accountability for sustained long-term regional performance. Awards under this plan would be based on growth in Shareholder Capital Value on the European Embedded Value (EEV) basis with performance measured over three years. Upon vesting, half of the awards would be released as shares and the other half would be released in cash. Participants are entitled to receive the value of reinvested dividends over the performance period for those shares that vest. The growth parameters for the awards would be relevant to each region and vesting of the awards between each performance point is on a straight-line sliding scale basis.

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.

Notes on the Group financial statements continued

I2: Share-based payments continued

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.

Jackson operates a performance-related share award which, subject to the prior approval of the Jackson 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 2006, 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 included 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 could, 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 2006 and 2005 were as follows:

Options outstanding (including conditional options)	2006 Number of options (millions)	2006 Weighted average exercise price £	2005 Number of options (millions)	2005 Weighted average exercise price £
Beginning of year:	**17.2**	**2.23**	18.4	2.21
Granted	**7.7**	**2.96**	3.7	1.83
Exercised	**(5.1)**	**2.75**	(1.1)	2.78
Forfeited	**(1.2)**	**0.85**	(1.9)	0.81
Expired	**(3.1)**	**4.09**	(1.9)	2.21
Adjustment in respect of Egg's employees	**1.0**	**3.64**	–	–
End of year	**16.5**	**2.47**	17.2	2.23
Options immediately exercisable, end of year	**0.2**	**3.56**	0.4	3.30

The weighted average share price of Prudential plc for the year ended 31 December 2006 was £6.25 compared to £5.01 for the year ended 31 December 2005.

Movements in share awards outstanding under the Group's share-based compensation plans relating to Prudential plc shares at 31 December 2006 and 2005 were as follows:

Awards outstanding	2006 Number of awards (millions)	2005 Number of awards (millions)
Beginning of year:	**4.9**	2.4
Granted	**3.2**	2.8
Exercised	**(1.0)**	(0.1)
Forfeited	**(0.5)**	(0.1)
Expired	**–**	(0.1)
End of year	**6.6**	4.9

The following table provides a summary of the range of exercise prices for Prudential plc options (including conditional options) outstanding at 31 December 2006.

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	5.7	8.6	–	0.0	–
Between £1 and £2	–	–	–	–	–
Between £2 and £3	3.2	2.3	2.66	0.0	2.66
Between £3 and £4	3.1	2.0	3.52	0.2	3.62
Between £4 and £5	3.8	3.6	4.60	–	–
Between £5 and £6	0.7	3.3	5.63	0.0	5.79
Between £6 and £7	0.0	0.6	6.41	0.0	6.34
Between £7 and £8	0.0	0.9	7.15	–	–
	16.5	4.8	2.47	0.2	3.56

Notes on the Group financial statements continued

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 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	1.9	2.66	–	–
Between £3 and £4	3.5	2.7	3.53	0.4	3.29
Between £4 and £5	0.8	3.9	4.07	–	–
Between £5 and £6	0.2	1.3	5.63	0.0	5.39
Between £6 and £7	0.0	1.1	6.56	0.0	6.66
Between £7 and £8	0.0	1.7	7.15	0.0	7.15
	17.2	3.9	2.23	0.4	3.30

The years shown above for weighted average remaining contractual life include the time period from end of vesting period to expiration of contract.

The weighted average fair values of Prudential plc options and awards granted during the period are as follows:

	2006 Weighted average fair value			2005 Weighted average fair value		
	RSP and GPSP £	**Other options £**	**Awards £**	RSP £	Other options £	Awards £
	4.30	**2.05**	**6.46**	2.96	1.82	4.59

The fair value amounts relating to all options including conditional nil cost options above were determined using the Black-Scholes and the Monte Carlo option-pricing models using the following assumptions:

	2006		2005	
	RSP and GPSP	**Other options**	RSP	Other options
Dividend yield (%)	**2.64**	**2.64**	3.19	3.19
Expected volatility (%)	**25.48**	**34.32**	42.93	40.38
Risk-free interest rate (%)	**4.68**	**4.70**	4.65	4.41
Expected option life (years)	**3.00**	**3.42**	3.00	3.62
Weighted average exercise price (£)	**–**	**5.06**	–	3.97
Weighted average share price (£)	**6.80**	**6.51**	5.01	5.12

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 and GPSP. For these options, 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 as 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. 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 2006, an average comparator volatility of 24 per cent and an average correlation of comparators of 19 per cent were used. In addition, for the GPSP, volatility and correlation between Prudential and an index constructed from a simple average of the TSR growth of 10 companies is required. For grants in 2006, an average index volatility and correlation of 14 per cent and 71 per cent respectively, were used.

I2: Share-based payments continued

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.

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 April 2006, Prudential became bound or entitled to acquire shares in Egg following the announcement of its intention in December 2005 to acquire the minority interests in Egg representing approximately 21.7 per cent of the existing issued share capital of Egg. As a consequence of this acquisition, employees of Egg that were participants of its SAYE schemes were requested to either rollover all or part of their options for equivalent options in Prudential shares or to take no action. Employees could adopt different courses of actions for options granted on different dates but may only adopt one course of action in respect of each grant of options. The rollover was based on employees receiving 0.2237 Prudential shares for each Egg share that was under option with total amount payable for the new Prudential shares being exactly the same as the total amount payable for the Egg shares.

In addition, all outstanding executive share options became exercisable and 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. At 31 December 2006, SAYE options to acquire 135,003 Egg shares remains outstanding because certain employees chose not to take any action.

In 2005, the Group maintained three main share award and share option plans relating to Egg shares, which are described below.

Awards of shares were made under the RSP at no cost to eligible employees selected by the Remuneration Committee. 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 with a market value of £4.2 million which were intended to be used principally for delivery of shares under the employee incentive plans. These shares with a nominal value of £1.7 million 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 had been conditional on service completed. The arrangements for the distribution to employees of shares held in trust and for entitlement to dividend depended on the particulars of each award. Shares held in trust were conditionally gifted to employees. The costs of share awards were charged to the income statement evenly over the period of service for which awards were 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 would 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 had six months after the contract matured in which to exercise the options. These options continued in force until their normal maturity dates.

Notes on the Group financial statements continued

I2: Share-based payments continued

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)	
	2006	2005
Outstanding at beginning of year	**–**	0.8
Forfeited	**–**	(0.7)
Exercised	**–**	(0.1)
Outstanding and exercisable at the end of year	**–**	0.0

Egg RSP awards made after 7 November 2002.

	Number (millions)	
	2006	2005
Outstanding at beginning of year	**6.1**	6.2
Granted	**–**	1.7
Forfeited	**(2.2)**	(1.5)
Exercised	**–**	(0.3)
Expired	**(3.9)**	–
Outstanding and exercisable at the end of year	**–**	6.1

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 £	
	2006	2005	**2006**	2005	**2006**	2005	**2006**	2005
Outstanding at beginning of year	**0.5**	0.7	**1.15**	1.16	**0.3**	0.4	**1.20**	1.20
Forfeited	**(0.0)**	(0.2)	**1.15**	1.20	**(0.0)**	(0.1)	**1.30**	1.19
Exercised	**(0.2)**	0.0	**1.15**	1.15	**(0.3)**	–	**1.20**	–
Transferred to Prudential SAYE scheme	**(0.3)**	–	**1.15**	–	**–**	–	**–**	–
Outstanding and exercisable at the end of year	**–**	0.5	**–**	1.15	**–**	0.3	**1.24**	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 £	
	2006	2005	**2006**	2005	**2006**	2005	**2006**	2005
Outstanding at beginning of year	**3.2**	3.0	**0.86**	0.85	**0.9**	1.0	**0.83**	0.84
Granted	**–**	0.9	**–**	0.86	**–**	0.1	**–**	0.86
Forfeited	**(0.3)**	(0.7)	**0.85**	0.87	**(0.0)**	(0.2)	**1.03**	0.88
Exercised	**(0.0)**	0.0	**0.80**	0.80	**–**	–	**–**	–
Transferred to Prudential SAYE scheme	**(2.8)**	–	**0.85**	–	**(0.9)**	–	**0.83**	–
Outstanding and exercisable at the end of year	**0.1**	3.2	**0.88**	0.86	**–**	0.9	**0.94**	0.83

I2: Share-based payments continued

Egg share option scheme awards made prior to 7 November 2002.

	Number (millions)		Weighted average exercise price £	
	2006	2005	**2006**	2005
Outstanding at beginning of year	**9.3**	11.5	**1.42**	1.42
Forfeited	**(2.1)**	(2.2)	**1.52**	1.43
Exercised	**(7.2)**	–	**1.39**	–
Outstanding and exercisable at the end of year	**–**	9.3	**–**	1.42

The weighted average share price of Egg up to the date of delisting was 127 pence compared with 106 pence at 31 December 2005.

The exercise prices and the weighted average remaining contractual life of the number of options outstanding at the year end are as follows:

	2006			2005		
	Exercise price £	**Number of options (millions)**	**Weighted average remaining contractual life (years)**	Exercise price £	Weighted average Number of options (millions)	remaining contractual life (years)
Restricted share plan						
Pre 2003 grant	**–**	**–**	**–**	–	–	–
2003 grant	**–**	**–**	**–**	–	2.8	0.2
2004 grant	**–**	**–**	**–**	–	2.0	1.6
2005 grant	**–**	**–**	**–**	–	1.2	2.2
3 Year Sharesave Scheme						
2001 grant	**–**	**–**	**–**	1.30	–	–
2002 grant	**–**	**–**	**–**	1.15	0.4	–
2003 grant	**1.17**	**0.0**	**–**	1.17	0.3	0.9
2004 grant	**0.80**	**0.1**	**0.9**	0.80	1.9	1.9
2005 grant	**0.86**	**0.0**	**1.9**	0.86	0.9	2.9
5 Year Sharesave Scheme						
2001 grant	**1.30**	**0.0**	**–**	1.30	0.1	0.9
2002 grant	**1.15**	**0.0**	**0.9**	1.15	0.2	1.9
2003 grant	**1.17**	**0.0**	**1.9**	1.17	0.1	2.9
2004 grant	**0.80**	**0.0**	**2.9**	0.80	0.7	3.9
2005 grant	**0.86**	**0.0**	**3.9**	0.86	0.2	4.9
Share option schemes						
Pre 2003 grant	**1.42**	**–**	**–**	1.42	9.3	–

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.

In the year ended 31 December 2006, no options were granted on Egg plc shares.

Notes on the Group financial statements continued

I2: Share-based payments continued

The significant assumptions and inputs used to estimate the fair value of the options granted in 2005 are as follows:

	2005		
	RSP	3 Year Sharesave	5 Year Sharesave
Share price (£)	1.09	1.03	1.03
Exercise price (£)	–	0.86	0.86
Risk-free interest rate (%) (note i)	–	4.14	4.15
Expected life (years)	3	3	5
Expected volatility (%) (note ii)	40	40	40
Dividend yield (%)	–	–	–
Share price volatility of comparator group (%) (note iii)	20	–	–
Fair value of option (£)	1.91	0.41	0.50

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:

	2006 £m	2005 £m
Share-based compensation expense	**22**	19
Amount accounted for as equity-settled	**14**	15
Carrying value at 31 December of liabilities arising from share-based payment transactions	**18**	10
Intrinsic value of above liabilities for which rights had vested at 31 December	**3**	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 £13,524,000 (2005: £13,688,000). This comprises salaries and short-term benefits of £8,927,000 (2005: £8,087,000), post-employment benefits of £1,032,000 (2005: £1,020,000), termination benefits of £291,000 (2005: £1,600,000) and share-based payments of £3,286,000 (2005: £2,969,000).

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 £1,880,000 (2005: £1,842,000), which is determined in accordance with IFRS 2, 'Share-Based Payments' (see note I2) and £1,406,000 (2005: £1,127,000) of deferred share awards.

Total key management remuneration includes total directors' emoluments of £11,084,000 as shown in the directors' remuneration report on pages 83 to 95, and additional amounts in respect of pensions, share-based payments and termination benefits. Further information on directors' remuneration is given in the directors' remuneration report.

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I4: Fees payable to auditor

	2006 £m	Restated 2005 £m
Fees payable to the Company's auditor for the audit of the Company's annual accounts	**2.3**	2.2
Fees payable to the Company's auditor and its associates for other services:		
Audit of subsidiaries and associates pursuant to legislation	**3.8**	3.6
Other services supplied pursuant to legislation	**4.0**	1.4
Other services relating to taxation	**0.2**	0.5
Services relating to corporate finance transactions	**0.7**	0.9
All other services	**1.3**	4.2
Total	**12.3**	12.8

The format of the table has altered from last year in order to comply with new disclosure requirements and the 2005 comparative figures have been restated accordingly. In addition, there were fees of £0.2 million (2005: £0.1 million) for the audit of pension schemes.

The Audit Committee regularly monitors the non-audit services provided to the Group by its auditor and has developed a formal Auditor Independence Policy which sets out the types of services that the auditor 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 auditor's objectivity and independence. More information on these issues is given in the corporate governance report on page 75.

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 directors' remuneration report. Key management remuneration is disclosed in note I3.

In 2006, three (2005: two) directors had credit card borrowings with Egg of £2,000 (2005: £7,000). In addition, in 2005 one director had a mortgage with Egg of £118,000 and one director had a life policy with a sum assured of £4.0 million. In 2006 and 2005, 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.

Notes on the Group financial statements continued

I6: Subsidiary undertakings

(i) Principal subsidiaries

The principal subsidiary undertakings of the Company at 31 December 2006, all wholly owned except 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* (99% owned)	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 January 2007, the Company announced that it had entered into a binding agreement to sell Egg Banking plc to Citi 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. Jackson 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 Jackson's statutory net gain from operations or 10 per cent of Jackson statutory surplus for the prior year. In 2007, the maximum amount of dividends that can be paid by Jackson without prior regulatory approval is US$412 million (£211 million) (in 2006: US$565 million (£329 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 Jackson are the two principal insurance subsidiaries of the Group, which together comprise approximately 76 per cent (2005: 77 per cent) of total Group assets. At 31 December 2006, the PAC long-term fund's excess of available capital resources over its regulatory requirement (as per line 42 of Form 2 of the PAC FSA regulatory returns) was estimated to be £9.7 billion (2005: £6.0 billion) and the statutory capital and surplus of Jackson was US$3.7 billion (£1.9 billion) (2005: US$3.4 billion (£2.0 billion)). The Group capital position statement for life assurance businesses is set out in note D5.

(iii) Acquisition of subsidiaries

2006

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. The whole of the minority interests were acquired in the first half of 2006. Under the terms of the offer, Egg shareholders received 0.2237 new ordinary shares in the Company for each Egg share resulting in the issue of 41.6 million new shares in the Company.

The Company accounts for the purchase of minority interests using the economic entity method. Accordingly, £167 million has been charged to retained earnings representing the difference between the consideration paid (including expenses) of £251 million and the share of net assets acquired of £84 million.

In January 2007, as described in note I8, the Company announced that it had agreed to sell its holding in Egg.

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.

I6: Subsidiary undertakings continued

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**

(iv) PAC with-profits fund acquisition

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 in 2006 and 2005. These were acquisitions for:

2006

- 53 per cent of the voting equity interests of Histoire D'or, a jewellery retail company, in April 2006;
- 51 per cent of the voting equity interests of Azzuri Communications, a business IT service company, in June 2006; and
- 60 per cent of the voting equity interests of Paramount plc, a restaurant company, in September 2006.

2005

- 40 per cent of the voting equity interests of Aperio Group Pty Ltd (AeP), a flexible packaging manufacturing company, in May 2005;
- 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
- 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 information relating to ventures acquisitions has been presented in aggregate throughout this note. Due to the nature of venture investments, it is not practicable to provide certain information for those acquisitions, 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.

Notes on the Group financial statements continued

I6: Subsidiary undertakings continued

The results of the aggregated ventures acquisitions in 2006 and 2005 have been included in the consolidated financial statements of the Group commencing on the respective dates of acquisition and contributed a loss of £7.7 million (2005: loss of £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.

The table below identifies the net assets of these acquisitions and minor business purchases by existing venture holdings. This reconciles the net assets to the consideration paid in 2006 and 2005:

	Fair value on acquisition 2006 £m	Fair value on acquisition 2005 £m
Cash and cash equivalents	**18**	29
Other current assets	**31**	144
Property, plant and equipment	**45**	82
Intangible assets other than goodwill	**139**	75
Other non-current assets	**100**	5
Less liabilities, including current liabilities and borrowings	**(581)**	(437)
	(248)	(102)
Less minority interests	**0**	(1)
Net assets acquired	**(248)**	(103)
Goodwill	**336**	105
Cash consideration	**88**	2

Aggregate goodwill of £336 million (2005: £105 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 2006.

(v) PAC with-profits fund disposals

2006

In 2006, Upperpoint Distribution Limited, Taverner Hotel Group Pty Ltd, Orefi, Aperio Group Pty Ltd and BST Safety Textiles Luxembourg S.a.r.l., all venture subsidiaries of the PAC with-profits fund, were disposed of for cash consideration of £133 million. Goodwill of £46 million and cash and cash equivalents of £19 million were disposed of. Note that, in addition, one venture subsidiary was classified as held for sale at 31 December 2006 (see note H9).

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).

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.

	2006 £m	2005 £m
Future minimum lease payments for non-cancellable operating leases fall due during the following periods:		
Not later than 1 year	**53**	61
Later than 1 year and not later than 5 years	**142**	186
Later than 5 years	**160**	204

The total minimum future sublease rentals to be received on non-cancellable operating leases for land and buildings for the year ended 31 December 2006 was £1 million (2005: £2 million).

Minimum lease rental payments for the year ended 31 December 2006 of £50 million (2005: £55 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 2006, the aggregate amount of contractual obligations to purchase and develop investment properties amounted to £146 million (2005: £199 million). The vast majority of these commitments have been made by the PAC with-profits fund.

I8: Post-balance sheet events – sale of Egg Banking plc

On 29 January 2007, the Company announced that it had entered into a binding agreement to sell Egg Banking plc, Prudential's UK banking business, to Citi.

Under the terms of the agreement, the consideration payable to the Company by Citi is £575 million in cash, subject to adjustments to reflect any change in net asset value between 31 December 2006 and completion.

In addition, the Company has agreed in principle, outline terms with Citi with respect to a UK distribution agreement through which Prudential will provide life and pensions products to Egg's customer base for a five-year period.

The Company has also been selected as a strategic provider to Citi for the distribution of life insurance products to Citi's consumer banking customers in Thailand, Indonesia and the Philippines.

The transaction is subject to regulatory approval and is expected to complete by the end of April 2007.

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 2006**	**Average for 2006**	Closing rate at 31 Dec 2005	Average for 2005	Opening rate at 1 Jan 2005
Hong Kong	**15.22**	**14.32**	13.31	14.15	14.92
Japan	**233.20**	**214.34**	202.63	200.13	196.73
Malaysia	**6.90**	**6.76**	6.49	6.89	7.30
Singapore	**3.00**	**2.93**	2.85	3.03	3.13
Taiwan	**63.77**	**59.95**	56.38	58.47	60.84
US	**1.96**	**1.84**	1.72	1.82	1.92

I10: Cash flows

Structural borrowings of shareholder-financed operations comprise core debt of the parent company and related finance subsidiaries, Jackson surplus notes and Egg debenture loans. Core debt excludes borrowings to support short-term fixed income securities programmes and non-recourse borrowings of investment subsidiaries of shareholder-financed operations. Cash flows in respect of these borrowings are included within cash flows from operating activities.

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 £nil and outflows of £5 million for 2006 and 2005 respectively. The outflows for 2005 are included in cash flows from operating activities.

I11: 2005 balance sheet

Reanalysis of assets and liabilities for acquired venture investment subsidiaries of the PAC with-profits sub-fund

Prior to 2006, no intangible assets other than goodwill had been identified for the acquired venture investment subsidiaries of the PAC with-profits sub-fund. In 2006, the Group re-evaluated the nature of the acquired assets and liabilities of those companies and has determined that there are some intangible assets that fall under the scope of IAS 38, 'Intangible Assets', and require separate identification. The Group has consequently altered the allocation between goodwill, intangible assets, and other assets and liabilities. No adjustment to the profits or amounts recorded for the individual line items in the income statement for 2005 was necessary. Accordingly, this reallocation has no effect on 2005 profit before or after tax or on shareholders' equity at 31 December 2005.

Certain reclassifications have been made to the balances presented in the comparative balance sheet at 31 December 2005 to conform this balance sheet to the current presentation as a result of this reallocation. The impact of the reclassifications is as follows:

	£m
Intangible assets attributable to the PAC with-profits sub-fund:	
Goodwill	(188)
Other intangible assets	260
Other debtors	(13)
Unallocated surplus of with-profits funds	27
Deferred tax liabilities	(86)